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Divergent Dynamics of Transformation: The Role of the European Union

Fruzsina Márta SIGÉR
Foreword

“Europeanization” has recently become a popular and dynamically developing field of research in the political sciences. Amongst the scholars of International Relations and Comparative Political Studies, the concept of Europeanization has been applied in a rather loose sense, thereby referring to a European-level governance, including all of its formal and informal rules and norms. Scholars scrutinise how and to what extent does such a process exert an effect on the national, regional and global levels. Nevertheless, even for economists with a well-delineated interest in institutions, and especially in the process of public policy formation, this stream of research may prove to be a useful orientation point. It is especially true in situations where the term Europeanization is interpreted more narrowly, i.e., how European policy-making influences (or, in extreme cases, determines) domestic policies. By asserting a causal relation between European and national-level policy-making, it is also assumed that domestic structures will change accordingly and thus become compatible with the EU.

It is undeniable that the European Union has gained extraordinary power to keep the transformation process of both member states and non-member states at bay. Yet, the intensity and the content of such power have changed dramatically. Although Europeanization always concerned an adjustment to Western values and models, and, therefore, it has been an externally driven process, differences did emerge over time. At the time of the accession of Ireland, Spain, Portugal or Greece, the requirements of becoming a member state were much easier. With the Eastern enlargement of the EU, however, Europeanization has been gradually reformulated as a kind of compulsory and unquestionable adaptation process, which called for an in-depth investigation of economic capabilities – besides the usual scrutiny of political conditions. While originally the expansion of the frontiers of the European Community was a process of actions and reactions, nowadays it has been simplified to a unilateral and asymmetric adaptation.

Some authors even argue that “member states from Central and Eastern Europe can claim the transformation of their political systems, their economies and their societies thanks […] to the rules, criteria and conditions of the enlargement method.” (Anastasakis 2007:2) There are some countries, however, where this statement does not hold. Irrespective of the stick and carrot policy of the EU, some states still show (or showed) resistance at some stages of their political and economic development. They do realise that becoming a member of the EU can be rather beneficial for them, but they are also aware of the fact that accession – at least in the short run – entails considerable costs, too, so, they refuse to join.

Fruzsina Sigér’s book is a clear attempt at explaining such an attitude, i.e., the resistance of states to EU accession. Accordingly, the author addresses two interrelated problems. Firstly, she asks what was the reason exactly for the emergence of such a deviant behaviour in some countries. Secondly, she raises the question of what can possibly trigger a change in their negative attitude, that is, what may induce countries to renege on their previous behaviour and make them support the idea of joining the EU. In her comparative study, Sigér has selected two countries in order to answer these questions. One of them, Croatia, along with many other countries on the Balkans, has long been labelled as a dissident by the international literature. The other country under analysis, Slovakia, however, is not a self-evident selection at all.

What is common in the two countries? On a more abstract level, it is their path-dependent character which binds them together. Yet on a more practical level, both
countries are newly formed states, which insist on defining themselves as homogenous nation-states. At the onset of their independence both countries experienced extremely nationalistic regimes. Croatia and Slovakia were burdened with nationalistic, minority conflicts, which turned into violent, armed conflicts in Croatia, whereas in Slovakia it emerged in the form of mostly harsh anti-minority rhetoric. While most countries in Central and Eastern Europe were busy with the dual challenge of creating a democratic political regime and an efficiently functioning market economy from the very beginning of the systemic change, these two countries dedicated themselves to the creation of a nation-state, overwriting the typical goals of countries in transition. Both a liberal democracy and a market economy would have impeded domestic elites to embark on a nationalistic state-building in Croatia and Slovakia. Instead, they opted for the establishment of an autocratic and illiberal democracy and quasi-market economy. It did not come as a surprise that the term “Balkanization”, that is, the denial of Western values, did not refer to Croatia only, but also to Slovakia in the first few years of their transformation.

Fruzsina Sigér has been successful, however, not only in collecting the commonalities of the two states, but also – and this is, most probably, the most welcome asset of her work – in showing how the regime change evolved in the two countries; more precisely, how the introverted, provincial attitude changed into a more extroverted and pro-European one. The book is an unambiguous documentation of the very different tracks that Croatia and Slovakia pursued during the regime change. Slovakia has not only become a member of the EU, as part of the big bang accession in 2004, but is also the only country in the Visegrád four which introduced the single currency in 2009. On the other hand, Croatia is still preoccupied with the accession negotiations, while two other countries of the Balkans, Romania and Bulgaria, have managed to outperform it.

Sigér’s work deserves attention not only for its precise, eloquent documentation of these shifts, but also for enriching the theoretical literature of Europeanization. She has managed to reinterpret the concept of Europeanization by using Croatia and Slovakia as her case studies. Her book elegantly shows that acknowledging one’s status as a laggard and the consequent desire to leave this behind (or, in the author’s words, “the perception of the misfit”) created such an adaptation pressure that eventually pushed both countries on the track of Europeanization. Such recognition can dramatically redefine the relation of the domestic structures to the EU, which can result in the reinterpretation of the state itself, too, by creating an almost new state identity.

The general conclusion of the book is that although a country can cope on its own for a certain period of time, provincialism resulting from economic and political nationalism can be profitable only in the short run. Such an attitude culminates only in stagnation and complete isolation in the longer run. Croatia and Slovakia serve as a warning to any country and its politicians that aim to sacrifice the future for short-term benefits. With the publication of Fruzsina Sigér’s work, the Doctoral School of the Faculty of Economics and Business Administration at University of Debrecen has now taken an active role in communicating this message to the larger public.

István Benczes
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# Table of Contents

Foreword..........................................................................................................................................7  
Acknowledgments..........................................................................................................................9  
Table of Contents..........................................................................................................................10  
List of Figures ...............................................................................................................................13  
List of Tables .................................................................................................................................14  
List of textboxes............................................................................................................................16  

I. Introduction................................................................................................................................ 17  
1 Method .......................................................................................................................................17  
2 The puzzles.................................................................................................................................19  
2.1 The puzzle of Croatia.............................................................................................................20  
2.2 Why compare with Slovakia?.................................................................................................21  

II. Theoretical and conceptual framework..................................................................................23  
1 Europeani zation: the theory .................................................................................................23  
1.1 Internal vs. external Europeanization ..................................................................................25  
1.2 Mechanisms of Europeanization .........................................................................................28  
1.3 The EU as an anchor..............................................................................................................30  
1.4 Adaptation capacity................................................................................................................31  
2 Five aspects of Europeanization.............................................................................................32  
2.1 Exporting democracy............................................................................................................32  
2.2 The market economy ............................................................................................................35  
2.3 Acquis communautaire..........................................................................................................37  
2.4 Common foreign and security policy ....................................................................................39  
2.5 Europeanization in narrow sense: from Europe to Europe? .............................................40  
3 Costs and benefits of Europeanization ....................................................................................42  
4 External factors – comparison of the association agreements ..............................................44  
4.1 The two agreements...............................................................................................................44  
4.1.1 Industrial products ..........................................................................................................45  
4.1.2 Agricultural concessions ..................................................................................................45  
4.1.3 Protection provisions .......................................................................................................45  
4.1.4 Promotion of economic development ............................................................................45  
4.1.5 Admission of labour .......................................................................................................46  
4.1.6 Institutions ........................................................................................................................46  
4.1.7 Evolution possibilities of the agreement .......................................................................47  
4.1.8 Conclusion.........................................................................................................................47  

III. Transformation and European integration in Croatia..........................................................49  
1 The initial conditions: Yugoslavia ............................................................................................49  
1.1 The dissolution – in practice ...............................................................................................54  
1.2 The dissolution – in theory .................................................................................................55  
2 The “nationalist” period of economic transformation and European integration – the Tudjman regime .................................................................................................................57  
2.1 Building a market economy ...............................................................................................57  
2.1.1 Macroeconomic development during the “nationalist” period ....................................59  
2.2 The common foreign and security policy in action: the Yugoslav war and the role of the EC/EU..............................66  

## List of Figures

| Figure 1: | Gross foreign debt in Yugoslavia 1975-1988, in billion USD | 50 |
| Figure 2: | Gross material product in Yugoslavia 1950-1990 (annual % change) | 50 |
| Figure 3: | Annual unemployment rate in Yugoslavia 1970-1990 (percentage of the total labour force) | 51 |
| Figure 4: | Unit value index of Yugoslavian foreign trade, 1960-1987 | 52 |
| Figure 5: | Cost of living index in Yugoslavia 1970-1991 (annual percentage change) | 53 |
| Figure 6: | Consumer price indices in Croatia 1992-2007, Monthly chain indices, previous month=100 | 59 |
| Figure 7: | GDP year-on-year rate of growth in real terms in Croatia, 1989-1999 | 60 |
| Figure 8: | GDP per capita, in international comparable prices by expenditure, at prices and PPPs of 2005 in USD | 60 |
| Figure 9: | Percentage change in employment (end-year) in Croatia, 1991-1999 | 61 |
| Figure 10: | Unemployment (end-year) in Croatia, as a percentage of the labour force, 1991-1999 | 62 |
| Figure 11: | Current account as a percentage of GDP in Croatia, 1991-1999 | 64 |
| Figure 12: | External debt in Croatia, as a percentage of GDP, 1991-1999 | 65 |
| Figure 13: | Net foreign direct investment in Croatia, in millions of USD, 1992-1999 | 66 |
| Figure 14: | Confidence in the EU in Croatia | 95 |
| Figure 15: | GDP year-on-year rate of growth in real terms in Croatia, 1991-2009 | 97 |
| Figure 16: | GDP per capita in Purchasing Power Standards (PPS), 1997-2008, EU-27 = 100 | 98 |
| Figure 17: | ILO unemployment rate in CEE and SEE countries, as a percentage | 98 |
| Figure 18: | Current account as a percentage of GDP in Croatia, 1991-2009 | 101 |
| Figure 19: | External debt in Croatia, 1991-2007, as a percentage of GDP | 102 |
| Figure 20: | Net foreign direct investment in CEE and SEE countries, in millions of USD | 103 |
| Figure 21: | FDI stocks 2006, inward and outward in CEE and SEE countries, millions of USD | 103 |
| Figure 22: | Gross fixed capital formation, as a percentage of GDP | 111 |
| Figure 23: | Growth diagnosis tree in Croatia: identifying the constraints | 113 |
| Figure 24: | Total employment rate in Croatia, as a percentage | 114 |
| Figure 25: | GDP year-on-year rate of growth in real terms, 1989-1998 | 132 |
| Figure 26: | Import and export of goods and services in Slovakia, percentage change in real terms, 1993-1998 | 134 |
| Figure 27: | Current account in Slovakia, in millions of USD, 1993-1998 | 134 |
| Figure 28: | External debt in Slovakia, as a percentage of GDP, 1989-1998 | 135 |
| Figure 29: | Net foreign direct investment, in millions of USD | 136 |
| Figure 30: | Unemployment rate in Slovakia, as a percentage, 1989-1998 | 138 |
| Figure 31: | Percentage change in employment (end-year) in Slovakia, 1989-1998 | 138 |
| Figure 32: | Asset share of state-owned banks, as a percentage, 1993-2006 | 150 |
| Figure 33: | GDP year-on-year rate of growth in real terms, 1989-2009 | 153 |
| Figure 34: | Import and export of goods and services in Slovakia, percentage change in real terms | 155 |
| Figure 35: | Current account in Slovakia, as a percentage of GDP | 156 |
| Figure 36: | External debt in Slovakia, as a percentage of GDP | 157 |
Figure 37: Net foreign direct investment, in millions of USD ......................................... 158
Figure 38: Unemployment rate in Slovakia, as a percentage.......................................... 160
Figure 39: Administrative vs. ILO unemployment rate in various CEE and SEE countries, difference in percentage points ........................................161
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.......161
Figure 41: Total employment rate, as a percentage.............................................................162
Figure 42: Europeanization in Slovakia and Croatia ........................................................ 194

List of Tables

Table 1: Migration and workers’ remittances....................................................................51
Table 2: Gross Social Product per capita in Yugoslavia 1952-1989, Slovenia=100 ..... 56
Table 3: Trade by main export partners 1994-1999.......................................................... 62
Table 4: Current account balance in Croatia 1991-1999, in million USD .................... 63
Table 5: FDI in Croatia by country of origin, 1993-1999, in million EUR and USD .................................................................................................................. 66
Table 6: Concentration index - share of assets of the largest banks in total bank assets in Croatia, 1994-1999.......................................................................................... 68
Table 7: Number of banks in Croatia, 1993-1999............................................................. 68
Table 8: Banking system by ownership in Croatia 1996-1999 ........................................ 69
Table 9: Large bank privatization in Croatia 1998-1999 ............................................... 69
Table 10: Key obstacles to business operation and growth of enterprises, Business Environment and Enterprise Performance Survey 1999.................... 70
Table 11: Trade agreements and EU integration process in CEE countries, Croatia, Bulgaria and Romania, as of 1999................................................................. 77
Table 12: Trade with the EU 1994-2006, as a percentage of total .................................. 77
Table 13: Croatian exports to the European Union and imports from the European Union, 2006.......................................................... 100
Table 14: Current account balance in Croatia, in million EUR .....................................101
Table 15: Number of greenfield FDI projects, by destination region, 2002-2007 (concluded)........................................................................................................... 103
Table 16: The origin of FDI in Croatia, 1993-2007, as a percentage................................. 104
Table 17: FDI in Croatia by sectors, 1993-2007, as a percentage ..................................... 104
Table 18: Selected large-scale privatization in Croatia 2001-2005 ................................. 106
Table 19: Large-scale bank privatization in Croatia 1998-2004 .................................... 108
Table 20: Number of banks in Croatia .............................................................................. 109
Table 21: Concentration index - share of assets of the 2(4) largest banks in total bank assets .......................................................................................... 109
Table 22: Domestic saving and investment in Croatia, selected years, as a percentage of GDP ........................................................................................................ 111
Table 23: Rankings on the ease of doing business in CEE and SEE countries, 2007 and 2008 .......................................................................................... 115
Table 24: Index of industrial production in Czechoslovakia, 1913=100 .......................117
Table 25: Czechoslovak foreign trade in million UDS and current prices ....................118
Table 26: Index of national income produced, based on Net Material Product, 1980=100........................................................................................................ 120
Table 27: Industrial production in Czechoslovakia in 1988

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

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

Table 30: Foreign debt in Czechoslovakia

Table 31: Import and export partners by main countries in Slovakia, as a percentage of the total

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

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

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

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

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

Table 37: Bank privatization in Slovakia

Table 38: Rankings on the ease of doing business in CEE and SEE countries, 2007 and 2008

Table 39: Total general government expenditure as a percentage of GDP

Table 40: Import and export partners by main countries in Slovakia, as a percentage of the total

Table 41: Structure of Slovakian foreign trade, breakdown by commodity group, millions of USD at current prices and as a percentage of the total

Table 42: Exports of goods and services in the CEE and SEE countries, as a percentage of GDP

Table 43: Credit-Rating History of the Slovak Republic

Table 44: The origin of FDI stock in Slovakia, 2004-2008, millions of USD and EUR

Table 45: Inward FDI flows in Slovakia by sectors, as a percentage of the total

Table 46: Number of greenfield FDI projects, by destination region

Table 47: Results in referenda on EU accession

Table 48: Hypotheses for identifying factors that support policy reform

Table 49: Similar and different features in Croatia's and Slovakia's paths of transformation

Table 50: Croatia: Transition indicators

Table 51: Slovakia: Transition indicators

Table 52: Overview of the accomplishment of Europeanization

Table 53: EBRD index of large-scale privatization

Table 54: EBRD index of small-scale privatization

Table 55: EBRD index of enterprise reform

Table 56: Overall infrastructure reform in CEE and SEE countries

Table 57: Private sector share of GDP, as a percentage

Table 58: EBRD index of bank sector reform
List of textboxes

Textbox 1: War in Croatia ..................................................................................................................72
Textbox 2: How did Croatia become a “Western Balkan” country? ...........................................81
Textbox 3: ZERP ................................................................................................................................93
Textbox 4: An example of a long delayed but essentially important measure: tax numbers ...............................................................................................................................112
Textbox 5: The NATO referendum – an example of struggles in democracy building ..........................................................................................................................126
Textbox 6: Smer in the European Parliament .............................................................................143
Textbox 7: What factors supported the reform process of Slovakia? An application of the Williamson-hypotheses ................................................................................................................166
Textbox 8: The challenge of EU membership for the shipbuilding sector .........................185
I. Introduction

One of the most important questions the countries of Central and Eastern Europe face since the early 1990’s is the question of the European integration. Whether the future is the European Union or not, whether it is life outside the European Union or not, whether there is an opportunity not to follow the mainstream enthusiasm (or must) towards EU membership, and whether there is a real opportunity for a real and sovereign decision.

This book aims to examine why some countries are frontrunners in transformation and European integration and others lag behind. Why some countries grasp the opportunity to join the European Union and others do not. Is it a conscious decision for a country to take part in the Europeanization process or does it rather “just happen”? Under what conditions is one country more likely to Europeanize then another? Why do some governments implement measures in order to fulfil EU requirements while 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 a more determinant role. Will external or internal conditions determine the level of Europeanization of a country? Or to be more precise, what is a “good mixture” of external and internal factors that results in successful Europeanization. Is external pressure in itself able to achieve 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 a 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 a democratic transformation to a market economy?

1 Method

The theoretical framework with which this book tries to answer the questions defined above 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 of isolating individual factors and then re-running 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: it remains unclear 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 the social sciences: researchers (even from the same school) are unable to agree even upon the meaning of the basic concepts of the analysis. Haverland (2006) shows the methodological difficulties of case selection as well. Concerning the establishment of causal effect or the relative importance of the EU, the author also shows evidence for biases towards EU-level explanations. The model of Cernat (2006)
demonstrates that Europeanization is not the only external factor, and that the impact of globalization and other international organizations may be also taken into account.

This study aims to discover countries’ economic and social systems. 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 the above mentioned fields of the social sciences. The entire economy, politics, society, ideology and culture of a country 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 those institutions which emerge historically and those which are ad hoc constructions 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 book 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 to mention 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 gives us the opportunity to compare them as the most similar cases.

Those who embark on comparing economic systems should be prepared for the possibility that they have to define new theoretical categories instead of using ready-made schemes, and have to struggle with 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 system theory. Lévai (2006:23) argues that historicism, analytical structuralism and functionalism and holism are the principles of any social science which uses 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 complexity1. Eucken describes two opposing systems: the centrally directed economy and the 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).

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1 The theory of complexity is the theory of the deterministic system school, a theory which generalizes nonlinear relations.
Comparative economics also defines itself as a discipline that examines economic systems, in which it is not only the elements which 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 impact-mechanism of the elements and their role in the system. According to Bara et al. (2007:6-7) the conceptual framework of comparative economics is Kornai’s system paradigm. Concerning methodology, comparative economics does not consider the economic system and institutions\(^2\) as given.

In broad terms, 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 system theory with Europeanization. However, as noted before, we understand Europeanization as an inter/transdisciplinary theory where the economic, political and social system of countries is seen as a whole. Although Europeanization may be seen as an episode in system 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 to 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.

### 2 The puzzles

This book has two initial hypotheses.

1. At the time of regime change in Eastern Europe, Croatia (as one of the successor states of Yugoslavia) is an “outstanding pupil” in transformation and European integration and thus has very favourable prospects for quick and successful Europeanization.

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

\(^2\) Which can be considered as systems as well, cf. Lévai 2006.
2.1 The puzzle of Croatia

According to the concept of transformation at the beginning of the 1990’s, Croatia was expected to undergo a quick and successful Europeanization process and EU membership. First, during the socialist period Yugoslavia (and especially its two more 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 an independent Croatia and early membership. Of course the war put everything in a different context, but still, according to 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 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 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 realistic prospects of achieving them.

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 a similar (or even lower) level of economic development 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 it could be ready for EU-entry, is 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, the 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 towards transformation. In the fourth group of countries the transformation is in most part only rhetoric – Byelorussia 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 at all obvious that Croatia would be an exception.

Thus the question arises as to why this 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 regarding the mainstream Europeanization process (i.e. missing the 2004 or 2007 round) was/is advantageous or rather disadvantageous for Croatia. Has Croatia benefited from the years out of the EU or rather wasted time?
2.2 Why compare with Slovakia?

Slovakia is a similar case in several respects. 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 broke up, 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 which also meant a ‘third way’ concept of 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 to fulfil 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 Slovak national identity had been Central European, which would pave the way to Europeanization, the newly independent Slovak nation first desired to find its own way without following anyone else’s dictates. This was considered to be in the national interest.

Disproving the hypothesis of a nationalist and under-developed country, within a few years Slovakia became the “Tatra Tiger”. Quick and attractive measures were needed to convince the international community and the EU of 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 had introduced the euro, the first to do so among the Visegrád states.

The question arises as to what was the origin of Slovakia’s willingness to turn to Europeanization and not just fulfil the requirements but over-fulfil them in reforming the state? Was it purely the fear of lagging behind? Another puzzling question is whether the rapid and deep reforms of the Slovak state are reversible or are firmly embedded after 2006.

When analysing the Croatian Europeanization process from a comparative perspective, at least two reference countries are possible: Slovenia and Slovakia. The case of Slovenia is more evident at first glance because of their common past within Yugoslavia and in previous periods. On the one hand, however, Slovenia seems to follow a very different road towards Europeanization after the break up of Yugoslavia. On the other hand, Slovakia and Croatia share numerous characteristics that make a comparison of the two reasonable and feasible. They both “emerge 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 smoother, and who both
belonged to the so-called “Luxemburg group”\(^3\). Both countries felt suppressed during their years as part of federal states (Czechoslovakia and Yugoslavia). For Croatia, Serbia was the suppressor who had ambitions to dominate the federal republic. In Czechoslovakia obviously the Czech Republic was the counterpart of Slovakia. In her paper, Heather Field (2000) argues (and maybe overstates her case) that Slovakia and Croatia\(^4\) are “awkward” states regarding 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 types of socialism in Yugoslavia and Czechoslovakia were highly dissimilar. Yugoslavian socialism was more a third way approach that contained numerous elements of a market economy. On the contrary Czechoslovakia introduced one of the most rigid and strict socialist systems 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 towards more advantageous prospects for transformation and European integration than in Czechoslovakia where the changes had very few precedents.

We will see that although the countries are examined in terms of a comparison of the most similar cases, from the aspect of Europeanization they prove to be the two most dissimilar cases.

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3 Poland, the Czech Republic, Hungary, Slovenia and Estonia
4 Heather Field also counts Serbia as an awkward state in her study. At the same time, however, most probably the rest of the Western Balkan states could also be labelled as “awkward” in 2000.
II. Theoretical and conceptual framework

1 Europeanization: the theory

The definition of Europeanization is a much 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 European integration.

Anastasakis (2005:77-78) summarizes what there is to know 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 on 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 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 associate different meanings with Europeanization – this is indeed an indicator of a lively 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 the 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 is realized as a result of the capacity for collective action. (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 distinctive of Europe beyond 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 a necessarily positive correlation between the first four types of Europeanization, and neither between each of them and a politically stronger Europe.

To avoid conceptual stretching, it is worth indicating not only what Europeanization means, but also what it does not mean. Radaelli points out the importance of drawing the line between Europeanization and the concepts of convergence, harmonization and integration. Europeanization does not equal convergence. Instead, the 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 arises of the relationship between Europeanization and the integration theories. The theories of integration focus on issues of whether European integration strengthens or weakens the state and whether it triggers multi-level governance\(^5\). The focus of Europeanization is on the role of domestic institutions in the process of adaptation 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 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 of methodology 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: the 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 a number of years: there is a trade-off at the level of initial assumptions as to whether the argumentation starts 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

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specific issue concerning the empirical research design of Europeanization (Radaelli and Exadaktylos 2009:510-511). The starting point for top-down models of empirical research is the presence of integration; what then follows is an examination of how well EU-level policy does or does not fit the member countries or candidates, and an explanation for 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 arises from exogenous (EU-level or global-level) variables.

Whichever definition of Europeanization we consider, there are two necessary pre-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 response to the adaptation pressure.

It is important to raise the issue of whether Europeanization concerns only the impact of the European Union. Europeanization is not necessarily ‘EU-ization’, although the term is often appropriated by scholars who are interested in the unification process between the European Union and its member states, and who concentrate on requirements coming from Brussels. The European Union is the most dominant institution of 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 refers to 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 an internal and external impact. The internal point of view reflects on the internal process of change in the European Community and the adaptation capacity of the member states. This “self-contained” (Demetropoulou 2004:6) type is called Europeanization Western-style. The process of this type of Europeanization is mutual; i.e. not only do domestic systems adapt 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–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 the institutions and policies of its own member states.

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Concerning the third group of mainly applicant countries, the self-contained approach of Europeanization is not relevant. The “outward looking” perception conceptualizes Europeanization as an external (mostly EU-led) process guiding applicant countries’ complex domestic economic, social and political transformations (Demetroplou 2004:6). The external Europeanization process differs from the interaction between the EU and its member states: it is not mutual but rather unilateral acceptance (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 with their accession the EU itself has to be renewed as well. Their impact is, however, rather indirect (Anastasakis 2005:83).

There are several types of external Europeanization. The example of the Europeanization process in Southern Europe i.e. in Spain, Portugal, and Greece is often referred to as 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 towards the advanced capitalist Europe (Anastasakis 2005:79).

The external concept of Europeanization also raises the issue of the relation between transition/transformation and Europeanization. Transformation has been much more than the implementation of a recipe of stabilization, liberalization and privatization. It also means the restructuring of the economic, social and political order, and of formal and informal institutions. After the collapse of communist regimes in Central and Eastern Europe the concept of Europeanization acquired 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 marketisation, but about a particular type of political, economic and social system change (Ágh 1998:49). Europeanization has a general historical meaning of a “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 a 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 as to 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, the 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 as to 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 as regards the EU than Central and Eastern European countries had. That is why Europeanization 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 sets the rule of the game and the countries of Southeastern Europe have little or no space to 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 countries belonging to 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. Unlike with EU-accession, the country is no more able to adopt ready-made solutions but has to take part in creating 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 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 these 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 the 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 the distribution of benefits. In other words, the EU’s bargaining strategy is reinforced by rewards. The presence of conditionality, however, does not necessarily bring successful rule transfer (Schimmelfennig–Sedelmeier 2004:670).

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

The instrument of conditionality was not invented by the 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, especially 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 also have a 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 the 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 removed from each other in time. As a result, conditionality is less effective at persuading 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 a 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 process outlined above, where the visible and realistic prospect of membership was the main carrot along the 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 marketisation and democratization and encouraged the adaptation of EU norms and practices (Anastasakis–Bechev 2003:49).

The second mechanism is mimicry, based on contagion and consent. Via the 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 the EU socializes countries rather than coerces them. Furthermore, 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 variations in 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 this model, the EU mainly follows the strategy of conditionality in which it sets its rules as conditions, and the CEE countries have to fulfil them 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 these rules. As a result, whether a third state adopts EU rules depends on the degree to which it considers rule adoption appropriate in the light of its collective identity, values, and norms.

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

1.3 The 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 change. 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 change. As was described above, post-communist transformation and European integration have intertwined, specifically in the case of Central and Eastern European countries.

There is certain evidence that in the case of CEE countries, the EU served as an anchor. Most policy decisions – whether taken by the left or right – were determined or suggested by the formal and informal requirements of the European Union. The momentum of reforms of 1989-1990 was lengthened by the presence of the EU. The impetus has two components. One is 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 damaging influence of vested interests in the frontrunner countries. In lagging countries 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 in 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. A number of authors8 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 from the agenda of the EU towards several Southeastern European countries, which is highly damaging. In recent years the EU has moved towards greater clarity about the future prospects of countries9.

Ágh detects two major factors for the success of the Europeanization process in the case of Eastern and Central European countries. The first is the determination of the EU to complete 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 a “return to Europe” and transform it into a pragmatic view and to a process of systematic accommodation. The consolidation of democracy and European integration are interrelated processes; the one does not occur without the other (Ágh 1998:44).

In Fisher’s (2006:3) opinion there was a choice in the countries at the beginning of the transition whether they would move towards democracy and a market economy or towards illiberal democracy and authoritarianism. Ágh writes about “forced democratization” in the case of transition countries, which had both negative and positive aspects. Progress can

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9 To mention some events from the recent past: the EU signed a stabilisation and association agreement with Bosnia and Herzegovina on 17th June 2008, or “If all conditions are met it will be possible to give candidate status to Serbia in 2009” said Jose Manuel Barroso on 3rd March 2008.
be considered negative because it imposed alien standards, sometimes over-generalized and over-simplified. At the same time it protected against the renewal of authoritarianism and the renewal of nationalistic anti-democratic forces, as happened in the case of the forced democratization of South European countries (Ágh 1998:34). This process seems to have failed during the first stage 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 Eastern enlargement was not felt to be close 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 grew considerably. The regular reports of the Commission took centre stage in CEE countries during these years. At the same time the Commission did its best to maximize the influence it wielded, which was based on its broad mandate.

All in all the power of the EU increased in great part due to the attitude of the candidates during the accession period of 1993-2004. The EU holds all the cards only while 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 do not reflect the domestic political and social convictions but appear only as external expectations.

As a consequence of the phenomenon described above, we see no evidence to determine whether the EU has more influence in the form of external or internal Europeanization. That is, whether the EU has more influence on its member states or on 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 fosters a response to the adaptation pressure varies between countries and also between policy areas. This 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 is 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 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 countries respond differently to the same adaptation pressure. Vachudova (2005:72-78) outlines various theoretical explanations. First of all, the author argues that the domestic costs of complying with EU rules are much higher for the ruling elite in some countries than in others. In liberal democracies the agendas of the ruling elite in many cases overlapped with EU
requirements, which 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 EU requirements threatens the power of the ruling elite. Fisher (2006) refers to the two types of ruling elite as “nationalist” and “Europeanist”.

Vachudova (2005) also sketches four other approaches to the diversity of responses, 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 the state, the sooner it bows to the EU. However, basically the EU did not force cooperation onto the post-communist states. The third explanation is *geographic proximity*: the closer the country is to the EU, the greater its willingness to implement democratic reforms. The fourth possible explanation is *economic prosperity*. This approach stresses the importance of the initial economic conditions of post-communist states: a higher level of income increases the ability to meet EU requirements. In a broader sense, the industrialization and urbanization which occurred before communist rule may determine the country’s transition prospects after communist rule collapsed. The fifth explanation says that for internal reasons, the EU “prefers” some countries to others. Different states may enjoy different membership prospects, and thus different levels of attention and aid.

Demetropoulou (2002:90) – based on Huntington (1993:209-210) and Ágh (1998) – describes three types of problem that can hinder the Europeanization process of new democracies. Structural obstacles emerge from 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 state concerned. 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. a strong state capable of enforcing the rule of law, a vibrant civil society and self-sustaining economic and social development. The author argues that taking the Europeanization process of the CEE as an example, EU-style adaptation could follow only after all the above mentioned have been put into practice.

### 2 Five aspects of Europeanization

According to our approach, the process of Europeanization may be seen in several areas of economic, political and social life. In our study we examine Europeanization in five particular fields. We review the theoretical background of each field and later the case studies will investigate the practical realization of the theory in Croatia and Slovakia.

#### 2.1 Exporting democracy

With the end of the Cold War the promotion of democracy became part of the development strategies of global international organizations such as the UN and the World Bank, but also on a 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 such as 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’s they witnessed the increasing activity of all-European institutions as
quasi supreme authorities in the region.

The EU is certainly one of the all-European institutions that requires democracy from
its members. The EC/EU was one of the first international organizations to include human
rights, democracy, and the rules of war in 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 declared
that any European state could apply for membership (Article 237). The Treaty of Rome
mentioned the promotion of democracy only in the context of the EC’s external affairs. It
was at the Copenhagen European Council on 7-8 August 1978 that the “Declaration on
Democracy”10 clarified the meaning of Article 237 and entailed a constitutional guarantee
democratic principles and human rights. In 1992 it was the Treaty of Maastricht 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 211 and is committed to
promoting them may apply to become a member of the Union” (Article 49).

The evolution of EU programs relating to the promotion of democracy was not the
result of a grand design, but is 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’s conditionality was transferred to
the Europe Agreements with the Central and Eastern European countries and by the mid-
1990’s political conditionality became an essential part of the EU democracy promotion
strategy (Börzel–Risse 2004:29).

The Copenhagen criteria made it clear that democracy acts as an entrance condition
to the EU. To put it more precisely, democracy is the very pre-condition of EU membership.
Democracy is the entrance condition even for the establishment of institutional ties, such
as association, and also for 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” also implies the threat
of negotiations being broken off.

Both conceptually and practically democratization has been closely connected with
European integration. Democratic transition has coincided with association with 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

10 EC Bulletin No. 3 (1978), at. 6.
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
The strategies and policies of the promotion of democracy are similar with regard to any type of external connection with the EU: as an accession state, in association, as a neighbour or as a third world country. 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).

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 concerned. In countries that are front-runners in democracy-building, the effect of democratic conditionality is quite limited. The authors argue that these countries were already on the way to 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 acquired 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 other hand, 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 a significant role in forming the nature of the opposition elites.

Following Ágh’s argumentation, after the end of the bipolar worldview the condition of democracy was “in the air” in Europe, and not only in relation 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 had already responded to the new “spirit of the age” when they encountered the EU’s democratic conditionality.

Referring back to the general theory of Europeanization, in the front-runners of democratization either liberal democratic concepts governed 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 governments to give 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 the Europeanization process in “the painful road from politics to policy”; in other words a shift from ideologically-driven political battles to concrete policy-making.

Malová and Dolný (2008:67-68) argue that in Central Eastern European countries the EU played a direct role in promoting democratic institutions and policies that stabilized the horizontal division of powers, the 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 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 as a 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 and their room for manoeuvre minimal.

Ágh (1999:269) highlights the importance of making a distinction between the terms of re-democratization and democratization, which refers to the basic difference between CEE and the Balkans. Most of the CEE countries had a 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’s. In the CEE countries the population with democratic experience developed an active resistance against state socialism and therefore in the late 1980’s they empowered the counter-elites to negotiate a transition. In the Balkans the ruling elites initially acted 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 The 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 the EU’s common market is one aspect of the Europeanization of states. This economic aspect of Europeanization is threefold. In one aspect 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 a European/continental style of capitalism.

Just like democracy, a market economy is the “default” for all European states. The transition from a 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 in parallel, the two processes have become entwined with each other. The economic transformation of Eastern European countries has been governed and supervised by the European Union and thus it has become one dimension of Europeanization.

A “functioning market economy” was understood as a given by the EU. The final outcome of the economic transformation was also influenced by other international organizations such as the World Bank or the IMF and by globalization itself. The final

12 See the argumentation of Dyson (2000) for the EMU as Europeanization.
13 See the argumentation above about Europeanization Eastern-style.
outcome is called “cocktail capitalism” by Cernat (2006), indicating a varied mixture of external impacts in different countries.

According to Agenda 2000, a 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) there is a broad consensus on 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 of economic integration is that the market of the Eastern European countries “merges” with the 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 element of the economic criterion relates to market 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, telecommunications, 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 aid, support for SMEs, etc.; (4) the degree and the pace of trade integration a country achieves with the Union before enlargement (this 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 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 at an equal level to the common external tariff of the EU.

Economic integration implies 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 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 will be eliminated or at least reduced and also the costs of passing customs at frontiers will be reduced: fewer time delays, fewer formalities etc. Second, technical barriers to trade will be reduced with the adoption of the 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 acceding countries. These include the risk that export credit guarantees are less well developed in the CEE and SEE countries and the political risk that democratic systems 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, to a certain extent, self-acting. As a consequence, market integration may occur without Europeanization as well, as Wolczuk (2004) explains in the Ukrainian case.

The case of the Eastern European applicants 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 aspects of Europeanization expounded above set very general conditions. The Copenhagen criteria do not define how a market economy works or what a stable democracy looks like. Are the new member states required to establish a German economy, a British civil service, a Swedish welfare state, and a French electoral system? Here one should not forget that the EU itself does not represent a uniform model of democracy or capitalism. Moreover, neither has it made any attempt to define one common model because diversity and respect for difference is considered a key feature of EU integration. Beyond EU diversity itself, one should not forget the various 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 for 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 in fact doubtful that 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: the 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 occurred 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 the EC/EU legal heritage. On the other hand, the aim of the external acquis dimension is 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. However, 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 concerning 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 the sense that the fulfilment of the third Copenhagen criterion means not only the implementation of the acquis communautaire, but also the candidate countries’ alignment towards the 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. This is 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 acquire 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” are open to interpretation. In previous enlargements, these obligations were understood as the implementation of the acquis

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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 social dialogue is part of the acquis, even though not all 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 accession negotiations. At the same time, the scope of the accession acquis also reflects 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 limited, as long as 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 enlargement to CEE countries entail. Grabbe (2002: 251-252) argues that the acquis adoption 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 easily measured 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’s 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 in the region 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 giving an impetus to political and economic liberalization in Eastern Europe. Security was more the task 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 intended to be developed 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 towards Eastern Europe immediately after the end of the Cold War. Smith (1999) argues that the common policy with supranational elements was feasible in the 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 on 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. Certainly the common foreign and security policy was intended to play an active role in influencing security issues in the rest of Europe. As a matter of fact the 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 the 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, in the first real test of the common foreign and security policy it did not work as it was designed to.

2.5 Europeanization in narrow sense: from Europe to Europe?

In the context of Central and Eastern European countries, talking about Europeanization in a grammatical or geographical sense is certainly meaningless (Csaba 2005:48). This region is part of Europe not only from a geographical but also from an 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 to 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.

15 Europe’s Hour: Come and Gone? by Denis MacShane, Newsweek, August 2006
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 by the historical factors the fact that, since the early Middle Ages, all political processes in Europe have been interconnected, and Europe as a whole has a 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 is rooted 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 alongside a similar pattern of economic development, social life also progressed in a similar way even if typical differences between regions have always existed. Among the significant economic patterns are the large-scale exchange of goods, labour and know-how. The parallel social development in the regions of Europe also meant simultaneous social crisis and radical change and then the 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 which 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 other things, 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 a common European identity. At the same time, the values and norms 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 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 “European” side. One is the transnational European discourse and the emergence of a European public space, which became particularly salient during the 1950’s. The other is European integration and the emergence of a European polity.
Individuals and social groups have multiple identities and the thus the question is how much space there is for “Europe” in collective identities. The appropriateness of the 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 identities, it is expected that they incorporate understandings of Europe faster. Beyond the resonance hypothesis Risse identifies two other explanatory factors. The political elites in general and also party elites continuously show 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 becomes consensual and sticky once it is successfully selected by the political elite. This is the socialization hypothesis, according to which collective nation-state identity is taken for granted and does 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 conceives identity as based on self-interested calculation – whether it is political or economic. 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 at a 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 the 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 Eurosceptic 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 judgements, intentionally or unintentionally we suggest that Europeanization is some kind of desirable outcome. In the following we try to align facts on both sides.

The Europeanization process and EU membership undoubtedly has both cost and benefits. Many authors have examined both sides of the argument in many papers. They usually agree on the result: the newcomers receive more benefits from membership than the costs they incur. 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 countries more attractive in the eyes of the investors that contribute to increasing FDI inflow. This foreign capital is often connected to new technology and know-how transfer.

On the political side, if a country joins 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 administrative 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 impossible, 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 EU commitments. Dezséri (1999) distinguishes direct and indirect costs of accession. Direct costs are paid to the common budget by each member state. Indirect costs are adaptation costs. These costs derive from changes in the trade system, harmonization of laws, the adjustment of the administrative institutions, and 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 costs are tangible, and can be counted (even if this is not a simple task) in terms of money. However, there is another, more intangible cost of cooperation and integration: the 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 interests of the ruling elite. In the case of crony capitalism where political competition is limited, the ruling elite has more opportunity to resist the pressure of change, whether it comes from internal opposition (if any) or from outside the country. Changes require the strengthening of opposition forces, and the 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 characteristics, i.e. they can be achieved over a longer term, while in the short term the static effects tend to cause repercussions first. An example of this is the growing trade deficit in the first years with EU countries, as was the experience of the CEE countries. Additionally, most of the costs also occur in the short run, caused by the need for 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 immediately 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 losses. Vachudova (2005:68) highlights that this motivation has been present in the 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 countries. In the 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 would decide: serious economic and geopolitical consequences were at stake. A large part of the cost of staying-out arises from the negative externalities\(^\text{16}\) 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 – comparison of the association agreements

As was described above, the aim of this research is to examine the interaction between the external impact of the EU and internal factors of particular countries. It is important 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 discover this because if the two were not the same, we could not expect the same outcome.

The impact of the European Union can be understood in numerous ways. However, we argue that the fundamental 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 a partner of the EU in its own right, it did not follow the path of a “frontrunner Visegrád” country. However, 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) represented a new initiative in the series 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 involved. The EU had the same intention for the SAAs as for the Europe Agreements: to provide 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 the association agreements. The comparisons are based on the framework of Balázs (2002:133-143) who examines seven key elements: free trade in industrial products, agricultural concessions, protection provisions, promotion of economic development, admission of the labour force, institutions and the evolution possibilities of the agreement.

\(^{16}\)See: Mattli (1999).
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 a long list of exceptions. The measures are asymmetric in favour of Slovakia. First, the liberalization steps Slovakia needs to take are delayed by four years on 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 provides for the creation of a free trade area over a maximum of seven years asymmetrically in favour of Croatia. The SAA adopted the preferential treatment that was established in a previous Council Regulation (CR 2007/2000) (Christie 2004).

In both cases textiles and steel products are regulated separately from other 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 shortages. Slovakia has the right to take 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, avoiding discrimination in procuring and marketing goods.

The SAA contains similar measures regarding dumping, re-export, market disturbances and shortages. The agreement with Croatia establishes a 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 includes several fields of
economic cooperation (Title VI): industry, science and technology, agriculture, energy, environment, transport, telecommunications, banking, regional development, tourism, etc., aiming at 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, and takes into account the absorption capacity of Slovakia and its ability to repay loans and accomplish 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, it declares the readiness of the Community to contribute to the economic reforms in Croatia. The fields of economic cooperation (Title VII) are rather similar to those 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

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 the setting up of operations on Croatian territory by companies and nationals, with timing asymmetry in favour of Croatia.

4.1.6 Institutions

The Europe Agreement establishes the Association Council which 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 creates 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. The 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 a greater emphasis on a multilateral framework and regional dialogue including other countries of the region. Regional cooperation is something aspired to only among the Europe
Agreement countries, whereas it is required among the SAA countries and becomes 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 explicitly express its willingness to accept the country as a future member state. The agreement includes a transition period of a maximum of 10 years divided into two five-year stages. The Association Council proceeds to examine the application of the agreement regularly. The future depends to a large extent on the decisions of the Association Council. The conditions of possible membership were described separately in the Copenhagen criteria but were not included in 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 Croatia to the fullest possible extent 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 prospects. In the case of Slovakia and the CEE countries, the prospect of membership was not clear in the association agreements but became tangible after the Essen summit in December 1994.

The SAA recognises Croatia as a “potential candidate”. However, a number of authors17 criticised this term, saying that neither the Stabilisation and Association Agreements, nor the European Partnership outlined clear membership prospects for the Western Balkan countries. At the same time the term “potential candidate” also means 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 very 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

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17 See e.g. Gligorov (2004c) and Anastasakis – Bechev (2003).
and Association Agreement with Croatia was signed in 2001. During the eight years which passed between the two, the EU’s enlargement policy changed as well. The package of conditions concerning Croatia has become more demanding than it was in the case of Slovakia and the other CEE countries. Firstly, the later the candidate arrives, the longer the integration agenda is. Secondly, beyond the Copenhagen criteria and the Stabilisation and Association Agreement there are also conditions related to peace agreements. In other words, beyond the “usual” agenda of economic 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 recognize the country as a possible future member state. However, the Europe Agreement countries later gained this 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 had come 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 a greater distance from the EU and from its impact. The association relation was established only after the changes in 2000. In the case of Slovakia, the pre-accession process started in December 1999 while in Croatia it started in June 2004. These details lead us on to the response capacity of the countries, i.e. how the external EU factor manifested itself 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, this does not spring purely from the EU but always includes reactions to the countries’ actions. However, the original intent of the EU can be considered the same towards both countries.

18 See section V.
III. Transformation and European integration in Croatia

Bićanić and Franićević (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 Croatia-specific transformation plan had a very important characteristic: it had to be different from the previous one. The third phase began 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 three phase process as “Croatia’s transformation U” with the lowest point being the 1998 bank-crisis.

1 The initial conditions: Yugoslavia

After World War II Yugoslavia was the first country in Eastern Europe to introduce a centrally planned economic system, of its own free will; and Yugoslavia was also the first to question 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 the upper hand. At the same time, new socialist elements were already introduced in 1952 (UNECE 1990:261). The Yugoslav model was based on two principles: decentralization and self-governance (Csaba 2007b:315). The decentralization existed not only in the economic autonomy of the federal republics but at the firm level 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 the market dominated, from 1974 there was a move away 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 a market economy was often hesitant and inconsistent. The Yugoslavian way proved to be successful until the late 1970's. The conceptual and political debates of the 1970's turned Yugoslavia back to a more 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 onset of an economic downturn, the pressure for democratization intensified. The political dominance over economic issues led to soft budget constraints and the existence of an unofficial economy. Despite the softening of the socialist system, the structure of the economy bore the marks of socialism; large firms outweighed small firms, and the economy functioned in a wasteful way. Ironically, by 1985
Yugoslavia’s economic system was more similar to the decentralized planning of Hungary than to a market economy. By 1989 similar reforms were on the agenda as in Central and Eastern Europe (Estrin 1991:188).

The internal problems led to huge external borrowing (Figure 1) but by 1980 this possibility was exhausted (UNECE 1990:261).

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

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

The openness of Yugoslavia was twofold. It was relatively open compared to other socialist economies in terms of the free movement of individuals. 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), most of them leaving 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

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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 unemployment was only partly hidden (Figure 3).

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

The openness of Yugoslavia was twofold. It was relatively open compared to other socialist economies in terms of the free movement of individuals. 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), most of them leaving Croatia. The remittances of the guest-workers were the largest contribution to the invisible account (World Bank 1983:25).

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<td><strong>net worker migrants (thousands)</strong></td>
<td>1100</td>
<td>870</td>
<td>825</td>
<td>800</td>
<td>790</td>
<td>770</td>
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<tr>
<td><strong>net workers’ remittances (in million USD)</strong></td>
<td>1772</td>
<td>1730</td>
<td>2034</td>
<td>2055</td>
<td>1902</td>
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The volume of foreign trade continued to increase between the 1960’s and 1980’s, while with the overall downturn the export performance also deteriorated (Figure 4). Yugoslavia was in a favourable relationship with the European Community. As the “shining star” of Eastern Europe (Lindstrom–Razsa 1999:4), it got 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. The Cooperation Agreement was signed between the parties in 1980 and the joint EFTA-Yugoslavia Committee was established in 1978, both long before CEE peers.

Figure 4: Unit value index of 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 varying between 0% and 35%. The use of quantitative restrictions was also widespread. Until the mid-1980’s 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 relatively closed compared to market economies (Yagci–Kamin 1987:9).

By 1988 the collapse of “contractual socialism” became obvious and structural changes were inevitable. The system was based on an ideologically inspired concept of reality and important principles of economic theory were overlooked. At the end of the 1980’s most previously taboo areas were opened up (Mencinger 1991:80). In 1988 the “Program of economic reform” was launched, which required the creation of an integral market including product, labour and capital. The constitutional conditions of the reform were created by amendments to the constitution in November 1988. The enterprise act adopted in December 1988 allowed the emergence of legal alternatives to social ownership; four types of ownership 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 a lack of support for such changes on the federal level on the other. 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 in hyperinflation in 1989, reaching an annual 1250% (Figure 5) and currency substitution with the 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 the Deutschmark and people kept their savings in foreign currency if possible (Škreb 1995:58).

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

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

The government drew up plans to consolidate and reform the economy. The package was passed by the federal parliament in December 1989 and included the following: the introduction of a fully fledged market economy, the establishment of pluralistic forms of ownership, clear identification of ownership rights in the social (public) sector, the integration of the Yugoslav economy into the international division of labour, the separation of economic management from politics and the 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 into second place behind the dispute over the future constitutional arrangements of the country (UNECE 1991:138). The stabilization program introduced in 1990 did not have an explicit European dimension and due to this deficiency, only a partial break was made with the tradition of self-management, and the credibility of the commitment towards a European model was very low (Bićanić–Franičević 2003:6).
1 The dissolution – in practice

Contrary to Slovenia, which was rather geographically isolated in Yugoslavia, Croatia experienced more directly the potential centralizing intentions from Belgrade. Croatia and Slovenia were allies in the centralist–decentralist debate (Lane 2004:169-170). In 1971, in what was 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’s Croatia was characterized by silence, and the Slovenes took on the role of challenging Belgrade’s 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.

Yugoslavia effectively ended with the Fourteenth Extraordinary Congress of the League of Communists 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 Communists 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 obtained the vast majority of seats in the Croatian parliament, the 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 had been a Partisan and was retired from the army as a major general. He put forward 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, and 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 the ultimate goal of establishing an independent Croatia, he kept open the possibility of a renewed Yugoslav community. But once Slovenia decided to leave Yugoslavia, Croatia followed it, for tactical reasons i.e., if a trouble broke out, the two republics would be better equipped to handle it together (Glenny 1993:87).

The HDZ government increased the emphasis on Croatian nationalist symbolism. The new citizenship law gave the right to ethnic Croats living abroad to apply for Croatian citizenship. The statue of Ban Josip Jelačić, the symbol of independent Croatia

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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 the Croatian language. This law caused difficulties later when Serbian refugees returned to Croatia.
was returned to the main square of Zagreb. These steps caused dismay among the Serb population in Croatia, who became a national minority rather than the constituent nation they had been previously (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, following an unofficial referendum, the Autonomous Province of Serb Krajina was declared. The rebellion spread to Serb populated parts of Slavonia as well. The Serbian idea was to cut away the Serb populated area of Croatia (Bartlett 2003:35-38).

Simultaneously, Tudjman and Milošević had plans regarding 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%, 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 as Slovenia.

A number of authors have joined a common debate concerning 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 for 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 cultures often caused conflicts as well. Despite the similarity, South Slavic peoples were and are ethnically and religiously mixed. Moreover, differences also appeared in the political concept of Yugoslavia. On the one hand, Serbian leaders were in favour of a more politically unified state with a strong central government. On the other hand, leaders in Slovenia and Croatia preferred greater national freedoms (Radelić 2007:13). All in all, Yugoslavia was a highly heterogeneous federal state with significant differences: two alphabets, three religions, four languages and six rival 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. Hereinafter 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 province - 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 doubled. The regionalization of Yugoslavia contributed to the survival 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 Yugoslavia20 1952-1989, Slovenia=100

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<td>58.0</td>
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<td>48.0</td>
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<td>Serbia incl. Vojvodina and Kosovo</td>
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<td>39.1</td>
<td>33.0</td>
<td>33.3</td>
<td>34.3</td>
</tr>
<tr>
<td>Macedonia</td>
<td>39.2</td>
<td>36.4</td>
<td>34.0</td>
<td>33.8</td>
<td>33.3</td>
</tr>
<tr>
<td>Kosovo</td>
<td>25.7</td>
<td>19.6</td>
<td>16.0</td>
<td>14.1</td>
<td>12.6</td>
</tr>
</tbody>
</table>

Source: Gligorov 2004b:84

The second element 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 the dissolution of federal states may take precedence over economic processes (Csaba 2007b:42). In the case of Yugoslavia, economic reasons were not among the most important ones 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. One is the thesis of “ancient hatreds” between Croats and Serbs, which made Yugoslavia unviable. Despite 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 not about the

20 Gross social product (also known as Material Product): gross national product of a centrally planned socialist economy (Routledge Dictionary of Economics)
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 one hand the principled recognition of differences, and on the other hand the suppression of those differences in political practice. The suppression of these differences caused resistance and the efforts taken to assure the survival of the state very often had 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 dropped Yugoslavia from the group of countries eligible for Western credits (Bissett 1999). Lane (2004:3-5) notes that the dissolution of Yugoslavia occurred in line with the ending of the Cold War and argues that the political system of the federal state was incapable of producing a new generation of leaders who could carry its project beyond communism. The constituent parts of Yugoslavia recognized the need for 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 linked 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 moved onto 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 a 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 the Croatian diaspora who worked in the West as guest-workers 21. The relative liberalization and prosperity

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.
and the freedom to travel and work abroad made its peer countries envious. The share of
the tertiary sector was relatively high, undoubtedly due to the tourism sector which also
profited from the relative openness of the borders. In the late 1980’s Croatia had every
chance to shift from a middle-income country to a developed one (Bićanić 2001:158-159;

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 enough fact that UNECE classified Yugoslavia as part of “Western
Europe and North America” instead of “Eastern Europe and the Soviet Union” in its
Economic Survey of Europe until 1993, although Yugoslavia was a planned economy, even
if not a classical centrally planned one.

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

Although the establishment of the independent statehood was not achieved peacefully,
the creation of the separate Croatian economy was smooth and its costs were low. Due to
the federal structure of Yugoslavia, the republics enjoyed a high level of independence
regarding their economic policy. With the dissolution of the federal state, Croatia left
the Yugoslavian convoy and had the opportunity to shape its own transformation policy
and concentrate on specific Croatian problems. Decision-making was simplified due to
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 Croatia-
specific transformation plan had a very important characteristic: to be different from the
one it inherited (Bićanić–Franičević 2003:10).

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

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 following month, and 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 the program was 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 able to implement it. Kraft (1995:483) argues that the reason for
success was rather administrative than market measures. The significant ownership share
of the Croatian state also meant that it was possible to dictate pricing behaviour to large
state-owned firms and to give a strong impetus to anti-inflation policy.
2.1.1 Macroeconomic development during the “nationalist” period

The GDP per capita in 1990 in Croatia was around the average of the Central and Eastern European (CEE) countries. However, the decline in GDP in the early 1990’s was deeper in Croatia than in the CEE or Southeastern European (SEE) countries (Figure 7). Croatia’s transformational recession (cf. Kornai 1993) was exacerbated by the break-up of the Yugoslav market and by the Yugoslav war. In 1991, partly due to the outbreak of the war, GDP fell by 21.1% and by 1994 it was reduced to two-thirds of the pre-war level. However, the magnitude of the fall in 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 GDP stopped and turned into a positive trend. The post-war reconstruction activity, including 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 for the downturn was the 1998-1999 bank crisis, during which 14 banks went bankrupt.

Source: HNB

22 This section is based on EUI country profiles of Croatia, if not otherwise noted.
23 We will examine the financial crisis in the next section.
Concerning the structure of the economy, the share of the tertiary sector had been relatively high since the beginning of the 1990’s, 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 exacerbated 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 strategically 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.
in 1998 and by 12.6% in 1999. Shipbuilding exports reached 782 million USD in 1998, making shipbuilding the largest single export sector\textsuperscript{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, which 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 insider capitalism (Soós 1986).

In the Croatian case the data available is highly contradictory. The administrative rate of unemployment was significantly higher than that based on the ILO survey\textsuperscript{25}. If we consider the administrative rate, the unemployment rate falls in the higher group. On the contrary, considering the ILO rates (Figure 10), Croatian unemployment was well below the SEE average and between 1995 and 1999 in line with the CEE average. The difference between the two types of rates in Croatia 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.

Overall employment fell dramatically in 1991-1992, partly due to the war-related loss of population (Figure 9). From 1993 changes in employment converged 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.

\textit{Figure 9: Percentage changes in employment (end-year) in Croatia, 1991-1999}

![Figure 9: Percentage changes in employment (end-year) in Croatia, 1991-1999](source)

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

\textsuperscript{24} Although the sector has been a major earner of foreign exchange through exports, it also has a high import content, accounting for about 80% of the total value, which means net exports are far less than gross export figures suggest.

\textsuperscript{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).
With the dissolution of Yugoslavia, the inland trade with the former federal republics became foreign trade which, by definition, made the Croatian economy more open. When declaring its independence in 1991, Croatia’s imports of goods and services as a percent of GDP ratio was 86% i.e. it was much more open than the former Yugoslavia ever was (Vujčić–Šošić 2004:7). However, the economy of Croatia was relatively closed during the 1990's. 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, Croatian exports focused more towards the EU. The EU share 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, this was missing in the case of Croatia. Among EU countries Germany, Italy and Austria were the main trading partners of the country with Slovenia and Bosnia and Herzegovina among the former Yugoslav republics.

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

Table 3: Trade by main export partners 1994-1999

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<tbody>
<tr>
<td><strong>Exports</strong></td>
<td></td>
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<td></td>
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<tr>
<td>EU</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>59%</td>
<td>58%</td>
<td>51%</td>
<td>51%</td>
<td>48%</td>
<td>49%</td>
</tr>
</tbody>
</table>
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 a trade deficit that was compensated for by the strong surplus in 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 a limited recovery in tourism and to the depressed shape of the economy that kept imports at a 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 for by tourist earnings due to the resumption of armed conflict. The tourism industry recovered further in 1996 and 1997 but was still far from its pre-war level and 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

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</tr>
</thead>
<tbody>
<tr>
<td>Merchandise exports fob</td>
<td>3292</td>
<td>na</td>
<td>3903</td>
<td>4260</td>
<td>4633</td>
<td>4512</td>
<td>4206</td>
<td>4605</td>
<td>4372</td>
</tr>
<tr>
<td>Merchandise imports cif</td>
<td>-3828</td>
<td>na</td>
<td>-4666</td>
<td>-5229</td>
<td>-7510</td>
<td>-7009</td>
<td>-9430</td>
<td>-8774</td>
<td>-7674</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-536</td>
<td>-303</td>
<td>-763</td>
<td>-969</td>
<td>-2877</td>
<td>-2497</td>
<td>-5224</td>
<td>-4169</td>
<td>-3302</td>
</tr>
<tr>
<td>Service balance</td>
<td>37</td>
<td>364</td>
<td>632</td>
<td>738</td>
<td>612</td>
<td>312</td>
<td>2022</td>
<td>2072</td>
<td>1626</td>
</tr>
<tr>
<td>Net private transfers</td>
<td>-7</td>
<td>391</td>
<td>126</td>
<td>224</td>
<td>366</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current account balance</td>
<td>-589</td>
<td>329</td>
<td>104</td>
<td>103</td>
<td>-1712</td>
<td>-1452</td>
<td>-2434</td>
<td>-1554</td>
<td>-1537</td>
</tr>
</tbody>
</table>

Note: Data for 1991 and 1992 excludes trade with former Yugoslav republics
Source: EUI Country profiles
Throughout the 1970’s Yugoslavia (as other countries) had borrowed heavily from the IMF and commercial banks. However, Croatia began its individual statehood with a relatively 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’s its yearly growth rate was about 40%. In March 1995 Croatia agreed with the Paris Club of creditor governments regarding 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 lend again to Croatia. Both Croatian banks and corporations and the Croatian government borrowed substantial amounts during 1996-1999. Concerning the external debt per GDP ratio, Croatia reached 50% in 1999 and exceeded the level of the peer country averages (Figure 12).
The amount of net foreign direct investments into Croatia remained low during the first half of the 1990's, mainly due to the war. In the mid-1990's the country’s current-account deficit was mainly covered by external borrowing, whereas FDI inflows were weak. After the war, in the second half of the 1990's 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, although 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 investors cautious. Foreign investors were deterred by the non-transparent relationship between the HDZ party and favoured businesspeople. There were many reports 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 exports. The lack of trade associations with the 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's had lost their markets, because firms from other transformation countries had restructured faster, often with contributions from foreign investors.

The largest investor countries were Germany, Austria and the USA between 1993 and 1999. Germany became one of the biggest investors when Deutsche Telekom bought 35% of Hrvatski Telekom in 1999 (Table 5). However, this large investor did not contribute to export growth.
2.1.2 Structural transformation during the Tudjman era

After two years of the successful stabilization program, Franičević and Kraft (1997) warned that 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 emphases. The pace of economic restructuring increased somewhat 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 continuation of social ownership, while reintroducing state ownership in any sector chosen by

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

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

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
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 continuation of social ownership, while reintroducing 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 separate Croatian privatization was first set out in a law of April 1991 that completely replaced the inherited Yugoslav laws. 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 the successor to two previous institutions. The HFP had responsibility for restructuring companies and selling shares.

The primary form of the Croatian privatization process was management and employee buyouts, while the secondary form was voucher privatization. About half the shares in each company were 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 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 rates and for long-term loans (EUI 1996:35).

Bićanić (1993:438-439) already noted in 1993 that the government was showing 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 a major role both on the regulation side and in becoming an owner of capital goods. This was partly a consequence of the inherited privatization plan and also of the war.

A next phase of privatization came in 1998, when the first round of the 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 35% of Hrvatski Telekom (EUI 2000:23). However, by the end of 1999 the state still held stakes in 1,610 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 had been extracted (Bićanić 2001:170).

Despite the slowness of privatization, according to the EBRD index of large-scale privatization (Table 53), between 1995 and 1999 Croatia reached level 3, which means that 50% of the assets were privatized. This level was in line with Slovenia, two Baltic states 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 from level 3 according to the EBRD
index of small-scale privatization (Table 54) but some of them fell back later on. Croatia reached the highest level - 4.33\textsuperscript{26} - relatively soon, in 1996.

The delay in enterprise restructuring has been one of the main challenges for the Croatian economy. In the absence of effective bankruptcy legislation, insolvent companies often continued operation as a “shell”, and were not formally closed down. Due to the weak judicial system, contracts were difficult to enforce in a culture of chronic non-payment (World Bank 1999:3). The progress in the EBRD index of enterprise reform (Table 55) shows that Croatia reached level 2.67 only in 1996, which was late relative to most of the CEE countries. However, the performance of Croatia was the best in the 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’s. The bank’s portfolios deteriorated because of the bad loans owed by 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 grew 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’s the banking system of the transformation countries in the 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).

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

<table>
<thead>
<tr>
<th></th>
<th>Two largest banks</th>
<th>Four largest banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>55</td>
<td>na</td>
</tr>
<tr>
<td>1995</td>
<td>54</td>
<td>68</td>
</tr>
<tr>
<td>1996</td>
<td>46</td>
<td>60</td>
</tr>
<tr>
<td>1997</td>
<td>40</td>
<td>53</td>
</tr>
<tr>
<td>1998</td>
<td>41</td>
<td>53</td>
</tr>
<tr>
<td>1999</td>
<td>44</td>
<td>58</td>
</tr>
</tbody>
</table>

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

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

Source: HNB

\textsuperscript{26} Level 4.33 refers to the following: standards and performance typical of advanced industrial economies, no state ownership of small enterprises.
The rehabilitation led to bank nationalization as well. The capital-increase through
government bonds increased the ownership share of the state. Although state-ownership
started to decrease after 1996, due to the consolidation in 1998 and 1999 the state remained
a dominant owner in the banking system (Table 8). Foreign bank entry was rather slow
and cautious at the beginning of the 1990's. The first foreign bank was 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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>State owned banks or private with a significant public stake</td>
<td>78.4</td>
<td>41.9</td>
<td>43.1</td>
<td>45.6</td>
</tr>
<tr>
<td>Private domestic banks</td>
<td>20.7</td>
<td>54.1</td>
<td>50.3</td>
<td>14.5</td>
</tr>
<tr>
<td>Foreign owned banks</td>
<td>1.0</td>
<td>4.0</td>
<td>6.7</td>
<td>39.9</td>
</tr>
</tbody>
</table>

Source: HNB

Table 9: Large bank privatization in Croatia 1998-1999

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Acquired by</th>
<th>Stake (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>Slavonska banka</td>
<td>Kartner Landes-und Hypothekenbank</td>
<td>na</td>
</tr>
<tr>
<td>1999</td>
<td>Privredna banka</td>
<td>Banca Commerciale Italiana</td>
<td>66</td>
</tr>
<tr>
<td></td>
<td>Zagrebačka banka</td>
<td>Allianz</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bankers Trust Co.</td>
<td>63</td>
</tr>
</tbody>
</table>

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, the functioning of
the judiciary, financing and the exchange rate proved to be larger obstacles in Croatia than
in the CEE countries. At the same time, inflation, infrastructure and anti-competitive practices were smaller obstacles.

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

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

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 detail. 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 can be traced 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 the private sector in GDP as a consequence of the Yugoslavian type of workers’ self-management and social ownership. In 1999 the private sector share reached 60% of GDP27 which was

27 Other sources estimate a higher share for the private sector.
significantly lower than in the CEE countries but lower than the SEE average as well (Table 57). The public sector was particularly large by European standards, the public administration and defence accounted 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 was also reflected in the general government expenditure that peaked at 56.6% of GDP in 1999. This level was the highest in the whole of Europe in that year. The war-finances had a long-lasting impact on the size of the state. The war was financed mainly through inflation and it also led to a large budget deficit and a very high level of budget expenditures (Bićanić 2001:169). Despite the end of the war, during 1996-99 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 remaining 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 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 the 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 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 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. The fourth phase, which began in the summer of 1995, was marked by increased US involvement.

28 Although the chronicle of the war is not strictly connected to the process of Europeanization, it is essential to understand the reasons for the conflict in order to understand the integration process of Croatia.
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 from 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 outbreak 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 ethnic minorities had a crucial role in the Yugoslav conflict.

In these three months the Croatian war began. Serb paramilitaries blocked main road and railway routes and as a result 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 expiry 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 the principle of mutual recognition. All countries - and the UN - were called 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 UN. In December 1991 Germany30 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, the Serbs declared the Krajina Serb Republic in December 1991, which included one third of Croatia's territory. The Vance Plan, which 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 posted 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 a third of its former territory (EUI 1996:28). The Croatian government was of the opinion that the international community was preserving the status quo instead of resolving the problem of Croatian statehood. The Croatian army had 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 Operation Storm (Oluja) was launched and within a few days the whole of the Krajina was reclaimed and around 150,000-200,000 Serbs left the territory for Bosnia and Serbia. Tudjman was more popular and powerful than ever before and he had ambitions to incorporate Herzegovina into Croatia (Bartlett 2003:47).

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30 This recognition is considered the first serious foreign policy initiative of the newly recognized Germany (Frydman et al. 1998:67).
The governments of the EC appeared to be unprepared for the challenge of the Yugoslav dissolution and were far from 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 would have to include armed conflict. 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 united diplomatic action. Although the Western European Union (WEU) could in principle offer military support, the EU’s role had been primarily diplomatic, economic and peacekeeping. The attempt to intervene in the framework of the WEU failed because ministers for foreign affairs could not agree. Finally the WEU played only a minor role beside 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 accompanied by a complex structure of military command, from the UN and NATO forces31 (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 negotiations on 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 a 12 month transformation period (extendable to 24 months) the Croatian administration would be established gradually; the region would be demilitarized from Serb units under the supervision of international forces and the opportunity for the return of refugees and displaced persons would be guaranteed (Erdut 1995). The region was gradually reintegrated into Croatia in 1997, and Zagreb gained 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 each other’s sovereign equality and to settle disputes by peaceful means; they committed 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).

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31 From 1995 on the structure also included the Rapid Reaction Force of French, British and Dutch troops.
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 Agreement and an innovative strategy to help the Southeast European region to come out of the crisis.

2.2.1 The ICTY

The International Criminal Tribunal on the former Yugoslavia (ICTY) was established with UN Security Council Resolution 827 passed in May 1993, based on Chapter VII of the UN Charter. The Tribunal was located in The Hague. The mission of the ICTY has been to prosecute individuals 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 individuals responsible would contribute to the restoration and maintenance of peace.

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 for joining the PHARE program and for negotiating a cooperation agreement but the condition was never fulfilled.

President Tudjman supported the establishment of the ICTY because he believed that Serbian war criminals will be prosecuted there. A constitutional law was approved in 1996 in cooperation with the Tribunal but the Tudjman government was reluctant to cooperate with the ICTY. In Tudjman’s opinion the country had 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. The government argued that Croat “defenders” could not be sent to The Hague. In Tudjman’s (and many Croats’) conception Croatia was the innocent victim of Serb aggression. The refusal to cooperate with the ICTY became the core element in the state-built myth of the Homeland war. However, even the opposition press in Croatia reported 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 international support for Croatia. There were trials of war crimes in Croatia as well but only against Croatian Serbs.

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

2.3 Pressure to build democracy and the strengthening of the 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 on this post-war popularity, he called for

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32 Action with respect to threats to the peace, breaches of the peace, and acts of aggression
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 the ICTY (HRW 1999).
new elections for the lower house of the parliament in August 1992. The HDZ won the elections with 44% of the votes and obtained an absolute majority of the seats. The elections for the upper house were held in 1993 and were also won by the HDZ. The opposition was fragmented. Tudjman also won the presidential election with 57% of the votes (Bartlett 2003:42-43).

Following the success of the Storm offensive, 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 on the military success and the popularity of the HDZ (Bartlett 2003:48). The HDZ won again with 45% of the votes and obtained an 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 in which the opposition made significant gains and the HDZ lost control of 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. Four times Tudjman vetoed the opposition nominee for mayor of Zagreb. Finally the government appointed its own nominee (Bartlett 2003:49-50; Frydman et al. 1998:66-68).

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 detailing twenty-one conditions required for the admission to the Council. 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 receiving 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 in 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 the HDZ party, and the frequent suppression of political opponents and the independent media (HRW 1996).

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34 The constitution adopted in 1990 established a bicameral parliament in Croatia.
35 Among the commitments were the signing 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 of the government’s refusal to allow a member of the opposition to become mayor of Zagreb.
In June 1997 Tudjman won the presidential election. The elections were considered 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 almost absolute executive power. The repeatedly modified election law was constructed according to the needs of the HDZ (Frydman et al. 1998:71).

The popularity of president Tudjman and the HDZ diminished throughout the post-war years. The increasingly independent and outspoken press reported on a variety of scandals relating to the president and the party (Bartlett 2003:50). Opposition victories in local elections were considered as a sign of changes. However, the opposition remained 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 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 a mainly positive opinion of the market economy (65% said that it is good and 18% wrong). However, 15% said the financial situation of their household had “got better”, while 38% said it had “got worse”. More people were satisfied with democracy (52%) than those who were dissatisfied (42%); and Croatia was among the three of all the nineteen countries surveyed, in which more people were satisfied. The same pattern appeared regarding respect for human rights: 74% said that they were respected compared to 20% who said they were not; and Croatia was among four of the nineteen countries surveyed where more people said yes. Moreover, in Croatia the level of people dissatisfied with respect for human rights was the lowest of all the countries surveyed. This result contradicts sharply with the Human Rights Watch report of 1995, which warned about human rights violations against ethnic Serbs in the recaptured areas (HRW 1995).

2.4 Conditionality towards “the rights and obligations that EU countries share”\(^{36}\)

With dissolution the Yugoslavia–EC cooperation agreement was abolished. The once preferential Yugoslav status disappeared and left the successor states in an unclear situation without a 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 a member of CEFTA. It did not have a bilateral agreement with EFTA and was not a WTO member. Because of the lack of an EU association agreement, Croatian exporters faced generally higher tariffs than those from the peer countries. From 1991-1999, the EU provided 349 million euros to Croatia for reconstruction in the framework of the Obnova program, humanitarian aid in the framework of ECHO, and supported the media, mine removal and human rights (EP 2001).

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\(^{36}\) This is how the EU glossary explains acquis communautaire (http://europa.eu/abc/eurojargon/index_en.htm).
Table 11: Trade agreements and EU integration process in CEE countries, Croatia, Bulgaria and Romania, as of 1999

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

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 prospect 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 in the country’s European integration process and as a form of pressure towards a
Southeastern European or Balkan integration. With the latter community Croatia would find itself in a worse situation than it had in Yugoslavia – he argued. Croatia protested against the principle that the regional integration of countries is set as a precondition of their individual relations with the EU, saying that the country did not need a “Euro-Yugoslavian and Balkan integration” as a pre-association stage. 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).

Despite the aversion to the EU, the country was keen on establishing preferential trade relations with it since most of the Croatian exports went to the EU-market (Bartlett 2003:74). The political disintegration of Yugoslavia led to economic disintegration too; both trade and investment relations 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 regarding both their trade and investment needs. However, the political nationalism of the successor states led to political disintegration from the EU. Political nationalism seemed to be inconsistent with economic Europeanization. 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 was a price for economic cosmopolitanism in terms of political nationalism (Gligorov 2004b:95).

The EU set two types of conditions for Croatia. The general conditions covered the entire Southeastern European 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 a market economy. Country-specific conditions towards Croatia were the following. Compliance with the obligations under the Basic Agreement on Eastern Slavonia and cooperation with the United Nations Transitional Authority in Eastern Slavonia, Baranja and Western Sirmium (UNTAES) and the Organization for Security and Co-operation in Europe (OSCE); the opening of the customs border between Croatia and Republika Srpska37; evidence of credible pressure on the Bosnian Croats to dissolve Herceg-Bosna38 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 the 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 the obligations under the Dayton and Erdut Agreements.

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.
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, progress in the country did not match the commitments. At the same time Croatia had a real opportunity to archive its aspirations but this required compliance with the relevant conditions, the report stated. The benefits from autonomous trade preferences were also questioned unless Croatia fulfilled 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 should stay in force but so should the suspension of its eligibility for the PHARE program. The report recognized some progress in the field of market economy reform and substantial progress in cooperation with neighbouring countries, but little or no progress in other areas (Commission 1998b).

The Fourth Conditionality Report (spring 1999) still found deficiencies in most of the issues monitored. The report noted that in several cases formal commitments were undertaken without real implementation. The Commission considered the suspension of the PHARE program still necessary (Commission 1999a). The outage from PHARE did not only mean financial losses for Croatia, but also reduced possibilities of participation in international projects and exchanges of experience (Samardžija et al. 2000:112).

In 1999 two new initiatives were formed for Southeastern Europe and accordingly for Croatia. 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 such as the EU Member States and the European Commission, USA, Russia, the UN, the OSCE, the Council of Europe, NATO, the 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 himself expressed fears about being excluded from the EU and NATO: European peace and stability is threatened by exclusion that creates an opportunity for destructive forces. That is why alliances have to deal with those who are not members (Tudjman 1997).

39 Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Moldova, Montenegro, Romania, Serbia and The Former Yugoslav Republic of Macedonia
As Jović (2006:85) argues, the integration process was delayed primarily because of Croatia’s self-made obstacles. These obstacles had a 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.

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

Tudjman accused Europe of not supporting the dissolution of Yugoslavia, but wanting to save it too long and in doing so it pushing 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 had 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 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 the economy40. “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 by 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 institut Zagreb, EIZ), with the financial assistance of the Ministry of the 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 of 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 preparations and major economic changes and adjustments, which the EU would require, would also encourage economic development. The study did not idealize the integration process but it identified that some sectors would experience drawbacks, and the cost of adjustment would be high in the short-term. However, in the long run the integration was assumed to

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 the 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).
bring more benefits than costs. Considering that Croatia is a small country with a small domestic market, the issue of its participation in EU integration should be considered as an imperative both in economic and political terms, instead of an alternative. When examining the cost of integration, it should not be viewed exclusively as the price of integration. The study stressed the widely acknowledged view that a 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 did Croatia become a “Western Balkan” country

From 1998 the EU introduced the terminus technicus “Western Balkans” that was also used by NATO and referred to Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia, the 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 it belonged. 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 debated. 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 countries strove for.

We argue that the question of “Europe or the Balkans” is meaningless considering that the Balkans is part of Europe both in geographic and historical terms. Thus setting “Balkan” and “Europe” as opposites 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 it. To find the border of the Balkans in political and historical terms is a far from easy and unambiguous task. Another slippery question is whether Croatia belongs to the Balkans in positive terms41.

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 onto a different path and did not join the group of Central and Eastern European countries as Slovenia did. On the contrary, it became a “Western Balkan” country according to the categorization of the EU and other international institutions. However, this labelling contradicts with the often expressed self-perception of Croats. They do not regard themselves as a Balkan people 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 always been in the geographical proximity of the West. The region belonged in a historical sense to the first wave of Europeanization or Westernization; it directly followed 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 is connected closely to the Habsburg Empire. At the same time, the Balkans were 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 an initial democratization process. Based on this description, Croatia clearly belongs to Central Europe.

41 For further discussion see Todorova (1996: 21-37).
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 the 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, represented the 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; indeed 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 the restoration of the 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 in which 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 in the Balkans, being 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 in 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 a huge redistribution of resources). In the latter case the political motive lies 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 that 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 to be independent was justified as a necessary liberation from its “Balkan burden” and the way to 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’s. They looked with bewilderment as it turned from a promising emerging democracy to a country lagging-behind 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 an extreme response to everything that was connected to the Balkans. In the second half of the 1990’s, 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 anti-EU. The positive impressions (37%) of the European Union outnumbered negative ones (13%), while 30% were 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 a 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’s. 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, Croatian democracy struggled with several deficiencies. Third, the country’s will to cooperate with the ICTY was at a low level. Fourth, and 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 also new-found independence as a 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. Second, Croatia was involved in a war from the very beginning of its own transformation process. The war caused tremendous costs for the country, in the form of defence costs, damage to infrastructure and many refugees. The 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 people were killed or had gone missing during the conflict (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 its advantages and disadvantages is a distinctive one because it differed from the other Eastern European countries in basic features. The Yugoslav model meant a third-way system of socialism with a quasi-market. Beyond the economic structure Yugoslavia also drifted Croatia towards the “Balkans in a 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 at first glance. 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 the market economy, the presence of the private sector since the 1950’s, the well-trained labour force and experience in entrepreneurship were all factors considered as advantages. The openness of the Yugoslav economy was relatively significant compared to other socialist economies in terms of the free movement of individuals. The managers of the large socially owned firms acquired certain experience in entrepreneurship. The markets for goods and services

\(^{42}\) 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 the United Nations (UN) High Representative. According to The Fund for Peace’s Failed States Index 2008, BiH has a score of 84.3 on a scale where Somalia is the most failed state with 114.2 while Norway is the least with 16.8.

\(^{43}\) The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia
were relatively developed and government intervention was only minor. Based on these preconditions, Croatia could have expected a relatively 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 workers, the enterprise ownership structure was dispersed, with a strong role for internal ownership, by managers, workers, and pensioners. This also hampered efficient corporate governance and restructuring. The self-management was partly disadvantageous from 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 international actors (EU, IMF, EBRD). In the case of insider privatization, the economy cannot make 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 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). This method of privatization perpetuated the worst features of the Yugoslav social ownership model. The evolved crony capitalism did not favour 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 nature of the Croatian economy is distinctive. In the early 1990's among the more developed transformation countries (referring to the Visegrád countries, the Baltic states, the 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 above-mentioned peer countries. The decision of Croatia to conduct the war and the transformation in parallel undoubtedly created unique circumstances. At the same time, the war should not unconditionally have meant the burden that it did in Croatia. A quick orientation towards the EU might have given the country the chance to leave behind the memory of the war.

The Croatian type of crony capitalism, which emerged in the 1990’s, was, on the one hand a consequence of the Yugoslav legacy, (Bićanić 2001:162). The relatively large private sector meant a large space for unofficial activities. The social capital that developed under these circumstances had little respect for the rule of law but showed an 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 formation of 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 to achieve structural change has been a 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 a highly captured state with a medium level of administrative corruption. The cause of the state capture was the weak accountability of the political regime based on nationalist politicians having close relationships to powerful enterprises. Although countries enjoy the advantages of the capacity of the state, the capture of the state can be
seen as a repression of this advantage. Once state capture is reduced, it can 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 also served as a transmission for individual and group strategies for rent-seeking (Bićanić–Franičević 2003:13).

The manipulation of the media, the dissatisfaction with privatization, the authoritarian style of governance and dissatisfaction with the international position of the country resulted in the HDZ government losing its popularity and finally its power at the end of the 1990’s. The EUI report (2000:12) detected that a large proportion of the population was discontented with the policy towards Bosnia and Herzegovina and considered that by supporting extremists among the Bosnian Croats, Croatia had to pay too high price regarding its international isolation. The economic crisis in 1998-1999 contributed to the defeat to a large extent as well (Bartlett 2003:57).

In autumn 1999 Tudjman became 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 a large margin.

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

The result of the elections meant a major change of power without violence and brought the end of the 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 very different views about Croatia and its international position. The isolation was recognised as undesirable and unviable in the long run.

\(^{44}\) 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 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 Southeastern European region. Croatia wanted to be a “normal” country, not an exception to the Europeanization among peer countries. The former political identity, which was based more on the opposition to “others”, seemed to be replaced by positive definitions. The coalition of parties was dedicated to quick political and economic reforms, in order to compensate for the time lost previously. The ambitions of the new government were warmly welcomed in the West. Both the EU and 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).

The new government promised to transform the country into a liberal democracy and to correct many of the flaws of Croatian democracy. It also announced it would 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 administrations. 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 came to satisfying Western conditions. The return of ethnic Serb refugees was challenged by a large public opposition. The same problem developed around the idea of extraditing war criminals to the ICTY (EUI 2000:12-13).

Conflicts within the coalition hampered the pace of the reform process, particularly in field of the 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 the intelligence service, the police, the judiciary and the army stayed almost unreformed during the Račan governments which indisputably 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 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 call early elections but asked Račan to form a new government. After weeks of negotiations, a new coalition of four parties (SDP, HSS, LS and HNS45) was assembled with a narrow majority (EUI 2002:7-8).

The ruling coalition remained on an unsteady footing in late 2002 and in 2003 and the polls showed that public support was waning. On the other hand the position of HDZ

45 Social Democratic Party of Croatia (SDP), Croatian Peasant Party (HSS), Liberal Party (LP), Croatian People’s Party (HNS)
strengthened. Since 1999 a moderate wing of the party had broken away and founded a new party, the Democratic Centre (Demokratski Centar, DC). The nationalist wing led by the 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 population in Croatia and the international community that the party had left behind its nationalist heritage and transformed itself into a modern European conservative movement. On the one hand, the increased popularity of the HDZ was a response to the economic situation. 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 in the defeat of the ruling coalition. The new government was formed by the 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 was a reformed, democratic centre-right party and the government’s aim was to speed up the EU accession process and to cooperate with the ICTY (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, which 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 discontented 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 reduce 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 in the presidential election against the HDZ’s nominee.

In 2006 Human Rights Watch expressed its concerns that Croatian authorities were making inadequate progress to facilitate the return of Serb refugees, 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, the judiciary system had a 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 used them to acquire 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 power of the executive. The confidence in the media

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

47 Eurobarometer has published the Croatian national report since autumn 2004.
was also poor. Only one-quarter of citizens in Croatia said that they were satisfied with way 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 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. this was the party that received the most votes (35%). However, SDP also won 32% of the votes and both parties started negotiations about forming the new government. Both big parties were in favour of EU accession. Finally the government coalition was formed by HDZ, and an alliance of the 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 democratic development in Croatia. In the Commission’s opinion the new political line could represent 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 said that he hoped Croatia would 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 the long-term stabilisation of the country and already serious work had started to revise earlier political shortcomings. The Commission commended the progress in the return of refugees and displaced people, full cooperation with the ICTY, improved regional cooperation and democratization of the media. The first encouraging steps in the economic sector were acknowledged as well. Although the report called for further steps in both fields, 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 which 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 a 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 EU–Croatia relations. The agreement established several joint bodies at a ministerial level (Stabilisation and Association Council), at a high official level (Stabilisation and Association Committee), at a parliamentary level (Joint Parliamentary Committee) and at a technical level (subcommittees). The Croatian Parliament ratified the SAA on 5 December 2001 and notified 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 Balkans” (Jović 2006:95).

To enter 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 cooperation with the 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 (the main opposition party at that time) because it did not offer a clear prospect of membership. 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 depended mostly on how successfully it implemented 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 the 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 economic isolation of the country. One of the main challenges of the new government was described as “implementing a comprehensive programme of structural reforms to achieve political and economic transition”. In 2002 the government’s efforts 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 with a view to 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 - 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 the Commission’s 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 had 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 the accomplishment of the accession negotiations in less than two years from mid 2004 to mid 2006 (Mimica 2003).

The Thessaloniki European Council (19-20 June 2003) declared that “the Western Balkan 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 the ICTY. This statement paved the way for a positive opinion regarding the country’s readiness to begin EU membership negotiations (EUI 2005:11-12). The Commission declared that the cross-party consensus on the political goal of EU membership had not changed since 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 was a longer time horizon than the National Program for 2003 had estimated. The government’s working program for 2004-2007, published in 2003, set an internal goal to be ready by the end of 2007 and to *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 the 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, 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 solve the issue of the arrest and transfer of General Ante Gotovina to The Hague (EU opens...2005). The Council also agreed that less than full cooperation with the ICTY could be a basis for the suspension of the negotiations (GAERC 2005).

The Chief negotiator of Croatia, Vladimir Drobnjak, stated in an interview in October 2005 that Croatia could learn from the Slovakian experience since this country went through the negotiations rather quickly, having joined the accession talks at a later stage, for 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 “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. In 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 a number of measures. To assume the obligations of membership, strengthening the administrative and judicial structures was considered to be necessary.

In June 2006 the first chapter of the accession negotiations - science and research - was formally opened and provisionally closed. One year after the opening of the negotiations, the screening was completed in October 2006. The second Progress Report (Commission 2006a) stated that Croatia had 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 had been partially addressed. A key Accession Partnership priority, the judicial reform had begun, but the reform was considered to be in an early stage. The 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 had 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 were evident in the fight against corruption, but further steps were needed in the area of judicial and administrative reform, minority rights, and refugee return, and in restructuring of the steel and shipbuilding industries.

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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” to block Slovenia’s direct access to international waters. There were several international disputes going on between Croatia and Slovenia at that time, stemming from the break-up of Yugoslavia in 1991. There had 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 the Ljubljanska banka, the largest regional bank in Slovenia in the Yugoslav era (EUI 2004:20).

The diplomatic tensions threatened 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 was also linked to its membership ambitions.

In late 2006 the Croatian parliament again passed the law 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 promised 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 would postpone it until the fisheries chapter was closed. With this step Sanader avoided the suspension of accession talks that Brussels had announced (Nacional 2007a). In December 2007 in its conclusion the Council called on Croatia to fully respect the 4 June 2004 agreement concerning ZERP. President Mesić also lobbied for the abolition of ZERP in December 2007 (Nacional 2007b).

However, ZERP came into force on 1 January 2008, just at the beginning of the Slovenian presidency and resulted in a slowdown in 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 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 - in a reference to the border dispute - that Croatia would not pay with territory for entering the EU. If this was the price then the country would prefer to stay out (nol 2009). In September 2009 Jadranka Kosor, newly elected prime minister of Croatia, came to an agreement with the Slovenian prime minister that they would continue negotiations under international supervision and that the border-dispute would not influence the Croatian accession negotiations (Euvalon 2009).

In February the Council adopted a revised accession partnership with Croatia. The document highlighted the key priorities, including judicial reform, public administration reform, an anti-corruption program, the Constitutional Law on National Minorities, completing the return of refugees, resolving the ZERP issue, maintaining full cooperation with the ICTY, and improving the business environment and economic growth potential (Council 2008).

The Slovenian presidency was not in favour of accelerating Croatian integration, although the European perspective on the Western Balkans has been among the presidency’s priorities.
On 12 June 2008 the Lisbon Treaty referendum took place in Ireland. The result of the referendum had an important impact on Croatia since the Nice Treaty was designed for 27 members and the Lisbon Treaty would have enabled the EU to enlarge further. French President Nicolas Sarkozy argued that the enlargement must be put on hold, since until the reform treaty has 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 would 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 for 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 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 still has 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 could become a historic year for Croatia, when the country reached the final stages of its EU accession process. 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 known 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 had been postponed, the confidence of the Croatian public in the EU fell to only 28%, from 42% in 2004 and Euroscepticism increased among Croatian

50 53.13% of the electorate took part in the referendum and 53.4% of them voted “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
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 Croats favour EU membership. The confidence of the Croatian public in the European Union began 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). 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's, 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 had 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 commitment of the Croatian government to cooperate with the ICTY ran through the years of peace as well and 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 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 The ICTY

It was the failure to cooperate with the ICTY which caused the informal economic and political isolation of the country. In April 2000 the chief prosecutor and deputy prosecutor visited Zagreb. The Račan government allowed ICTY representatives to investigate war crimes committed in Croatian territory for the first time 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 the 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. 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 should not act like this in order to obey international pressure or interests but on behalf of its own future which was nothing else but part of a united Europe (Mesić 2003:II).

With the indictment of Gotovina and Bobetko, Croatia faced the most delicate situation 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 expectations, the new HDZ government committed to cooperate with the ICTY. The government extradited (in some cases, voluntarily) 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. In March 2005 the Chief Prosecutor concluded that Croatia still 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 as being made under political pressure from some EU member states (HRW 2005). Finally, Ante Gotovina was arrested in Spain in December 2005.

However, due to the changes in the constitution, the president’s power was reduced to a near ceremonial level. However, Gotovina had still not been arrested. The public’s support for Gotovina had 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 would be cooperating fully once Gotovina was handed over to the ICTY (HRW 2004).
3.5 Building a market economy

3.5.1 Macroeconomic performance in the 2000’s

After a costly consolidation, Croatia emerged from the recession in the final quarter of 1999 and growth picked up in 2000. Until 2003 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 changes in January 2000. However, a growth path based on domestic consumption is dangerous and unsustainable on the long run in the case of a small open economy like Croatia. From 2004 the growth lost momentum and stayed below the peer country average (Figure 15). This solid economic performance leaves room for improvement. 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*

![GDP chart](chart.png)

*Data for 2008 is an estimation; data for 2009 is a projection*

*Source: EBRD Selected economic indicators*

GDP per capita reached the level of 1990 in 2003, which indicates a slower pace of catch up than in the Visegrád countries but faster than Latvia and Lithuania. Considering the GDP per capita compared to the EU average, Croatia reached 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 an estimation, and from 2004 to 2008 is a forecast. Source: Eurostat

The relatively slow enterprise restructuring process and implicit labour shedding may have prevented a 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 a low employment rate) reflects the rigidity of the labour market. The limited job turnover and job creation remain among the most compelling economic problems in Croatia (Commission 2006a:19).

Figure 17: ILO unemployment rates in CEE and SEE countries, in percentages

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 to WTO membership; in July 2000 Croatia joined the WTO. According to the agreement, Croatia committed to remove 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.

Despite the improvement in access to global markets, the real export growth remained lower than that of imports, 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 start of 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.

Concerning the structure of exports to the European Union, this developed unfavourably during the second half of the 1990’s. The current structure is characterized by a high 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 exports (Table 13). The export performance of manufacturing industry is poor despite the high level of FDI inflow into this sector. This suggests a low return on investments. Since the export performance depends largely on FDI-attracting capacity, 55

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

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

Notes: Product groups mentioned by Standard International Trade Classification
nen.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-thirds 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).
The stock external indebtedness of Croatia has been rising since the beginning of the 1990’s. In the 2000’s the external debt stock grew by 22% on average. Since 2004 Croatia has belonged to the severely indebted group of countries according to the World Development Indicators categories (Figure 19). Considering other indicators, such 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’s. 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 a possible “Argentinean scenario” financial crisis because of the high debt figures, which were later disclaimed by exports (FR-online 2008).
The amount of net foreign direct investment into Croatia has approached both the 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, an amount 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 has 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) found both Croatia and Slovakia a front-runner in reference to inward FDI, both its FDI performance and FDI potential in 2005.
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 the 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 15: Number of greenfield FDI projects, by destination region, 2002-2007 (concluded)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia</td>
<td>33</td>
<td>46</td>
<td>41</td>
<td>46</td>
<td>39</td>
<td>32</td>
<td>237</td>
</tr>
</tbody>
</table>

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 the 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.

\textit{Table 16: The origin of FDI in Croatia, 1993-2007, in percentage}

<table>
<thead>
<tr>
<th></th>
<th>1993-2007</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-15</td>
<td>82.1</td>
<td>84.0</td>
</tr>
<tr>
<td>2004 EU member countries</td>
<td>11.5</td>
<td>12.0</td>
</tr>
<tr>
<td>Other developed countries</td>
<td>3.7</td>
<td>0.0</td>
</tr>
<tr>
<td>International fin. institutions</td>
<td>1.4</td>
<td>1.0</td>
</tr>
</tbody>
</table>

\textit{Source: Croatian National Bank}

\textit{Table 17: FDI in Croatia by sectors, 1993-2007, in percentage}

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

\textit{Source: Croatian National Bank}
3.5.2 Structural changes since 2000

One of the main tasks the Račan government faced 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 of reducing the government deficit 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 to control public sector wages and to reduce the number of government employees. The arrangement ended in May 2002. The central government deficit decreased 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 reforms endangered 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 legislative debate. 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 had 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 broader health care reform was adopted, but by autumn 2007 slow progress had 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 the 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 restructuring of 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 does not receive aid.

The Račan government decided to consolidate state holdings of shares into the privatization fund (HFP). In 2000 the EBRD reported on the 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 Elektroprivredna), 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.

56 If not indicated otherwise, the chapter is based on EUI country reports 2000-2007 and EBRD Transition Reports 2000-2007.
In July 2001 energy laws were adopted concerning electricity, gas, oil and other energy sectors 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 privatizations in Croatia 2001-2005

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

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 sale 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 a minimum 20% of Hrvatska Telekom for sale on the Zagreb and London stock exchanges. In November 2006 the government sold a 17% stake in INA. In June 2007 there was a major corruption scandal that resulted in the removal of the HFP management.

Following a repeated tendering procedure, the buyers of three metal companies were chosen in April 2007. The privatization of these companies was a condition for the second tranche of World Bank Programmatic Adjustment Loans (PAL II).

According to the 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 Macedonia and Poland but lower than Romania and Bulgaria and the CEE countries. However, among peer countries in the Western Balkans Croatia reached the highest level of large-scale privatization.

Although Croatia had already reached the highest level of 4.33 on the EBRD index of small-scale privatization in 1996 (Table 54), there were several small and medium-sized enterprises in 2000 under the management of the HFP, some of which the previous government had taken over in relation to bank rehabilitation. The small-scale privatization achieved progress in 2002 but slowed down in 2003 after the privatization of the 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% of GDP which was significantly lower than in the CEE countries but lower than the SEE average as well (Table 57). In 2007 it increased to 70% of GDP, partly because the pace of privatization had 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 project founded by the World Bank to improve judiciary effectiveness concerning the 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 had previously met opposition from the labour unions. The law aimed to improve the 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 the EBRD index of enterprise reform (Table 55) shows that Croatia only reached level 3.00 in 2004, which was relatively late compared to most of the CEE

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57 Željezara Split was acquired by the Polish Złomrex and the post-privatization restructuring was financed by an 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 for the private sector.
countries. However, the performance of Croatia is the 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) regularly advise a faster pace for the implementation 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 is among the most advanced in the region according to the EBRD index of bank sector reform (Table 58). The banking sector is also the success story of the inward FDI in Croatia. This sector saw the most comprehensive privatization of all 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 resources 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, which 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 privatizations in Croatia 1998-2004**

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

*Source: EBRD, RBA Croatia Weekly Report no. 100*

The number of banks has 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 holding 41% of total assets in 2007.

Table 20: Number of banks in Croatia

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

Source: HNB

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Two largest banks</th>
<th>Four largest banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>54</td>
<td>68</td>
</tr>
<tr>
<td>1996</td>
<td>46</td>
<td>60</td>
</tr>
<tr>
<td>1997</td>
<td>40</td>
<td>53</td>
</tr>
<tr>
<td>1998</td>
<td>41</td>
<td>53</td>
</tr>
<tr>
<td>1999</td>
<td>44</td>
<td>58</td>
</tr>
<tr>
<td>2000</td>
<td>48</td>
<td>62</td>
</tr>
<tr>
<td>2001</td>
<td>46</td>
<td>60</td>
</tr>
<tr>
<td>2002</td>
<td>44</td>
<td>59</td>
</tr>
<tr>
<td>2003</td>
<td>43</td>
<td>62</td>
</tr>
<tr>
<td>2006</td>
<td>43</td>
<td>65</td>
</tr>
<tr>
<td>2005</td>
<td>43</td>
<td>65</td>
</tr>
<tr>
<td>2006</td>
<td>41</td>
<td>64</td>
</tr>
<tr>
<td>2007</td>
<td>41</td>
<td>64</td>
</tr>
</tbody>
</table>

Source: HNB

According to the EBRD Business Environment and Enterprise Performance Survey (BEEPS), the quality of the Croatian business environment improved from 1999 to 2002. The improvement in the sector quality of infrastructure was significant (from 1.9 to 1). The level of corruption decreased by 0.9 percentage points and reached value 2, the quality of the judiciary stayed unvaried at 2.4. On the contrary, in the field of regulation the level of obstacles grew from 1.3 to 1.6 (EBRD 2002:42). The BEEPS 2005 shows a statistically significant improvement in the field of regulations and taxes (EBRD 2005). The first one-

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.
stop shop for company registration was established in May 2005, but the inefficiency of the judicial system still caused dissatisfaction in the business community. 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 has stabilization in Croatia 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 achieve a 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 achieving the stability of prices and a mistaken exchange rate level, while all other tasks were left behind. Bićanić (2001:172) argues that the largest failures of the stabilization were the lack of fiscal changes and the 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 economic growth in 1997. (1) a high rate of domestic saving and investment; (2) a thorough restructuring, both on the level of firms and of the state itself; (3) further and 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 investment side, 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 domestic investment represents 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 has stood out among both groups of countries. However, the high level of investments is associated with a low growth rate. Until the bank privatization, which started in 2000 after the financial crisis, the financial intermediary system was almost entirely in state ownership, which explains the inefficiency (Csaba 2007b:46).

60 Domestic saving are important because they allow 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 needs to be adapted (Aghion et al. 2006).
Table 22: Domestic saving and investment in Croatia, selected years, as a percentage of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Domestic saving</th>
<th>Government</th>
<th>Private</th>
<th>Domestic investment</th>
<th>Government</th>
<th>Private</th>
<th>Savings-investment gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>11.6</td>
<td>2.7</td>
<td>8.9</td>
<td>18.4</td>
<td>na</td>
<td>na</td>
<td>-6.8</td>
</tr>
<tr>
<td>1996</td>
<td>19.5</td>
<td>4.9</td>
<td>14.6</td>
<td>23.9</td>
<td>na</td>
<td>na</td>
<td>-4.4</td>
</tr>
<tr>
<td>1997</td>
<td>13.2</td>
<td>3.3</td>
<td>9.9</td>
<td>25.2</td>
<td>na</td>
<td>na</td>
<td>-12.0</td>
</tr>
<tr>
<td>1998</td>
<td>17.6</td>
<td>5.2</td>
<td>12.4</td>
<td>24.7</td>
<td>na</td>
<td>na</td>
<td>-7.1</td>
</tr>
<tr>
<td>1999</td>
<td>18.5</td>
<td>1.4</td>
<td>17.1</td>
<td>24.7</td>
<td>na</td>
<td>na</td>
<td>-6.2</td>
</tr>
<tr>
<td>2000</td>
<td>20.3</td>
<td>-4.0</td>
<td>24.3</td>
<td>24.7</td>
<td>2.5</td>
<td>21.5</td>
<td>-3.7</td>
</tr>
<tr>
<td>2001</td>
<td>20.4</td>
<td>-0.2</td>
<td>20.6</td>
<td>29.3</td>
<td>3.9</td>
<td>25.2</td>
<td>-8.7</td>
</tr>
<tr>
<td>2002</td>
<td>23.8</td>
<td>-0.2</td>
<td>24.0</td>
<td>31.1</td>
<td>5.3</td>
<td>25.8</td>
<td>-7.3</td>
</tr>
<tr>
<td>2003</td>
<td>25.5</td>
<td>0.3</td>
<td>25.2</td>
<td>30.6</td>
<td>4.4</td>
<td>26.2</td>
<td>-5.1</td>
</tr>
<tr>
<td>2004</td>
<td>24.6</td>
<td>0.1</td>
<td>24.5</td>
<td>31.0</td>
<td>3.9</td>
<td>27.1</td>
<td>-6.4</td>
</tr>
<tr>
<td>2005</td>
<td>25.1</td>
<td>1.2</td>
<td>23.8</td>
<td>32.8</td>
<td>3.5</td>
<td>29.3</td>
<td>-7.7</td>
</tr>
</tbody>
</table>


Figure 22: Gross fixed capital formation, as a percentage 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, as did the latest IMF Country Report (2008). Considering the state, further steps are needed in the area of judicial and administrative reform, the 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, which also hampers the efforts to establish 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 a 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, Croatian economic growth increased, while from 2004 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 rapid progress in the above mentioned reforms, the Croatian economy could grow even more slowly in the future because the country has lost the growth “bonus” coming from the transformation. At the same time – depending on the reforms carried out – there is a potential for further improvement. Croatia is not as good a place as it could be.

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

In the absence of tax identification numbers it is impossible to monitor the revenues and taxes paid by both citizens and legal entities, which limits transparency of state finances and creates space for corruption and rent-seeking. The introduction of tax numbers is a criterion established by the EU negotiations and is also an important anti-corruption measure. After several years of preparation on 1 January 2009 the government started the introduction of tax identification numbers for the newborn and newly established legal entities, and by the end of 2010 for other persons (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 constraints 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 growth is hampered by low returns to economic activity or the high cost of finance (Figure 23). The latter i.e., the high cost of finance can be excluded. Croatia has abundant access to international finance as 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 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 on 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 returns on economic activity there may be two factors: low social returns, i.e. low total returns on factor accumulation, or low appropriability i.e., low private returns even

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61 I am grateful to Maruška Vizek (Ekonomski institute Zagreb) who drew my attention to this topic.
if social returns are high. Examining the possibility of low social returns, three factors emerge. The geographical location of Croatia is favourable both in terms of trade and tourism. The infrastructure is also favourable by regional standards (Table 56).

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

![Growth diagnosis tree in Croatia]


The third factor, human capital is one of the explanations for the constraint on growth. The Institute of Public Finance in Zagreb carried out a study in 2004 that had damning 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 is low (Figure 24) which may 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 has been above it. The performance of the labour market failed to keep step with the overall macroeconomic development.

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

In terms 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 eliminates the possibility that market failures in the form of information externalities would be the major problem. The diversification of the export base and innovations measured by new patents are in line with regional (EU new member states) standards. Turning to public sector problems, the public sector is not likely to produce macro risks that obviously constrain growth. Monetary risks are low: the Hrvatska Narodna Banka has successfully maintained low inflation and broad exchange rate stability since the mid-1990’s. The authors argue that despite the high level of public debt, the fiscal stance of the country is not a direct and immediate constraint on 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 least favourable among CEE and SEE counties (Table 23). The World Bank Doing Business Report 2008 ranked Croatia in 107th place, which meant Croatia was just above Albania and Bosnia and Herzegovina among SEE and CEE countries. The report for 2009 ranked the country in 106th place, which represented a one place downgrading in the regional subranking as well. However, in the Doing Business Reports of 2007 and 2008, Croatia can be found among the Top Reformers63. The progress reports of the European Commission mention

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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.
the importance of the fight against corruption. According to the reports, the operation of the courts is insufficient, the procedures are too long and the enforcement of judgements is often obstructed. 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

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


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’s. The governments with reform ambitions (whether the opposition or the HDZ) did not have an easy task, either in the political or the economic field.

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

Based on the above factors, we can conclude that the social, political and economic
circumstances in Croatia are more complicated as a result of the war and the special
form of nationalism linked 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’s is characterised by the personality of Franjo
Tudjman. His personality was more dominant than the HDZ movement, which managed
to change its profile after Tudjman’s death. The approach and personality of Stjepan
Mesić has characterized the 2000’s, but his impact has been somewhat milder than that of
Tudjman’s, partly because the sphere of authority of the president has been weaker since
2000.

The macroeconomic performance shows that the economy of the country integrated
strongly into the EU market, both in terms of trade and FDI flows. Economic integration
has been present since the beginning of their transformation, even though during the
“nationalist” period it was less noticeable. That is, the geographical proximity of the EU
market has had a strong impact on the Croatian economy during both periods.

The pressure from the EU and from other international organizations has had a strong
impact on Croatian policy making, even if at a slower pace than in the CEE countries. The
characteristics of these relations did not change radically with the end of the Tudjman
era. Even since 2000 the EU has used a wide range of political conditionalities 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. A long road was travelled to arrive at this statement. Our
original expectation (i.e. that Croatia would be a frontrunner in Europeanization) was
based on the country’s identity, historical and cultural heritage. These expectations were
based on the deep roots of Croatian identity, and the country’s historical and cultural
heritage. The realization of this expectation seems to be only delayed but not abandoned.
The middle or long term development of the country points towards Europeanization.
Croatia has experienced a detour from the “mainstream” Europeanization path. The
country’s latest intention suggests that the end of the detour is close.

The accession of Romania and Bulgaria in 2007 awoke latent European identity and
desire towards the EU in Croatia. This notion was further enhanced by the failure of the
Lisbon Treaty that shed a special light on what might 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 were promising. However, with the dissolution of Czechoslovakia, Slovakia moved onto a different path to its Czech counterpart and this path did not lead clearly in the direction of Europe. After some years of following this “third” road, the orientation of Slovakia changed dramatically and the country became a Central European success story.

1 The initial conditions: Czechoslovakia

When it was created in 1918, Czechoslovakia consisted of two different parts. Czech and Slovaks came together to fashion a “united state out of their disparate ethnic and historical backgrounds and with totally different economic and educational heritage(s)” (Wallace 1988:9). The two lands had never formed an administrative unity before, although they were both part of the Austro-Hungarian Monarchy. The Czech lands were administrated by the Austrian side of the Monarchy 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, the Slovak language was never officially accepted and Slovakia was never recognised as an administrative unit (OECD 1994:42). Thus the newly established Czechoslovakia had two distinctive regions. The Czech lands inherited the most developed and most industrialized territories of the Monarchy. On the other hand, Slovak industries, which were competitive in the Hungarian context, became unviable and uneconomical under the new circumstances. The ratio of the industrial to the 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’s which was only stopped by the Great Depression of 1929 (Table 24). Production was export-oriented and the trade balance was positive (Table 25) During the 1930’s a structural crisis flared up in Czechoslovakia, but it still 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). In terms of the nature of employment, 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

<table>
<thead>
<tr>
<th>Year</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1913</td>
<td>100</td>
</tr>
<tr>
<td>1920</td>
<td>60</td>
</tr>
<tr>
<td>1924</td>
<td>102</td>
</tr>
<tr>
<td>1929</td>
<td>141</td>
</tr>
<tr>
<td>1933</td>
<td>73</td>
</tr>
<tr>
<td>1937</td>
<td>107</td>
</tr>
</tbody>
</table>

Source: Berend – Ránki 1976:459
Table 25: Czechoslovak foreign trade in million USD and current prices

<table>
<thead>
<tr>
<th>Year</th>
<th>Export</th>
<th>Import</th>
</tr>
</thead>
<tbody>
<tr>
<td>1920</td>
<td>391</td>
<td>332</td>
</tr>
<tr>
<td>1924</td>
<td>839</td>
<td>781</td>
</tr>
<tr>
<td>1929</td>
<td>1027</td>
<td>1001</td>
</tr>
<tr>
<td>1932</td>
<td>370</td>
<td>374</td>
</tr>
<tr>
<td>1937</td>
<td>417</td>
<td>383</td>
</tr>
</tbody>
</table>

Source: Berend – Ránki 1976:496

Hamberger argues that the first common Czech and Slovak state was created in the light of Czech state-formation ambitions and 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 Czech society did not accept that Slovak society was separate and different from Czech society (Hamberger 1997:8-12). The Czech people entered Czechoslovakia with the previous experience of their own statehood and they felt the common state was their own. On the contrary, Slovaks had not had their own statehood previously, which is why they had a different perspective on the issue of statehood (Hamberger 1997:43).

In 1939 under the shadow of German expansion and the pressure of Adolf Hitler, the first independent Slovak state was established in March 1939 under the leadership of Jozef Tiso. The establishment was not the logical 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 relief from the competition of Czech industry and the development following the German demands resulted in industrial prosperity. The German liabilities (including the billeting of German troops) totalled 1 billion Deutschmarks between 1939 and 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 discredited it in the eyes of the international community. The uprising in August 1944 was directed 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 Czechoslovakia in its pre-1938 form. However, the Czech party rejected the idea of a symmetric federal state, partly because the Czech population was twice as large as the Slovak. At the same time, Czech society began to accept the Slovaks as 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 power and destroy all open opposition. The economy was reoriented from the pre-war structure of consumer goods export towards heavy industry. It seemed to be an economic structure that offered stability and secured export markets (EUI 1996:3). In the Slovak area
the heavy industrialization gathered further momentum to add to the development begun under the Tiso regime. 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’s centralization and “Czechoslovakism” intensified (Hamberger 1997:31).

By 1962 the industrial growth had 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 a 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 limitations, 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 had been eroded 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 a 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 to be elected president of Czechoslovakia in May 1975 and held 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 the Czech and Slovak Republics (Žatkuliak 1998:261). Slovak politicians entered 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 also strengthened 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’s and 1970’s. Its industrial production had 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's to around 60% in 1948 and to nearly 80% in 1968. By the early 1970's it was equal to that of the Czechs (World Bank 1991:1).

Czechoslovakia's economic performance over the 1970's and 1980's was relatively good. Per capita income was improving steadily, although the rate of growth slowed down considerably in the second half of the 1980's (Table 26). Both internal and external financial stability was maintained. Open inflation stayed under 2% on average during the 1980's. 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) had 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's, and the gap between the respective average growth rates actually widened during the 1980's. Czechoslovakia's terms of trade deteriorated significantly during the second half of the 1970's, which was partly due to the lagged adjustment of oil prices within the CMEA (Council for Mutual Economic Assistance). These serious economic inefficiencies were felt during the 1980's. Together with adverse external factors, these inefficiencies led to a period of slow growth and then stagnation during the 1980's (World Bank 1991:20-23).

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

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>index</td>
<td>64.2</td>
<td>100.0</td>
<td>114.4</td>
<td>117.2</td>
<td>119.9</td>
<td>124.7</td>
<td>127.0</td>
</tr>
</tbody>
</table>

*Note: data for 1989 is estimation

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 an 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

<table>
<thead>
<tr>
<th>sector</th>
<th>share in total industrial production (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>machine</td>
<td>22.0</td>
</tr>
<tr>
<td>iron metallurgy and nonferrous metals</td>
<td>11.3</td>
</tr>
<tr>
<td>chemicals and rubber</td>
<td>13.5</td>
</tr>
</tbody>
</table>
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 of 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).

Analysing the openness of the country is problematic because of the isolation from world markets. During the 1980’s, 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 Soviet raw materials. Table 29 demonstrates that Czechoslovakia exported a 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 the machine industry in some small European countries around 1980

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of exports in machine industry (%)</th>
<th>Share of imports in machine industry input (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czechoslovakia</td>
<td>28.4</td>
<td>22.3</td>
</tr>
<tr>
<td>Belgium</td>
<td>66.4</td>
<td>70.9</td>
</tr>
</tbody>
</table>
Note: The figure for Czechoslovakia was equal to the average of small Eastern European countries.


Table 29: Czechoslovakia’s export shares by selected sectors and countries, 1986-87

<table>
<thead>
<tr>
<th>Sector</th>
<th>East</th>
<th>West</th>
<th>rest of the world</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USSR</td>
<td>DDR</td>
<td>Hungary</td>
</tr>
<tr>
<td>All sectors</td>
<td>73.0</td>
<td>74.2</td>
<td>70.3</td>
</tr>
<tr>
<td>67 Iron and steel</td>
<td>4.6</td>
<td>6.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Sectors 1 to 66</td>
<td>0.0</td>
<td>10.7</td>
<td>21.4</td>
</tr>
<tr>
<td>Sectors 69 to 77</td>
<td>37.0</td>
<td>44.5</td>
<td>25.6</td>
</tr>
</tbody>
</table>

Note: Based on SITC-2 digit level COMTRAD data in dollars at official exchange rate.


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’s 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 GNP (Table 30), while the hard currency debt of the government was 1% of GDP in 1989 (OECD 1991:14).

Table 30: Foreign debt in Czechoslovakia

<table>
<thead>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt, in million USD</td>
<td>2689</td>
<td>2877</td>
<td>3582</td>
<td>3875</td>
<td>4328</td>
<td>5460</td>
<td>5913</td>
<td>5560</td>
</tr>
<tr>
<td>Total debt stock/GNP (%)</td>
<td>11.7</td>
<td>12.1</td>
<td>12.8</td>
<td>14.2</td>
<td>15.7</td>
<td>18.4</td>
<td>29.7</td>
<td>28.8</td>
</tr>
</tbody>
</table>


65 The table shows all exports representing at least 3% of total trade to one of the zones under consideration. Sectors 1 to 66 include 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, 65 Textile yarn, fabrics and 66 Non-metal minerals. Sectors 69 to 77 include 69 Metal manufactures, 71 Power generating equipment, 72 Machines for specialised industry, 73 Metalworking machinery, 74 General machinery, 75 Office machines and 77 Electric machinery.
To sum up, at the time of the Velvet Revolution in 1989, some of the 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 exist; and hence neither did the legal and institutional base of the market economy. Prices were almost totally controlled and economic activity was concentrated in large companies to an extreme degree. 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, and in 1989 the hard currency debt was 15% of GDP and government debt was 1% of GDP (OECD 1991:11-15). While the other Visegrád countries could rely on earlier reforms, these were 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. 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 economic transformation also resulted in the strengthening of Slovak national identity. Although Václav Havel made all efforts to keep the country together, the two republics could not agree on the form of 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 – i.e. 2:1 - and not on economic performance. This meant an annual 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 a market economy caused much more serious problems in the Slovak part of Czechoslovakia. During the period between 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 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 debate about the future (OECD 1991).

Industrialization had deeper roots in the Czech lands while most of the heavy industry was present in Slovakia. The closing down of the Czechoslovak heavy armament sector was not only a federal decision but also the result of international pressure. Since

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).
two-thirds of the sector was located in Slovakia, in this republic it had serious economic and social consequences. The economic reforms, which were developed on a federal level, affected Slovakia more seriously. The general view considered the market reforms 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. Slovak policy-makers had different views about the method of privatization and they even called for their own central bank and the right to issue money. Václav Klaus, federal finance minister rejected the idea of implementing the same package of reform differently in the two republics, although he recognized the different needs of the regions in 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, but also the average Slovak and Czech 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 political preferences, creating 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 their 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 and came into force on 1 January 1993.

The break-up was a two-step process. 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 the 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 placed above the value of the federation. Hilde goes against the general view that the secession of the Czechoslovak state was a consequence of growing Slovak nationalism. He argues that the Czech standpoint had a similar, if not more significant, role. They considered the Slovak politics as an obstacle to stabilization and economic reforms (Hilde 1999:649). As was described previously, the difference in political views was not a new phenomena but 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 counter-revolution”

After the separation of the Czech and Slovak Federal Republics, Slovakia was considered to be the weaker successor state. The administrative infrastructure of the federal republic existed, and it was not the first time that Slovakia had enjoyed 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 Republics, 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 the HZDS. Vladimír Mečiar became the first prime minister of the independent country. His third government was established in 1994, after winning the third elections to be held since 1989. For the first time, the government was able to remain in office for the full term.

It became clear that Slovakia had left the Czechoslovak transformation path and the promising Central European path of transformation followed by the other three Visegrád countries67 – 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 counter-revolution”. 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 personal over national interests. Slovakia possessed the basics of democracy; democratic institutions were 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 for the fragile democracy was rooted in the divisions among the elites over the subtle issues of national identity and sovereignty, the issues which have dominated Slovak public debate for centuries. The establishment of the independent Slovakia on 1 January 1993 failed to resolve these issues and did not abolish the elite divisions. The nationalist elite sought opportunities in the Slovak government to keep their political power and control over privatization and they appeared to defend national sovereignty against internal and external enemies – as they interpreted them.

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 an alternative elite group claiming power (Szomolanyi 2003:159).

Until the very end of the 1990’s Slovakia was considered an “awkward” case of democratic and market transformation in CEE. The theoretical expectations were not promising for Slovakia. The reasons for the pessimistic trajectories were based on the

67 The Northern Hungarian town of Visegrád hosted the royal summit of the Central European emperors in the 14th century. The modern form 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.
accumulation of less favourable conditions for democratic consolidation and the higher number of tasks that Slovakia had to fulfil. 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 services. The additional challenge of state-building had further complicated the democratization in Slovakia.

Mečiar tended to centralize power in his own hands. 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 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 was able to keep control in his own and his trusted subordinates’ hands. The party had a strong grassroots organization that provided wide support. The overlap among the state, the party and the economy was considerable. The HZDS government increased 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 country’s membership of NATO. The referendum was not free from political conflicts. The vote was supposed to decide whether Slovakia would try to join NATO and whether it would change the way its president is elected. Three questions related to NATO: 1. Do you support Slovakia joining NATO? 2. Do you favour deploying nuclear weapons on Slovak 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 presidential 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 the NATO Summit in Madrid decided not to invite Slovakia to join the Alliance.

The question arises why the democratic conditionality of the EU did not have a vigorous effect on Slovakia as it had on other Visegrád countries. Slovakia differed significantly from the rest of the Visegrád group in terms of the political costs of satisfying EU democratic conditionality. These costs, just as in the 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

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\(^{68}\) The ethno-cultural heterogeneity of the population should not automatically mean unfavourable conditions. However, in case of Slovakia, the presence of minorities (especially the Hungarian) caused social frictions.

\(^{69}\) 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 hands. The HZDS managed to reach a high level in both areas.
dependent on the willingness of the 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).

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 support Czechoslovakia, Hungary and Poland’s political and economic transformation. The Association Agreement (known as the 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 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 held meetings once a year. The Association Committee was formed in a similar way to the Council itself. The Association Parliamentary Committee was composed of members of the European Parliament and the Slovak parliament, including the opposition.

In 1993 Slovakia also joined other international organizations such as 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 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 positive, i.e. it was less problematic to identify where democratic norms were lacking compared to where they appeared to have firm roots (Rybář 2005:85).

The government program of January 1995 stated that EU-membership was one of the foreign policy priorities of Slovakia and underlined the commitment to full 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 as 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 for 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 was 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 the 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 also have caused difficulties for the existing customs union between the two republics because the EU could not allow such an arrangement between a member and a non-member state70 (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 of an improvement in 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 was 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 an opportunity for EU-influence. The Association Council served as a forum where the EU representatives tried to influence their Slovak counterparts to adopt the EU principles concerning 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 would be respected and the legislation on the use of minority languages enacted71. In April of the following year the EU representatives emphasized that concrete steps at improving

70 Another example of possible Czech and Slovak 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.
71 Sme, February 26 1997
the situation in Slovakia needed to be taken before the Slovak aspirations for integration could be fulfilled\textsuperscript{72}. Their Slovak counterparts could not agree and stated that the EU opinions were based on biased sources\textsuperscript{73}. The Association had more frequent meetings and adopted critical resolutions more frequently. The composition of the Slovak delegation (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 result in recognition of the 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 to other countries of Central and Eastern Europe (Rybář 2005:84-90). Regarding the respect for democratic norms, the distance between the government and the European Union was progressively increasing between 1994 and 1998. Samson (1999) argues that state-building was an easier task for Slovakia than that of European integration. The former did not have any external obstacles, 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, involving 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 over 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 respect for plurality in political opinions, for the constitution and for Slovakia’s international obligations (Rybář 2005:86-90).

It was a fairly common practice among applicant countries that they had patrons among the member states. Slovakia lacked this kind of inside sponsorship. Its case was complicated because previously foreign affairs with the member states were conducted by Prague; therefore Bratislava had to develop these bilateral relations from scratch. Germany and its Ostpolitik were particularly important in supporting the applicants from CEE. Slovakia had a rather uneasy start with Bonn due to various mutual misunderstandings and some diplomatic blunders on the Slovak side.\textsuperscript{30}. Some EU member states even functioned as reverse-patrons (the UK and the Netherlands as well as Germany) because of their critical views on Slovak affairs. The various demarches were initiated by leading Western politicians worried about the growing executive power in Slovak politics, the attempts to undermine parliamentary control and the opposition parties, assaults on the independent media and discrimination against the Hungarian minority in official matters (Pridham 2002: 211-213).

\textsuperscript{72} Pravda, April 29 1998
\textsuperscript{73} Sme, March 19 1998
\textsuperscript{74} Chancellor Helmut Kohl had a personalised approach to European policy making and he did not get on with Vladimír Mečiar. However, beyond Kohl’s personal animosity, his own democratic sensitivity was also offended by internal developments in Slovakia (Interview with Pavol Hamžík, cited by Pridham 2003:226.)
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 independence has always been highly divisive both among the elite and the population as a whole. In 1993 when the dream of independent statehood was realised, the split within society, concerning national identity, ethnic questions, and economic transformation was significant (Szomolanyi 2003:153-156).

One fundamental characteristic of Slovak national identity has been the way it has defined itself against primarily Hungarian, and also Czech identity, since both Hungarian and Czech politics rejected the existence of an independent ethnic Slovak nation. As a consequence a complex of inferiority and an overvaluation of Slovak values and status developed.

The Slovak national identity was developed in the framework of being part of the Western Slavs, and strongly attracted to the Eastern Slav area as well. In other words Slovak national identity balanced between Western Europe and Eastern Europe, which had a serious impact on the integration policy of the young state as well (Hamberger 2003:345-363). Mečiar conceived of Slovakia as a bridge between West and East. The government tried to have a good relationship with Moscow, which questioned the redirection of external policy towards Western Europe. Mečiar was not familiar with Western foreign languages but was good at Russian. He appeared regularly in Brussels and Strasbourg but he had difficulties in the subtleties of diplomacy. The absence of engagement with Western representatives was apparent even with top officials in the Mečiar government. The foreign affairs ministry suffered from its small size and lack of experienced staff, problems exacerbated 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 a 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 aim was principally short-term. The government considered European affairs from the point of view domestic politics. In order not to lose political control over the economy through 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.

The reactions varied from a partial denial of the problem, through the misunderstanding of the Slovak position, to accusations of intervention in

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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 for 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.

internal affairs. In autumn 1995 EU ambassadors handed Mečiar an EU demarche and his answer was that he ran “a sovereign country”, and thus did not care about the EU protest\textsuperscript{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 public feeling, in 1995 November the Central and Eastern Eurobarometer (CEEB 6) reported that in most of the Europe Agreement countries positive impressions of the European Union outnumbered negative ones, but in Slovakia (together with other three countries) a more neutral view predominated.

The CEEB 8 from 1997 reported that 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 Slovaks 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 a 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 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 rapid economic growth from 1994 which 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. Only in 1994 was growth led by exports\textsuperscript{78}, while in 1995 and 1996 it was mainly driven by domestic demand (OECD 1999:26). From 1997 the Slovakian growth rate decreased to below the CEE average and stayed there until 2006 when GDP grew by 8.3\%. The economic slowdown was a result of governmental efforts to slow down investment and consumption, aiming at lower imports and reducing the trade and current account deficits (Commission 1999c:20).

The increase in employment and real wages underpinned 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 several ways: for 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).

\textsuperscript{77} Interview with Petr Greger, EU delegation to the Czech Republic, Prague, March 2000, cited by Pridham 2003:226.

\textsuperscript{78} The revival of Western European economies created an opportunity for export-led growth.
The economic profile of Slovakia was characterized by the dominance of heavy industry, especially armaments. Czechoslovakia was the second largest weapons producer of the Warsaw Pact and the Slovak side provided 65% of this capacity with 80,000 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 decline was inevitable. The transformation of the defence industry came at a high price (Kiss 2005). However, the sectoral structure of the Slovakian economy had changed considerably since the beginning of the 1990’s. 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 GDP compared to 34% in 1991.

After 1989 the trade between Czechoslovakia and the EC began to increase as the direction of trade of all CEE countries turned to the 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 imports and 42% in exports in 1993. The two new countries formed a customs union with common external tariffs, but without free movement of goods coming from third countries. The EU share increased steadily during these 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 Slovak exports were 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: Slovakia’s import and export partners, by main trading groups/countries in, as a percentage of the total\textsuperscript{79}

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1995</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Imports</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU</td>
<td>20.6</td>
<td>34.8</td>
<td>51.7</td>
</tr>
<tr>
<td>CEFTA</td>
<td>39.3</td>
<td>33.1</td>
<td>23.4</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>19.5</td>
<td>16.6</td>
<td>12.0</td>
</tr>
<tr>
<td><strong>Export</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU</td>
<td>24.1</td>
<td>37.4</td>
<td>59.4</td>
</tr>
<tr>
<td>CEFTA</td>
<td>49.8</td>
<td>44.3</td>
<td>29.8</td>
</tr>
</tbody>
</table>

Source: IMF, WTO and European Commission

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

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USD</td>
<td>%</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td>Import</td>
<td>Export</td>
<td>Import</td>
</tr>
<tr>
<td>Agricultural products</td>
<td>723</td>
<td>11%</td>
<td>551</td>
</tr>
<tr>
<td>Food</td>
<td>580</td>
<td>9%</td>
<td>364</td>
</tr>
<tr>
<td>Fuels and mining products</td>
<td>1555</td>
<td>25%</td>
<td>457</td>
</tr>
<tr>
<td>Fuels</td>
<td>1322</td>
<td>21%</td>
<td>na</td>
</tr>
<tr>
<td>Manufactures</td>
<td>4038</td>
<td>64%</td>
<td>4449</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>na</td>
<td>na</td>
<td>888</td>
</tr>
<tr>
<td>Chemicals</td>
<td>719</td>
<td>11%</td>
<td>0%</td>
</tr>
<tr>
<td>Machinery and transport equipment</td>
<td>1850</td>
<td>29%</td>
<td>1058</td>
</tr>
<tr>
<td>Office and telecom equipment</td>
<td>337</td>
<td>5%</td>
<td>73</td>
</tr>
<tr>
<td>Automotive products</td>
<td>267</td>
<td>4%</td>
<td>221</td>
</tr>
<tr>
<td>Textiles</td>
<td>179</td>
<td>3%</td>
<td>268</td>
</tr>
<tr>
<td>Clothing</td>
<td>92</td>
<td>2%</td>
<td>198</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>6313</td>
<td>5457</td>
<td>9440</td>
</tr>
</tbody>
</table>

Source: WTO Statistic Database, own calculations

\textsuperscript{79} Note: Until 2001 the EU means the EU-15, in 2005 it means the EU-25. The Central European Free Trade Association (CEFTA) here includes Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. Trade with Romania is not included.
Slovakia had been a very open economy and the country was strongly dependent on the external sector. Both consumers and investors had a large demand for imported goods and required a strong export sector as well.

The import growth rate exceeded exports in 1995 and in 1996 the deficit exceeded even the CEE average (Figure 26). Although in the next two years exports 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 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**

**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 had been 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 from the government, in spite of government proposals to limit it (EUI 1998 and 1999). From May 1997 the koruna faced significant selling pressure because of the large current account deficit. After an expensive defence action the NBS decided to allow the koruna to 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. Indebtedness increased steadily but the external debt per GDP ratio stayed under the peer country average until the middle of the 1990’s. However, between 1993 and 1998 the external debt doubled relative to 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 such as highway construction and other infrastructure projects (EUI 1999:18).

The capital movement liberalization process started on 1 February 1995 when direct investments in European Union member countries were liberalized. FDI flows were small compared to peer countries during the 1990’s, the net stock of FDI stayed under the CEE average during the decade (Figure 29). Foreign investors had a cautious approach towards the country; they had no confidence in the commitment of the authorities towards 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 to allowing foreign participation in the privatization process; in most cases foreigners were excluded (OECD 1996, Commission 1997b). The openness of the country (which was also realized on the trade side) contradicted with the approach towards foreign investors, i.e., that the authorities had a 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 were established in Slovakia (EBRD 1998).

The external debt also rose, 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 direct investments in European Union member countries were liberalized. FDI flows were small...
compared to peer countries during the 1990’s, the net stock of FDI stayed under the CEE average during the decade (Figure 29). Foreign investors had a cautious approach towards the country; they had no confidence in the commitment of the authorities towards 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 to allowing foreign participation in the privatization process; in most cases foreigners were excluded (OECD 1996, Commission 1997b). The openness of the country (which was also realized on the trade side) contradicted with the approach towards foreign investors, i.e., that the authorities had a 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 were established in Slovakia (EBRD 1998).

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

![Figure 29: Net foreign direct investment, in millions of USD](image)

*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% respectively of total FDI stock in 1993. The EU altogether possessed around three-fourths of the FDI stock (Table 33).

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

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1995</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USD</td>
<td>%</td>
<td>USD</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>91.8</td>
<td>7.4</td>
<td>312.3</td>
</tr>
<tr>
<td>Germany</td>
<td>292.2</td>
<td>23.4</td>
<td>431.6</td>
</tr>
</tbody>
</table>
A very large proportion 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

<table>
<thead>
<tr>
<th>Sector</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>69.6</td>
</tr>
<tr>
<td>Construction</td>
<td>1.1</td>
</tr>
<tr>
<td>Wholesale and retail trade, repairs of motor vehicles</td>
<td>15.4</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>-0.2</td>
</tr>
<tr>
<td>Transport, storage, post and telecommunications</td>
<td>2.4</td>
</tr>
<tr>
<td>Financial intermediation</td>
<td>8.4</td>
</tr>
<tr>
<td>Real estate, renting and business activities</td>
<td>3.5</td>
</tr>
<tr>
<td>Other community, social, and personal services</td>
<td>-0.2</td>
</tr>
</tbody>
</table>

Source: National Bank of Slovakia, Monetary Surveys

Along with the transformation of Slovakia, unemployment rose quickly to 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 were accompanied by mandatory conditions on the maintenance of employment levels (EUI 1998:17). As a consequence, Slovak employment levels changed less drastically than the average of the CEE countries (Figure 31).
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 was 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 a lesser extent through direct sales. From 1993 the pace of large-scale privatization slowed down, however, in the EBRD 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 the introduction of direct sales reflected the desire of the Slovak authorities to sell property to knowledgeable owners who would take a strategic interest in the companies under their control. In the 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 carried some risk, because Slovakia lacked business experience and skills (OECD 1996:59-62). At the same time, direct sales provided some positive potential as well, since local managers and owners know the company and its environment very well (OECD 1999:108).

In 1994 15 out of the top 20 companies in Slovakia were owned by the state or the National Property Fund or were declared to be of strategic interest with the state owning 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 still played a dominant role in several sectors of the economy. Among private enterprises the proportion of foreign ownership was under 10% and of mixed ownership was around 10%. The share of the private sector in GDP had already reached the CEE average in 1993 and the Visegrád countries average in 1996 (Table 57).

In 1989 in Czechoslovakia 90% of 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 non-existent. 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 peer countries. However, after 1989 the number and importance of SMEs and private entrepreneurs grew quickly. By the end of 1994, SMEs accounted for 35% of gross output in the industrial sector; and together with the self-employed, they represented around 40% of total employment. By this time Slovakia earned level 4 in the 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. The OECD suggested in its 1998-1999 Survey, that the level of transparency of the privatization process was still not satisfactory (OECD 1999:101). In the 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 downgraded to level 2.67.
In the communist regime’s 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. The Československá obchodní banka (ČSOB, Czechoslovak Trade Bank) handled foreign exchange transactions in both republics. The two-tier banking system was created in 1990 when the SBCS became the exclusive bank and the regulator of the banking system. The commercial functions were transferred to newly created banks – the Všeobecná úverová banka (VÚB, General Credit Bank) in the Slovak Republic and the Investičná banka (IB, Investment Bank) in both republics. The saving bank (later Slovenská sporiteľňa, SLSP, Slovak Savings Bank) and the ČSOB became universal commercial banks and entry was liberalized. A state owned Konsolidačná banka (KBB, Consolidation Bank) was established in 1991 (and later separated into Czech and Slovak successors) to take over special credits that were issued for inventory financing and carried low interest rates. These credits consisted of 20% credits to enterprises and accounted for 11% of GDP. The KBB was the instrument for bank recapitalization and later took part in enterprise restructuring by purchasing the debts of enterprises in bankruptcy proceedings. During 1991 a second phase of recapitalization occurred in October, equivalent to 5% of GDP (EBRD 1995:57,158).

The National Bank of Slovakia was established as a successor to the SBCS in January 1993. In 1993 foreign banks entered the market of the newly independent Slovak Republic and soon there were 13 foreign-owned banks out of 28 (EBRD 1995). Through coupon privatization 49% of the equity of the VÚB and 66% of the Investičná a rozvojová banka (IRB, Investment and Development Bank, which assumed Slovakia’s share of IB’s assets) were transferred to the 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, state ownership remained significant. Foreign ownership stood at only 23.7% in 1998 in spite of the relatively large number of foreign owned banks (Table 35).

The three large banks endured losses from 1996, because most of the bad loans were on their books. At the end of December 1997 the IRB had to be placed under conservatorship because of financial difficulties. The three large banks owned 70% of the total lost claims of the banking system. The amount of bad debt seemed to be manageable, although it increased significantly between 1993 and 1998 (Table 36).

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

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<tbody>
<tr>
<td>Slovakia</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>28 /13</td>
<td>29 /14</td>
<td>33 /18</td>
<td>29 /14</td>
<td>29 /13</td>
<td>27 /10</td>
</tr>
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Source: EBRD Structural and institutional change indicators
Table 36: Selected indicators of the banking system, 1993-1998

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<tr>
<td>Asset share of state-owned banks (in percent)</td>
<td>70.7</td>
<td>66.9</td>
<td>61.2</td>
<td>54.2</td>
<td>48.7</td>
<td>50.0</td>
</tr>
<tr>
<td>Asset share of foreign-owned banks (in percent)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>12.7</td>
<td>19.3</td>
<td>23.7</td>
</tr>
<tr>
<td>Non-performing loans (as a percentage of total loans)</td>
<td>12.2</td>
<td>30.3</td>
<td>41.3</td>
<td>31.8</td>
<td>33.4</td>
<td>44.3</td>
</tr>
</tbody>
</table>

Source: EBRD Structural and institutional change indicators

Concerning the EBRD banking sector reform index (Table 58), Slovakia reached a level of 2.67 - among the leading group - in 1992, but stayed at the same level until 1999, thus falling to last place in the CEE group.

2.6 Conclusion

Pridham (2002:214) concludes that in the Mečiar era EU-influence was limited. The demarches had little impact on the Slovak government; moreover they often even had a 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 civil society to defend 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, they became more repellent in the eyes of the voters.

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

When marking the Mečiar regime as isolated and unaffected by pressure from Brussels, this does not mean that the pressure had no effect at all. First, the government showed a certain defensiveness in response to EU criticisms. From this point of view, the effect of democratic conditionality on the state was rather negative, but not insignificant. Second, at the level of civil 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 legacies of the Mečiar regime were large fiscal and current account deficits, increasing pressure on the fixed exchange rate regime and the subsequent floating of the currency, and delays in enterprise and financial restructuring. The high public infrastructure investment, extra-budgetary spending and borrowing led to an overheated economy with a twin deficit problem. The large regional disparities were another crucial task to deal with. The GDP per capita in PPP terms in the Bratislava region was around the EU average, while the Eastern rural areas possessed only one third the capital level. The disparity was rooted in several factors such as a high rate of unemployment, insufficient
infrastructure and an uneven allocation of investments within the country (OECD 1999:9-23; EBRD 1999:262-263).

The 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 on the part of political elite (at that time in opposition) and the people.

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

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

Both the internal and external expectations towards the new government were huge, because the new government could provide answers to such questions as whether the foreign policy orientation would face East or West; whether the rule of law would prevail 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 from 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 it possible for the left-right coalition to stay in power for the full term.

The government operated under pressure from several sides. First, there was 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 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 to pass constitutional legislation in accordance with EU requirements. However, apart from this common line, it was not easy to manage the coalition and internal tensions sometimes made Brussels worried (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 regarding minority rights. Ethnic Hungarians entered government for the first time since Slovakia’s independence, and Pál Csáky, a member of the SMK became

\(^80\) The Christian-Democratic Movement, Democratic Union, Democratic Party, Social Democratic Party of Slovakia and Green Party of Slovakia, respectively
the deputy 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 nationalist authoritarianism represented by Vladimír Mečiar and the re-election of Mikuláš Dzurinda’s center-right coalition was considered an important indication of democratic consolidation (Krause 2003:65). Dzurinda was among the few politicians in the CEE who was re-elected. The participation rate was less than in 1998 (70%, as compared to 84%) and fewer parties entered 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 high enough to be valid. Therefore the reform process could be continued. The political consensus proved to be strong enough and popular enough for the reforms to be accepted.

The parliamentary elections in 2006 came early (in June) because the ruling coalition struggled with growing disunity and a strong opposition. Some elements of the reform program created deep unpopularity, which provided an opportunity for the opposition to conduct 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 had 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 to suspend the membership of the Smer-SD because of its coalition with 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 the KDH (Christian-Democratic Movement), which was a member of the parliamentary group (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 concerned 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 halt some large privatization programs and keep its ownership in strategic companies. The suspension disappointed foreign investors whose offers had been approved. The lost privatization revenues reached 3.5% of GDP. Some reforms of the previous government regarding the health care sector and
the labour market were rescinded. Despite these steps, the government did not endanger overall public finances. The government also aimed to win back foreign investors’ 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 reduced 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). The GDP growth rate reached 10.4% in 2007, which 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 were long-term (EUI 2008:3).

According to the EUI country profile (2007:8), the change of government had no impact on the functioning of the country’s institutions. Key institutional leaders and lower-ranking bureaucrats were gradually replaced, which is in line with the usual political practice in a 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 political weaknesses, and 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 had 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 was allowed to function.

The second Regular Report (Commission 1999b) concluded major changes had occurred compared to the previous year since it stated that Slovakia had 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 had 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 the 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 from scratch. In February 1999 an Action Plan for intensifying Slovakia’s integration was accepted. An
EU delegation to Bratislava in June pronounced that the country would hopefully receive a delayed invitation to the first EU enlargement round and would join the other Visegrád 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 predictable because the second Regular Report expressed an appreciative opinion regarding the development of Slovakia. It soon became clear 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 had begun 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 had 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 had 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 relating to political conditions and complicated negotiation chapters were under control (Pridham (2003:219-220). At the same time, the government had to prove its commitment again and again in order to dissolve doubts in Brussels.

The fourth Regular Report (Commission 2001b) stated that Slovakia continued to fulfil the Copenhagen political criteria and the country had 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 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 developments 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
had 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 on the big bang enlargement so that the European Union completed accession negotiations by the end of 2002 with the candidate countries that were ready for 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 Parliamentary 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 a considerably improved macroeconomic performance, although some imbalances remained significant. In field of the reform path, also in the public finance area, the Report detected a 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. Among their first tasks of the new Prime Minister Dzurinda and other cabinet members was to visit Brussels and other Western European countries and open up a high political level dialogue that had been missing previously. The aim was to get Slovakia in a similar position to 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 establishing 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 had gone.

### 3.4 Building a fully fledged market economy

At the time when the Dzurinda government appeared, the Slovak economy stood at a turning point because the previous growth path had reached its limits. The required reforms were not only important in order to move onto a sustainable growth path but also in order to improve the image of the country.

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The reform package had three pillars: macroeconomic 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 to economic challenges was further complicated by coalition disputes because the governing parties had different approaches. To find effective stabilizing measures that would be acceptable for every party within the 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 investors’ confidence (OECD 1999:14).

The new government introduced the stabilization program in December 1998. It cut public spending and raised revenues: froze 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 Slovaks who had been educated abroad and then 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 endorsed them. Ivan Mikloš was present 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 managed to push through several contentious 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 the lack of transparency 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 for the year 2000 (Mathernová–Renčko 2006:634).

There was a critical mass of enterprises that had already been 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 in order to improve the efficiency of bankruptcy that had not been 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 in instalments. The government decided to re-privatize the Nafta Gbely oil and gas storage company because it had been 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 to that date. In 2000 U.S. Steel took over the core business of 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 allow the state to lower its stake in strategic enterprises below 51% was amended at the end of 2003, opening the way for further privatization. In 2005 Austrian Airlines increased its share in Slovenské Aerolínie. By 2006 a 66% stake in the main electricity generator Slovenské elektrárne had been sold to the Italian company ENEL (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 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 the bankruptcy law of 2000, the banking law of 2001, the commercial code amendments, the investment funds law, financial market regulation and labour market legislation of 2002, and the energy market liberalization of 2003.

As a result of the large-scale privatization projects, the share of the private sector in GDP reached 80% in 2000 according to the EBRD indicator (Table 57). Interestingly enough, the further privatizations of the 2000's were not reflected in the share of the private sector in the GDP rate.

The legal and institutional changes aimed – among other things – 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 telecommunications. An independent financial market regulator was established. More large companies were sold to strategic investors in 2000 as well.

In the next year – 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, the 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 for 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 already taken, Slovakia had still the highest unemployment (about 40%) among low skilled and the lowest employment rate (about 20%) among the 55 and 64 year-old population in the OECD area. The long-term unemployment among the Roma minority was extremely high. The new labour market law came into force in 2003, which was 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 was 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 split up.

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 practitioners and specialists. In 2004 the government paid 0.8% of GDP for the health sector debt.

The pension-reform was aimed at enhancing the connection between contributions and benefits of the pay-as-you-go system that is, it 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 had been previously expected. The revenues from the partial privatization of the gas utility Slovenský plynárens ký 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 to introduce a flat tax rate on personal income. This measure represented a shift from direct to indirect taxation. Many tax exemptions were eliminated while some forms of taxes were also abolished, for example real estate transfer, gift and inheritance taxes. The double taxation of income (e.g. the tax on dividends) was eliminated as well. The government predicted that the balance of the tax reform would be revenue-neutral. 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 of 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 the IRB and Banka Slovakia in 1999, and the VÚB and part of 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 konsolídačná (consolidation agency) and the KBB, in charge of the bad loans of the three large banks and increased their capital by 18.9 billion SKK (EBRD 2000:207). The privatization plans of the government had been completed (Table 37). By May 2006 foreign ownership was above 90% in the banking sector (Figure 32), the second largest proportion in CEE and a rather dramatic change from about 10% in 1998. The foreign ownership was spread relatively evenly over the number of foreign banks (EBRD 2006:28). The majority (over 90%) of the foreign owners came from the EU, considering the number of foreign owned banks; Austria and the United Kingdom were the largest investors as of 30 June 2005 (NBS 2005).

Concerning the EBRD banking sector reform index (Table 58), Slovakia had caught up with peer countries in the field of bank sector reforms by 2000.
Table 37: Bank privatizations in Slovakia

<table>
<thead>
<tr>
<th>Name</th>
<th>Share</th>
<th>Purchaser</th>
<th>Purchase Price (in SKK)</th>
<th>Signing Date</th>
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<tr>
<td>Slovenská sporiteľňa a.s.</td>
<td>87.18%</td>
<td>Erste Bank der Oest. Sparkassen AG, Austria</td>
<td>18 530 000 000</td>
<td>11.01.2001</td>
</tr>
<tr>
<td>VÚB a.s.</td>
<td>15.96%</td>
<td>Slovenská konsolidačná, a.s.</td>
<td>1 303 134 990</td>
<td>09.02.2001</td>
</tr>
<tr>
<td>VÚB a.s.</td>
<td>68.58%</td>
<td>Comit Holding International S.A., Luxembourg</td>
<td>17 006 187 000</td>
<td>04.07.2001</td>
</tr>
<tr>
<td>Investičná a rozvojová banka a.s.</td>
<td>69.56%</td>
<td>OTP Bank Rt., Hungary</td>
<td>526 115 000</td>
<td>07.12.2001</td>
</tr>
<tr>
<td>Slovenská sporiteľňa a.s.</td>
<td>10.00%</td>
<td>Erste Bank der Oest. Sparkassen AG, Austria</td>
<td>2 888 280 000</td>
<td>15.04.2004</td>
</tr>
<tr>
<td>Banka Slovakia, a.s.</td>
<td>60.03%</td>
<td>Meinl Bank AG, Austria</td>
<td>360 000 000</td>
<td>05.05.2003</td>
</tr>
</tbody>
</table>

Source: National Property Fund of the Slovak Republic (Fond národného majetku, FNM)

Figure 32: Asset share of state-owned banks, as a percentage, 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 time limits for benefits 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 problems. The task for the government was to make participation more attractive and cut social benefits, and at the same time to reduce the tax wedge by cutting labour costs. The combined contribution rate to finance social insurance exceeded 50% of gross wages - 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 in order to reach cost recovery level.

According to the EBRD Business Environment and Enterprise Performance Survey (BEEPS), the quality of the Slovakian business environment had improved from 1999 to 2002 considering five aspects out of seven. The improvement of the quality of infrastructure was significant (from 1.9 to 1); there were 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).

Several large automobile manufacturing companies started new investments in 2003 and 2004, highlighting the improvements in the country’s business environment. According 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 demonstrated considerable improvement concerning all the factors of the business environment, 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 in 37th place, while the Report for 2009 in 36th place. In both years Slovakia earned 4th place among SEE and CEE countries; only the Baltic states have more favourable business environments (Table 38).

Table 38: Rankings on the ease of doing business in CEE and SEE countries, 2007 and 2008

<table>
<thead>
<tr>
<th>Regional subrank</th>
<th>Country</th>
<th>Rank in 2008</th>
<th>Country</th>
<th>Rank in 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Estonia</td>
<td>18</td>
<td>Estonia</td>
<td>22</td>
</tr>
<tr>
<td>2.</td>
<td>Latvia</td>
<td>26</td>
<td>Lithuania</td>
<td>28</td>
</tr>
<tr>
<td>3.</td>
<td>Lithuania</td>
<td>28</td>
<td>Latvia</td>
<td>29</td>
</tr>
<tr>
<td>4.</td>
<td>Slovakia</td>
<td>37</td>
<td>Slovakia</td>
<td>36</td>
</tr>
<tr>
<td>5.</td>
<td>Bulgaria</td>
<td>44</td>
<td>Hungary</td>
<td>41</td>
</tr>
<tr>
<td>6.</td>
<td>Romania</td>
<td>47</td>
<td>Bulgaria</td>
<td>46</td>
</tr>
<tr>
<td>7.</td>
<td>Hungary</td>
<td>50</td>
<td>Romania</td>
<td>47</td>
</tr>
<tr>
<td>8.</td>
<td>Slovenia</td>
<td>64</td>
<td>Slovenia</td>
<td>54</td>
</tr>
<tr>
<td>9.</td>
<td>Czech Republic</td>
<td>65</td>
<td>Macedonia FRY</td>
<td>71</td>
</tr>
<tr>
<td>10.</td>
<td>Poland</td>
<td>72</td>
<td>Czech Republic</td>
<td>75</td>
</tr>
<tr>
<td>11.</td>
<td>Macedonia FRY</td>
<td>79</td>
<td>Poland</td>
<td>76</td>
</tr>
<tr>
<td>12.</td>
<td>Montenegro</td>
<td>84</td>
<td>Albania</td>
<td>86</td>
</tr>
<tr>
<td>13.</td>
<td>Serbia</td>
<td>91</td>
<td>Montenegro</td>
<td>90</td>
</tr>
<tr>
<td>14.</td>
<td>Croatia</td>
<td>107</td>
<td>Serbia</td>
<td>94</td>
</tr>
</tbody>
</table>

82 In BEEPS the values range from 1 to 4, where 1 indicates no obstacles to business growth and operation, and 4 indicates major obstacles.
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.
As a result of the Dzurinda reform agenda, the level of public expenditure (Table 39) decreased 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 is closer to the level of Baltic and South Eastern European member states than the other Visegrád countries.

Table 39: Total general government expenditure as a percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxembourg</td>
<td>43.9</td>
<td>45.7</td>
<td>45.5</td>
<td>44.5</td>
<td>39.7</td>
<td>41.1</td>
<td>40.7</td>
<td>41.1</td>
<td>39.2</td>
<td>37.6</td>
<td>38.1</td>
<td>41.5</td>
<td>41.9</td>
<td>42.5</td>
<td>41.8</td>
<td>39.0</td>
<td>37.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>26.8</td>
<td>24.7</td>
<td>35.1</td>
<td>38.5</td>
<td>38.9</td>
<td>37.0</td>
<td>36.2</td>
<td>40.6</td>
<td>41.8</td>
<td>37.3</td>
<td>34.6</td>
<td>35.6</td>
<td>34.8</td>
<td>35.8</td>
<td>35.6</td>
<td>37.2</td>
<td>38.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>43.4</td>
<td>45.5</td>
<td>45.6</td>
<td>45.0</td>
<td>44.5</td>
<td>42.9</td>
<td>41.3</td>
<td>40.2</td>
<td>39.6</td>
<td>39.8</td>
<td>40.7</td>
<td>41.8</td>
<td>42.9</td>
<td>43.3</td>
<td>44.5</td>
<td>44.6</td>
<td>43.7</td>
</tr>
<tr>
<td>Germany</td>
<td>46.3</td>
<td>47.2</td>
<td>48.2</td>
<td>47.9</td>
<td>54.8</td>
<td>49.3</td>
<td>48.4</td>
<td>48.0</td>
<td>48.1</td>
<td>45.1</td>
<td>47.6</td>
<td>48.1</td>
<td>48.5</td>
<td>47.1</td>
<td>46.9</td>
<td>45.4</td>
<td>43.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>54.9</td>
<td>55.7</td>
<td>55.7</td>
<td>53.5</td>
<td>56.4</td>
<td>49.4</td>
<td>47.5</td>
<td>46.7</td>
<td>46.0</td>
<td>44.2</td>
<td>45.4</td>
<td>46.2</td>
<td>47.1</td>
<td>46.1</td>
<td>45.2</td>
<td>46.1</td>
<td>45.9</td>
</tr>
<tr>
<td>Finland</td>
<td>56.7</td>
<td>62.3</td>
<td>64.7</td>
<td>63.9</td>
<td>61.6</td>
<td>60.0</td>
<td>56.2</td>
<td>52.5</td>
<td>51.5</td>
<td>48.3</td>
<td>47.7</td>
<td>48.8</td>
<td>50.0</td>
<td>50.2</td>
<td>50.5</td>
<td>48.8</td>
<td>47.5</td>
</tr>
<tr>
<td>Croatia</td>
<td>38.9</td>
<td>37.3</td>
<td>25.3</td>
<td>48.9</td>
<td>45.3</td>
<td>44.4</td>
<td>54.6</td>
<td>56.6</td>
<td>52.7</td>
<td>50.7</td>
<td>50.8</td>
<td>51.3</td>
<td>49.7</td>
<td>48.5</td>
<td>47.7</td>
<td>47.6</td>
<td>47.6</td>
</tr>
<tr>
<td>Austria</td>
<td>52.4</td>
<td>52.9</td>
<td>56.0</td>
<td>55.5</td>
<td>56.0</td>
<td>55.4</td>
<td>53.1</td>
<td>53.4</td>
<td>53.2</td>
<td>51.4</td>
<td>50.8</td>
<td>50.7</td>
<td>51.1</td>
<td>50.2</td>
<td>49.9</td>
<td>49.3</td>
<td>48.2</td>
</tr>
</tbody>
</table>
3.4.2 The macroeconomic performance of the Dzurinda governments

As a result of the stabilization policies, Slovakia was able to avoid 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 was equal to the 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’s and since 2000 at 4%. The sectoral breakdown of the Slovakian economy has not changed during the 2000’s.

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 led 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 an estimation; data for 2009 is a projection
Source: EBRD Selected economic indicators
The share of the EU in Slovakia’s foreign trade grew significantly from 1998 and reached 63% of imports and 85.4% of 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 joined the 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 a percentage of the total

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1995</th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imports</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU</td>
<td>20.6</td>
<td>34.8</td>
<td>51.7</td>
<td>49.8</td>
<td>51.2</td>
<td>63.0</td>
<td>61.1</td>
</tr>
<tr>
<td>CEFTA</td>
<td>39.3</td>
<td>33.1</td>
<td>23.4</td>
<td>22.6</td>
<td>23.5</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>19.5</td>
<td>16.6</td>
<td>12.0</td>
<td>14.8</td>
<td>12.5</td>
<td>10.7</td>
<td>9.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1995</th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU</td>
<td>24.1</td>
<td>37.4</td>
<td>59.4</td>
<td>59.9</td>
<td>60.7</td>
<td>85.4</td>
<td>86.7</td>
</tr>
<tr>
<td>CEFTA</td>
<td>49.8</td>
<td>44.3</td>
<td>29.8</td>
<td>30.0</td>
<td>25.3</td>
<td>na</td>
<td>na</td>
</tr>
</tbody>
</table>

Source: IMF, WTO and European Commission

Table 41: Structure of Slovakian foreign trade, breakdown by commodity group, millions of USD at current prices and as a percentage of the total

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2003</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USD</td>
<td>%</td>
<td>USD</td>
</tr>
<tr>
<td>Import</td>
<td></td>
<td></td>
<td>Export</td>
</tr>
<tr>
<td>Agricultural products</td>
<td>927</td>
<td>8%</td>
<td>652</td>
</tr>
<tr>
<td>Food</td>
<td>732</td>
<td>7%</td>
<td>402</td>
</tr>
<tr>
<td>Fuels and mining products</td>
<td>1814</td>
<td>16%</td>
<td>840</td>
</tr>
<tr>
<td>Fuels</td>
<td>1440</td>
<td>13%</td>
<td>478</td>
</tr>
<tr>
<td>Manufactures</td>
<td>8371</td>
<td>75%</td>
<td>8536</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>294</td>
<td>3%</td>
<td>897</td>
</tr>
<tr>
<td>Chemicals</td>
<td>1255</td>
<td>11%</td>
<td>794</td>
</tr>
<tr>
<td>Machinery and transport equipment</td>
<td>4200</td>
<td>38%</td>
<td>3964</td>
</tr>
</tbody>
</table>

84 Note: Until 2001 the EU means the EU-15, in 2005 it means the EU-25. The Central European Free Trade Association (CEFTA) here includes Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. Trade with Romania is not included.
Following an import boom in 2001 and then an export boom in 2003, export and import growth rates developed neck and neck (Figure 34). 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 well above the average in CEE (66% in 2006) (Table 42). Exports grew also due to the car industry.

Figure 34: Import and export of goods and services in Slovakia, percentage 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 an estimation
Source: EBRD Selected economic indicators

Table 42: Exports of goods and services in the CEE and SEE countries, as a percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovakia</td>
<td>73</td>
<td>71</td>
<td>76</td>
<td>74</td>
<td>76</td>
<td>84</td>
<td>86</td>
</tr>
<tr>
<td>CEE average</td>
<td>57</td>
<td>58</td>
<td>55</td>
<td>56</td>
<td>59</td>
<td>62</td>
<td>66</td>
</tr>
<tr>
<td>SEE average</td>
<td>37</td>
<td>36</td>
<td>33</td>
<td>34</td>
<td>37</td>
<td>40</td>
<td>43</td>
</tr>
</tbody>
</table>

Source: World Bank, World Development Indicators online
As a result of a strong export performance and import contraction, and despite the sharp price increase in 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 of a sharp increase in investment related imports and a change in the accounting methodology.

Figure 35: Current account in Slovakia, as a percentage of GDP

Note: Data for 2008 is an estimation, data for 2009 is a 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 moved 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 remained stable after the 2006 elections.

Table 43: Credit-Rating History of the Slovak Republic

<table>
<thead>
<tr>
<th>Year</th>
<th>Standard &amp; Poor’s</th>
<th>Moody’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>BB- stable outlook (since February)</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>BB+ stable outlook (since April)</td>
<td>Baa3 (since May)</td>
</tr>
<tr>
<td>1996</td>
<td>BBB- stable outlook (since April)</td>
<td>Baa3</td>
</tr>
<tr>
<td>1997</td>
<td>BBB- stable outlook</td>
<td>Baa3</td>
</tr>
<tr>
<td>1998</td>
<td>BBB- negative outlook (since April)</td>
<td>Baa3 negative outlook (since February)</td>
</tr>
<tr>
<td></td>
<td>BB+ negative outlook (since September)</td>
<td>Ba1 negative outlook (since March)</td>
</tr>
<tr>
<td>1999</td>
<td>BB+ stable outlook (since November)</td>
<td>Ba1 stable outlook (since October)</td>
</tr>
<tr>
<td>2000</td>
<td>BB+ positive outlook (since November)</td>
<td>Ba1 positive outlook (since November)</td>
</tr>
<tr>
<td>2001</td>
<td>BBB- positive outlook (since October)</td>
<td>Baa3 stable outlook (since November)</td>
</tr>
</tbody>
</table>
### DIVERGENT DYNAMICS OF TRANSFORMATION: THE ROLE OF THE EUROPEAN UNION

<table>
<thead>
<tr>
<th>Year</th>
<th>Rating</th>
<th>Outlook</th>
<th>Rating</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>BBB</td>
<td>positive outlook</td>
<td>A3</td>
<td>stable outlook</td>
</tr>
<tr>
<td>2003</td>
<td>BBB</td>
<td>positive outlook</td>
<td>A3</td>
<td>stable outlook</td>
</tr>
<tr>
<td>2004</td>
<td>A-</td>
<td>positive outlook</td>
<td>BBB+</td>
<td>positive outlook</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(since December)</td>
<td></td>
<td>(since March)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>stable outlook</td>
<td>A3</td>
<td>positive outlook</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(since June)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>A</td>
<td>stable outlook</td>
<td>A2</td>
<td>positive outlook</td>
</tr>
<tr>
<td>2006</td>
<td>A</td>
<td>stable outlook</td>
<td>A1</td>
<td>stable outlook</td>
</tr>
<tr>
<td>2007</td>
<td>A</td>
<td>stable outlook</td>
<td>A1</td>
<td>stable outlook</td>
</tr>
<tr>
<td>2008</td>
<td>A+</td>
<td>positive outlook</td>
<td>A+</td>
<td>stable outlook</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(since March)</td>
<td></td>
<td>(since November)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>stable outlook</td>
<td>A1</td>
<td>positive outlook</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(since July)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>A+</td>
<td>stable outlook</td>
<td>A1</td>
<td>stable outlook</td>
</tr>
</tbody>
</table>

**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 the CEE average (Figure 36). Slovakia belongs to the medium indebted group of countries in the region.

*Figure 36: External debt in Slovakia, as a percentage of GDP*

With the new millennium, the reputation of Slovakia changed dramatically. From a highly unpredictable and risky country it became an open and macro-economically 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 the regulatory, administrative and judiciary fields (OECD 2005:25). There was a substantial increase in foreign direct investment inflows as well; they reached 10% of GDP in 2000. In 2002 Slovakia received the highest amount of FDI per capita flow in the region (reaching 17% of GDP) and came 8th in the 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 and 2.4% in 2004. In 2005 it increased further due to the 49% privatization of electricity 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

<table>
<thead>
<tr>
<th>Year</th>
<th>CEE average</th>
<th>Slovakia</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>1997</td>
<td>3000</td>
<td>3000</td>
</tr>
<tr>
<td>1999</td>
<td>4000</td>
<td>4000</td>
</tr>
<tr>
<td>2001</td>
<td>5000</td>
<td>5000</td>
</tr>
<tr>
<td>2003</td>
<td>6000</td>
<td>6000</td>
</tr>
<tr>
<td>2005</td>
<td>7000</td>
<td>7000</td>
</tr>
<tr>
<td>2007</td>
<td>8000</td>
<td>8000</td>
</tr>
<tr>
<td>2009</td>
<td>9000</td>
<td>9000</td>
</tr>
</tbody>
</table>

Note: Data for 2008 is an estimation; data for 2009 is a projection
Source: EBRD Selected economic indicators 2009

During the course of the decade the Netherlands became the largest investor, followed by Germany (17.9%) and Austria (14.8%) in 2006 (Table 44). Among peer countries Hungary and the Czech Republic are the main investors. Concerning the annual FDI inflow, Korea was the largest investor in 2005, and Italy in 2006.

Table 44: The origin of FDI stock in Slovakia, 2004-2008, millions of USD and EUR

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USD</td>
<td>%</td>
<td>USD</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>3197</td>
<td>23.0</td>
<td>3518</td>
</tr>
<tr>
<td>Germany</td>
<td>2682</td>
<td>19.3</td>
<td>3293</td>
</tr>
<tr>
<td>Austria</td>
<td>1994</td>
<td>14.3</td>
<td>2728</td>
</tr>
<tr>
<td>Italy</td>
<td>1023</td>
<td>7.4</td>
<td>2258</td>
</tr>
<tr>
<td>Hungary</td>
<td>1028</td>
<td>7.4</td>
<td>1112</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>959</td>
<td>6.9</td>
<td>966</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>720</td>
<td>5.2</td>
<td>871</td>
</tr>
</tbody>
</table>

Source: UNCTAD FDI Country profiles and National Bank of Slovakia FDI statistics
Taking FDI intensity as a measure of market integration, the position of Slovakia had changed dramatically since 2000. The FDI capacity strengthened and came up to around the CEE average.

FDI has gone both to privatized enterprises and to greenfield investments. A great proportion of FDI was directed to the export-oriented manufacturing sector, which contributed to capacity and output growth (Table 45). Other important recipients were financial intermediation (11.4%) and the wholesale and retail trade (15.9%). In 2002, due to the sale 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 these increased from year to year. Concerning the regional distribution, the FDI inflow is highly concentrated; in 2005 about two-thirds of the total investment stock was located in the Bratislava region.

*Table 45: Inward FDI flows in Slovakia by sectors, as a percentage of the total*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, hunting, and forestry</td>
<td>2.1</td>
<td>0.0</td>
<td>0.3</td>
<td>0.0</td>
<td>0.8</td>
<td>1.0</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Mineral raw materials extraction</td>
<td>na</td>
<td>1.2</td>
<td>0.7</td>
<td>0.1</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>36.9</td>
<td>17.2</td>
<td>43.7</td>
<td>6.8</td>
<td>46.3</td>
<td>75.2</td>
<td>49.0</td>
<td>24.5</td>
<td>25.7</td>
</tr>
<tr>
<td>Electricity, gas, and water supply</td>
<td>na</td>
<td>0.0</td>
<td>0.2</td>
<td>74.7</td>
<td>-1.5</td>
<td>-0.7</td>
<td>1.5</td>
<td>0.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>Construction</td>
<td>0.0</td>
<td>0.0</td>
<td>0.8</td>
<td>0.1</td>
<td>2.2</td>
<td>1.4</td>
<td>0.9</td>
<td>0.3</td>
<td>-0.2</td>
</tr>
<tr>
<td>Wholesale and retail trade, repairs of motor vehicles</td>
<td>48</td>
<td>3.8</td>
<td>10.6</td>
<td>5.0</td>
<td>13.6</td>
<td>25.4</td>
<td>14.5</td>
<td>6.8</td>
<td>10.5</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>5.6</td>
<td>0.1</td>
<td>0.7</td>
<td>0.0</td>
<td>0.2</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Transport, storage, post and telecommunications</td>
<td>0.1</td>
<td>74.5</td>
<td>13.8</td>
<td>-0.6</td>
<td>0.9</td>
<td>-24.7</td>
<td>5.8</td>
<td>2.9</td>
<td>0.4</td>
</tr>
<tr>
<td>Financial intermediation</td>
<td>2.2</td>
<td>2.5</td>
<td>25.8</td>
<td>10.9</td>
<td>7.2</td>
<td>18.4</td>
<td>19.2</td>
<td>7.6</td>
<td>35.8</td>
</tr>
<tr>
<td>Real estate, renting and business activities</td>
<td>5.6</td>
<td>0.6</td>
<td>3.1</td>
<td>1.3</td>
<td>2.3</td>
<td>3.6</td>
<td>8.6</td>
<td>5.7</td>
<td>26.3</td>
</tr>
<tr>
<td>Public administration and defence, compulsory social security</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>0.0</td>
<td>279</td>
<td>0.0</td>
<td>0.0</td>
<td>51.5</td>
</tr>
<tr>
<td>Education</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Health and social work</td>
<td>na</td>
<td>0.1</td>
<td>0.0</td>
<td>1.4</td>
<td>0.0</td>
<td>0.1</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other community, social, and personal services</td>
<td>0.1</td>
<td>0.0</td>
<td>0.3</td>
<td>0.1</td>
<td>0.0</td>
<td>0.4</td>
<td>0.3</td>
<td>0.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Activities of private households</td>
<td>na</td>
<td>na</td>
<td>0.0</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

*Note: Data for 2007 is preliminary*
Source: National Bank of Slovakia, Monetary Surveys

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.
Table 46: Number of greenfield FDI projects, by destination region

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovakia</td>
<td>63</td>
<td>89</td>
<td>119</td>
<td>118</td>
<td>100</td>
<td>489</td>
</tr>
</tbody>
</table>


In order to combat long-term unemployment and regional disparities, several steps were taken, and the flexibility of the labour market improved. Tax and welfare reforms 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.

Since the beginning of 2005 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 the unemployment rate decreased to 13% in 2006.

Figure 38: Unemployment rate in Slovakia, as a percentage

Note: Data for 2008 is an estimation
Source: EBRD, Selected economic indicators 2009
Figure 39: Administrative vs. ILO unemployment rate in various CEE and SEE countries, difference in percentage points

Source: Croatian National Bank, own calculations

The productivity of the labour force in Slovakia became among the highest in the CEE region, 70.5% of that of the EU-27 in 2006 (Figure 40). Starting from a relatively low initial level, hourly labour productivity between 1998 and 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, which 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 at around the labour productivity growth rate which 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 a forecast by Eurostat. Data on Poland and Croatia is an 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, job creation has begun to outweigh job shedding. The rate of employment growth tended to exceed the CEE average growth in 2005 and 2006. However, the employment rate in Slovakia (59.4% in 2006) has been under the CEE average (Figure 41).

Since 2000 net employment creation picked up but the unemployment rate remained very high among low skilled workers and the regional disparities remained. Employment growth accelerated to 2.3% and thus the 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 relative to 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 were 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 not fulfil either the criterion on price stability, or 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 continued.

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 led to a spurt in inflation as well. Slovakia had been 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 regarding the excessive deficit. The general government deficit reached 7% of GDP at the beginning of the decade but was reduced significantly from 2002 and reached 3.1% of GDP in 2005. General government debt had 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 had participated in ERM II; that is, it entered the second stage of euro-introduction. After 12 months the Commission reported that the koruna remained above the central rate except for a short 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 in the ERM II for one year. Average long-term interest rates in Slovakia had been 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 of 2006 came to the same conclusion as the previous report: 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 might abandon the euro-project, this did not happen. Introducing the euro first among the Visegrád states was an important goal for the Fico government and conformed 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 had fulfilled the convergence criteria and gained legal compatibility. In July 2008 the Council abrogated the derogation of Slovakia regarding the non-fulfilment of the necessary conditions for the adoption of the single currency and the SKK/EUR conversion rate was set at 30,1260. By 1 January 2009 Slovakia had entered into the euro area.

### 3.5 European identity

The 2001 Eurobarometer found that 7% of the population in Slovakia felt ‘only European’, 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, Slovakia had the lowest number who had only national feelings. National pride in Slovakia was reported as being lower than the accession countries and also the EU-15. At the same time, European pride was considerably higher than in the accession countries and the EU-15. In 2002 and 2003 Slovakia was the country where most people considered themselves only European and a considerable number of people were proud
to be European. National pride in Slovakia was reportedly 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, support was very stable and also relatively very high – i.e. ranging from 58% to 60%. The first Standard Eurobarometer (2004) reported that right before the actual accession the membership support was relatively low (46%).

The referendum on 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 yes (Table 47).

**Table 47: Results in referenda on EU accession**

<table>
<thead>
<tr>
<th>Country</th>
<th>Turnout %</th>
<th>Yes %</th>
<th>No %</th>
<th>Support %</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>na</td>
<td>58</td>
<td>25</td>
<td>na</td>
<td>Autumn 2002</td>
</tr>
<tr>
<td>Malta</td>
<td>91.0</td>
<td>54</td>
<td>46</td>
<td>49.1</td>
<td>March 8, 2003</td>
</tr>
<tr>
<td>Slovenia</td>
<td>60.3</td>
<td>90</td>
<td>10</td>
<td>54.3</td>
<td>March 23, 2003</td>
</tr>
<tr>
<td>Hungary</td>
<td>45.6</td>
<td>84</td>
<td>16</td>
<td>38.3</td>
<td>April 12, 2003</td>
</tr>
<tr>
<td>Lithuania</td>
<td>63.3</td>
<td>91</td>
<td>9</td>
<td>57.6</td>
<td>May 10-11, 2003</td>
</tr>
<tr>
<td>Slovakia</td>
<td>52.2</td>
<td>93</td>
<td>7</td>
<td>48.5</td>
<td>May 17, 2003</td>
</tr>
<tr>
<td>Poland</td>
<td>58.9</td>
<td>77</td>
<td>23</td>
<td>45.4</td>
<td>June 7-8, 2003</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>55.2</td>
<td>77</td>
<td>23</td>
<td>42.5</td>
<td>June 13-14, 2003</td>
</tr>
<tr>
<td>Estonia</td>
<td>63.0</td>
<td>67</td>
<td>33</td>
<td>42.1</td>
<td>September 14, 2003</td>
</tr>
<tr>
<td>Latvia</td>
<td>72.5</td>
<td>67</td>
<td>32</td>
<td>48.6</td>
<td>September 20, 2003</td>
</tr>
</tbody>
</table>

Source: European Economy (2006:21)

The people of Slovakia stepped into the EU with more optimistic expectations of the impact of membership. 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 was above the new member states average. Slovaks expressed the negative aspects less often but more often were concerned about the loss of cultural identity. Still, their cultural identity was perceived in sensitive way, but not as being endangered by EU membership. The perception of the European Union among the Slovak public indicates a high level of idealization.

Political and cultural elites in Slovakia understood that national and European identity were not exclusive. This approach was widespread in society as well. The most frequent answer on the national and European identity question is the phrase “national and European identity”.

In 2008 for a majority of Slovaks the European Union meant the freedom to travel, study and work, even though this number had 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 the EU, which is 23% points above the EU-27 average. The high level of trust of Slovaks in the European Union also has 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 has changed profoundly since the late 1990's. During the first Dzurinda government the Slovak macroeconomy was stabilised and the reform gap with its neighbours was 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, alongside liberalization, can accelerate the catching-up process of a country. The coherence of the reforms together with EU membership persuaded the international business actors that it was worth investing 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, particularly 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 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 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 the 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 began successfully and they also had the potential to improve the overall performance of the public sector.

Slovakia became a member of the European Union together with its Visegrád neighbours; moreover it was transformed from a disqualified EU candidate to one of the most successful pupils and recovered its historical, political and geographic place among the new democracies in Central Europe (Harris 2004:206). The EU accession process meant 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 several 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, extensive reforms were implemented right after the government took office. Similarly, the hypothesis that extensive reforms need a demoralized and fragmented opposition (that is unable to act as an effective resistance) was also verified in many cases. The hypothesis that reform requires an authoritarian regime proved to be invalid, as did the hypothesis that reform would be an inherently right-wing project. In most cases the party with reform intentions needed to disguise its intent in order to get elected. This 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 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 external financial or intellectual help for their measures. The governments had a solid political base in most of the countries where the reform took root.

Table 48: Hypotheses for identifying factors that support policy reform

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>General assessment</th>
<th>Slovak case</th>
</tr>
</thead>
<tbody>
<tr>
<td>visionary leader</td>
<td>strong support</td>
<td>valid</td>
</tr>
<tr>
<td>coherent economic team</td>
<td>strong support</td>
<td>valid</td>
</tr>
<tr>
<td>political base</td>
<td>strong support</td>
<td>valid</td>
</tr>
<tr>
<td>“voodoo politics”</td>
<td>most cases</td>
<td>invalid</td>
</tr>
<tr>
<td>comprehensive agenda</td>
<td>most cases</td>
<td>valid</td>
</tr>
<tr>
<td>external help</td>
<td>most cases</td>
<td>valid</td>
</tr>
<tr>
<td>perception of crisis</td>
<td>many cases</td>
<td>valid</td>
</tr>
<tr>
<td>“honeymoon hypothesis”</td>
<td>many cases</td>
<td>valid</td>
</tr>
<tr>
<td>fragmented opposition</td>
<td>usual in democracies</td>
<td></td>
</tr>
<tr>
<td>use of the media</td>
<td>little support</td>
<td></td>
</tr>
<tr>
<td>compensate the losers</td>
<td>little support</td>
<td>invalid</td>
</tr>
<tr>
<td>accelerate the gains</td>
<td>little support</td>
<td>valid</td>
</tr>
<tr>
<td>authoritarian regime</td>
<td>invalid</td>
<td>invalid</td>
</tr>
<tr>
<td>right-wing</td>
<td>invalid</td>
<td>invalid</td>
</tr>
</tbody>
</table>

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 lagging behind in the international integration. The participation level was over 84% (Slivkova 1999:3) in 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 a 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 the application of 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 the capacity to obstruct the reform process. External help was present both in the form of intellectual support and as a motivation factor. The promise of international integration and international pressure fuelled the reform, although the first Dzurinda government also faced 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 following panic in the market in May 1999 accelerated progress. The fear of staying out of EU enlargement also operated 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 while the demand for them remained high. Maybe these measures would not have been possible later on because of 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 in time for the next elections. Thus the reform powers had eight years to conduct their program (Mathernová–Renčko 2006:637-639). However, the people had lost their appetite for reform by 2006. The reform measures were not without cost. The reforms, especially those concerning welfare benefits faced a difficult trade-off between dealing with benefit dependency and risking increasing poverty. The losers of the reforms were most probably the previous beneficiaries of the generous welfare allowances. Although curbing benefit dependency and encouraging efforts to work 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 the 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 (and also in Slovakia) social partnerships were not launched or revitalized, as happened in several EU member states during the 1990’s in connection with the euro adaptation (Benczes 2006). The compensation of the losers was not sufficient, which also contributed to the election defeat of 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 criteria presented by 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 an accession agreement with the European Community. Bound to Czechoslovakia, Slovakia belonged to the “mainstream” Central European transformation and European integration process. The legacy of the former Czechoslovakia meant a more rigid planned economy than in the other Visegrád states, but the difference was slight compared to the special conditions 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 its elementary features.
The new independence of Slovakia is *neither a significant nor distinctive* factor among the SEE and CEE countries, since the majority of them started their transformation process as newly independent countries. 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 counter-revolution”. Slovakia was the only candidate country that could not fulfil the Copenhagen democratic criteria. The newly independent, relatively backward country seemed to move down the road of path dependence, where the disadvantageous initial conditions determine the future of the country.

The reform path, which was adopted by the Dzurinda governments, seemed to be deep and more or less durable. The common priorities of EU accession and euro adoption kept the party alliances of the Fico coalition alive. The outside pressures served as an anchor in policymaking. Slovakia was able to change the rather pessimistic scenarios about its Europeanization process. It became evident that the disadvantageous initial conditions of the country could be corrected by reform measures. The “nationalist detour” ended surprisingly quickly after 1998. However, since 2006 the “ghost of nationalism” does not seem to have been completely laid.

Both periods of Slovakia were characterized by the determining 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 also functioned as agents 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 the countries from five aspects: democracy-building, transition to a market economy, accepting the acquis communautaire, the common foreign and security policy towards these countries, and issues of European identity in the countries. Based upon these country studies, we attempted to identify 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 were similar from a number of aspects, which makes a comparison feasible.

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 to discover whether they show a 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 also showed highly similar characteristics, except for one. However, the outcome of the Europeanization process proved to be very different. In the following we highlight the causes of the different outcomes. Certain features (1-4.) appeared in both countries during the “Europeanist” era, only their intensity was different. Other features (5-7.) proved to be unique in the case of Croatia.

Table 49: Similar and different features in Croatia’s and Slovakia’s paths of transformation

<table>
<thead>
<tr>
<th>Similar</th>
<th>Different</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial conditions</td>
<td></td>
</tr>
<tr>
<td>leverage of the Austro-Hungarian monarchy</td>
<td>form of socialism: very strict vs. soft</td>
</tr>
<tr>
<td>socialism</td>
<td></td>
</tr>
<tr>
<td>multinational federal state</td>
<td></td>
</tr>
<tr>
<td>feeling of being suppressed</td>
<td></td>
</tr>
<tr>
<td>good prospects for Europeanization based on Yugoslavia’s Western orientation and Czechoslovakia’s participation in the frontrunner Visegrád-group</td>
<td>even better prospects for Europeanization in Yugoslavia (Croatia)</td>
</tr>
</tbody>
</table>
1. In both countries the end of the nationalistic regime occurred with the victory of the opposition (1998 in Slovakia and 2000 in Croatia). In Slovakia, although there was friction, the governing coalition stayed together, and could stay in power for two terms. There was consensus among the elite about the future of the country and the population was ready to accept the reform measures. However, the Slovak people seemed to be losing their appetite for reform by 2006. But by then the direction of public policy had already changed.

2. In both countries the political obstacles to 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 situation was more complicated than simply the abolition of the nationalistic ruling system. Thus the turn was not sharp enough, although the expectations 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 country’s economic system and the size of the state was reduced dramatically. In Croatia, the restructuring process was burdened by continuous delays. The system of crony capitalism was not...
abolished with the changes in 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 were pro-EU and ready to accept reform measures initiated by the EU. The attitude of the population to being “European” in Slovakia was one of the driving forces of the quick reorientation and European integration. “Europeanness” in Slovakia was almost equivalent to that in the EU, while “Europeanness” in Croatia did not equal that in the EU by any means. At the same time, in Croatia the level of Euroscepticism was very high. The armed conflict resulted in a different approach to 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. Croatian society was more divided concerning its attitude towards “Europe”.

5. The tourism sector and its revenues created tempting opportunities to delay crucial restructuring decisions in Croatia. It may have helped to close the loophole which would otherwise have emerged 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 secede from Czechoslovakia without border disputes. Beyond the war with Serbia and Bosnia and Herzegovina, Croatia has further border disputes with Slovenia that are still current. This dispute (together with the argument on frozen deposits) has overshadowed the relations between the two countries and they have become enemies rather than allies in the integration process of Croatia.

7. Rupnik (2000:273) considers a major difference between the dissolution of the two federations the fact that unlike in Czechoslovakia, in Yugoslavia the separation was initiated by the more democratic, more Western and more prosperous member of the federation. A more important difference is that the sovereignty of Croatia was achieved through violence. The Yugoslav war of secession lasted from 1991 to 1995 and it was only in 1998 that 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 contributed to the peaceful and negotiated outcome. 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 fundamentally important regarding EU-relations, but it was burdened by public opposition that made governments hesitate. The extremely mixed feelings of the population towards the ICTY and the indicted generals excluded the possibility of consensus on a social level. Such a commitment was not present in EU-Slovakia relations. In Croatia the war and its consequences caused locked-in and higher social costs of Europeanization.
2 What do 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 a 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 had lost the advantage arising from 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 least 3. Croatia had a 3.52 average score in 2007 and only the 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 speeds among the examined sectors. Some sectors remained typical of rigid planned economies until 1995 in Croatia and 1994 in Slovakia. Later the standard deviation decreased as every sector started to transform. The Slovak transformation shows higher standard deviation scores between 1997 and 2000 due to the slow changes in the field of infrastructure. Later on the Croatian scores tend 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 the field of trade and the forex system. Overall infrastructure reform appeared relatively late in Slovakia.

Table 50: Croatia: Transition indicators

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Large scale privatization</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>2.00</td>
<td>2.00</td>
<td>2.00</td>
</tr>
<tr>
<td>Small scale privatization</td>
<td>3.00</td>
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<td>3.00</td>
<td>3.00</td>
<td>4.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Enterprise restructuring</td>
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<td>1.00</td>
<td>1.00</td>
<td>4.00</td>
<td>4.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Price liberalization</td>
<td>2.67</td>
<td>3.67</td>
<td>3.67</td>
<td>4.00</td>
<td>4.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Trade &amp; Forex system</td>
<td>2.00</td>
<td>2.00</td>
<td>3.00</td>
<td>3.00</td>
<td>3.00</td>
<td>3.00</td>
</tr>
<tr>
<td>CompetitionPolicy</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Banking reform &amp; interest rate liberalization</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Securities &amp; non-bank financial institutions</td>
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<td>1.00</td>
<td>1.00</td>
<td>2.00</td>
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<tr>
<td>Overall infrastructure reform</td>
<td>1.33</td>
<td>1.33</td>
<td>1.33</td>
<td>1.33</td>
<td>1.33</td>
<td>1.33</td>
</tr>
<tr>
<td>Year</td>
<td>Large scale privatization</td>
<td>Small scale privatization</td>
<td>Enterprise restructuring</td>
<td>Price liberalization</td>
<td>Trade &amp; Forex system</td>
<td>Competition/Policy</td>
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<tr>
<td>1989</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>1990</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
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<td>1991</td>
<td>4.00</td>
<td>3.00</td>
<td>2.00</td>
<td>2.00</td>
<td>1.00</td>
<td>1.00</td>
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<tr>
<td>1992</td>
<td>4.00</td>
<td>4.00</td>
<td>2.00</td>
<td>2.67</td>
<td>1.00</td>
<td>1.00</td>
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<tr>
<td>1993</td>
<td>4.00</td>
<td>4.00</td>
<td>2.00</td>
<td>2.67</td>
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<td>1.00</td>
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<td>1994</td>
<td>4.00</td>
<td>4.00</td>
<td>3.00</td>
<td>2.67</td>
<td>2.67</td>
<td>1.00</td>
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<tr>
<td>1995</td>
<td>4.00</td>
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<td>3.00</td>
<td>2.67</td>
<td>2.67</td>
<td>1.67</td>
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<tr>
<td>1996</td>
<td>4.00</td>
<td>4.33</td>
<td>3.00</td>
<td>2.67</td>
<td>2.67</td>
<td>1.67</td>
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<td>1997</td>
<td>4.00</td>
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<td>3.00</td>
<td>2.67</td>
<td>2.33</td>
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<tr>
<td>1998</td>
<td>4.00</td>
<td>4.33</td>
<td>3.00</td>
<td>2.67</td>
<td>2.33</td>
<td>1.67</td>
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<td>1999</td>
<td>4.00</td>
<td>4.33</td>
<td>3.00</td>
<td>2.67</td>
<td>2.33</td>
<td>2.00</td>
</tr>
<tr>
<td>2000</td>
<td>4.00</td>
<td>4.33</td>
<td>3.00</td>
<td>3.00</td>
<td>2.33</td>
<td>2.00</td>
</tr>
<tr>
<td>2001</td>
<td>4.00</td>
<td>4.33</td>
<td>3.00</td>
<td>3.33</td>
<td>2.33</td>
<td>2.33</td>
</tr>
<tr>
<td>2002</td>
<td>4.33</td>
<td>4.33</td>
<td>3.00</td>
<td>3.33</td>
<td>2.33</td>
<td>2.67</td>
</tr>
<tr>
<td>2003</td>
<td>4.33</td>
<td>4.33</td>
<td>3.00</td>
<td>3.33</td>
<td>2.67</td>
<td>3.00</td>
</tr>
</tbody>
</table>
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 a shorter 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 scores higher than or equal to Croatia. Croatia’s scores show a higher standard deviation.

This short review reveals a rather small (0.22 score) average difference between the two countries (a 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 a considerable gap between the two. The explanation of this phenomenon is threefold. (1) Undoubtedly the result partly derives from the limits of the EBRD indicators, to which the EBRD itself calls our attention. (2) The two countries are close to each other on a scale from a rigid centrally planned economy to an industrialised market economy. However, this similarity is not reflected 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 section 3.5.3, problems with property rights and contract enforcement; the large size of the government, inefficient bureaucracy and high regulatory burdens; and corruption are the four most important micro risks that determine the quality of the 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 successfully outside the European Union. Part of this “success” is based on the performance of the tourist sector.

Other numerical data show a clear difference can 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 was highlighted previously, both countries suffered from state capture and a 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 the lowest government redistribution in the EU and is closer to the level of Baltic and South Eastern European member states than the other Visegrád countries (Table 39).

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)
Although the size of the state has decreased by 9 percentage points since the end of the Tudjman regime, the Croatian state is still among the largest, both among CEE and EU states. The size of public expenditure relative to GDP shows an interesting picture in Croatia, in comparison with the Yugoslavian period. In communist countries public expenditure is high by definition. Yugoslavia was an exception, where there was a difference between the state and social sector. Still, the level of state expenditure was high in Yugoslavia, but in a number of respects it was lower than it has been recently in Croatia (Gligorov 2002).

3 Internal factors – the response to Europeanization pressure

The outcome of the Europeanization process is explained by the “concerted action” of 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 to be successful when the EU serves as an anchor during the transformation process. The countries vary on how they respond to EU adaptation pressure.

At the beginning of this study we highlighted that the external factors were present in both countries and can be considered as identical. The domestic factors are responsible for the perception of the misfit and for the nature of the response. 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 populations’ 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 an end to the previous regime, reforms and a return to European integration. As we demonstrated, the internal factors were quite similar in the “nationalist” phase and they have become 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 the “nationalist” period. We consider the following period from the time when opposition governments got into power and refer to it as the “Europeanist” period. The turning points are 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>
<thead>
<tr>
<th></th>
<th>Croatia</th>
<th>Slovakia</th>
</tr>
</thead>
<tbody>
<tr>
<td>initial conditions</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>nationalist</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Europeanist</td>
<td>well...</td>
<td>yes</td>
</tr>
</tbody>
</table>

Table 52: Overview of the realization of Europeanization
3.1 Initial conditions

The Europeanization impact, in the sense of the impact accompanying the transition of post-communist Eastern European countries, reached both of our case study countries before they were 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 Community 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 a highly advantageous basis for Europeanization.

Contrary to the advantageous prospects, the developments during the last years of Yugoslavia set aside the Europeanization process on a federal level. Yugoslavia (understood as a country of six republics until 1991) gave the European Community plenty to think about. 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 at that time, since 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 for the Maastricht Treaty all 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 accentuated than ever before. They had very different attitudes 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 started it was also among the first countries to open negotiations about EC association agreements (Europe Agreements), in December 1990. Czechoslovakia was among 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 organised for integration. In favour of this new geopolitical aim, Czechoslovakia pushed Visegrád cooperation and an opening towards Western countries, especially Germany. However, after the 1992 elections Czech and Slovak foreign policy interests started to diverge (Hamberger 1997:175-176).

To sum up, at the time Croatia and Slovakia became independent, the development in their successor states was already pointing in the direction of Europeanization. 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 for 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 the case of Yugoslavia grew immensely when the armed conflict broke up and the ability to respond to adaptation pressure was overshadowed by internal developments.
3.2 Two countries – four cases

We start the comparison of Slovakia and Croatia with an application of Vachudova’s theoretical explanation on why countries vary in their response to EU adaptation pressure. 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, both tried to ignore the influence of the EU during the 1990’s. On the logic of initial economic conditions, both Yugoslavia and Czechoslovakia should have performed well since they were relatively rich. Some of the successor states performed well but some did not. Of course not all the Yugoslav republics were rich. The regional disparities were huge but the relative wealth of Croatia and Slovenia did not determine their paths either. The initial economic conditions are surely important but are not everything: 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 parts 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, which meant preferential treatment compared to the other communist countries. However, during the last months of 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 a not unfavourable or even a good reputation in the eyes of the EC at the beginning. However, the dissolutions changed the picture. Where pro-EC governments achieved power in the successor states, the good relations were sustained. At the same time, if nationalist powers got into 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 the Europeanization process in Croatia and Slovakia. We argue that the self-interpretation and scope for action of the political elite matters. This elite has dynamic roots in the cultural and historical heritage of the country. Since the Europeanization process depends primarily on policy decisions, the attitude of the political elite is fundamentally important.

3.3 Croatia in the Tudjman era – the nationalist period

As outlined above, two conditions must be present before we can 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’s, the misfit was undoubtedly present.

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 EU side 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 at all. The difference in
perception of the misfit – we argue – was rooted in the different perception of the war: in the Croatian reading it was the Homeland war and Croatia was the victim of 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 a response 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 defensively rather than cooperatively to make Croatia conform to the EU's wishes. In fact, the need to conform did not arise. Instead, the pressure from the EU was seen as a threat to the national interest. As a result, there were no or little efforts made in order to meet EU requirements and European integration had a very low priority. Croatia did not become a Europe Agreement country and as a result EU membership was a less than real prospect. The role of the EU in the transformation process was minor.

According to what we have described above, can we talk about Europeanization during this period in Croatia? The evidence shows that the three conditions were not realized. Thus the EU did not play the role of anchor in the Croatian transformation process; instead the country 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 Croatian national life. The presence of the EU-pressure had an impact on the country’s life even if not in 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 act the way they did. 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 share. In Croatia the following factors are potentially different.

First, the transformation process of Croatia began in 1988 during the last years of Yugoslavia; therefore Croatia inherited this path. This factor is special but not unique: Slovenia inherited the same background but it was 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 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, although new independence is not a distinctive factor, the way it was gained needs to be examined further.

Here we arrive at the third possible distinctive factor: the first years of transformation in Croatia were complicated by a war, which caused a shift in priorities. We argue that this feature of the Croatian (and other post-Yugoslav) economy(ies) 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 ahead 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 was not directly connected to the regime change, the Yugoslav war of secession has had deep impact on 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 an example of successful transformation which was complicated by a long armed conflict among any of the transformation countries in Eastern Europe.

Among other things the war was the factor that displaced 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 Western Balkan group 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 ascribed to the war?

The war led first of all to loss of life 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, which 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, and the war led to increasing international isolation, which continued in the post-war period as well. The isolation deprived Croatia of important flows of international assistance and international integration.

Regarding the economy, the war led to heavy direct economic losses (27.5 billion UDS - more than a year’s GDP). 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 which led to a loss of foreign direct investment flows. The transformational recession was combined with a war recession that contributed to a particularly severe economic crisis. The country’s GDP fell by almost 30%, which was the most severe decline among CEE countries (including Bulgaria and Romania). The war increased the role of the state: beyond defence expenditure, a huge demand for social protection was created among people affected by the war (World Bank 2001:2-3). Powerful interest groups benefited from the armed conflict and continued to benefit from various supports after the war as well, e.g. salaries, pensions. The grey and back economy (including criminal activities) flourished during the war and 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, foreign policy priorities did not change.

With the end of the war, the war itself did not disappear from the collective mentality of politicians and the people. The reference to the war continued to influence policy decisions. The size of the state did not decrease after the end of war and 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 a new context and changed the balance of power among interest groups in 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 also had a special impact on national identity, which was fundamental in terms of the above mentioned state- and nation-building connected to the transformation.

3.3.3 Born to be “European”?

Although CEE countries declared that they have always been in “Europe”, every country strove 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 feel that Croatia should strive to demonstrate its alignment to EU norms and rules. They only referred to their roots in Europe (historically, culturally and geographically) and maintained these 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 it. Some EU conditions (especially the cooperation with The Hague) were unacceptable for the population. Both the transformation and European integration were subordinated to the “national interest” which 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 also changed 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 closer 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 the real or putative national interest.

The existence of responding factors changed after 2000. Following the elections the opposition gained power and the orientation of external relations turned towards the EU. EU integration became a pronounced political priority.

Since 2000 the dynamics of Europeanization have been visible. During the period of the opposition and also later when the renewed HDZ regained power, the EU was always a high priority in the government’s rhetoric and it presented ambitious integration schedules
from time to time. Willingness to respond to the adaptation pressure strengthened significantly. The response 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 weakness of the coalition and the will of the electorate. The return of the HDZ did not go along with the return of nationalistic rule, inter alia because the emblematic HDZ leader Franjo Tudjman had died in 1999. Stjepan Mesić, president of Croatia said in 2000 that he hoped Croatia would have earned EU membership before his term ended in early 2005. However, Croatia applied for EU membership in February 2003, became a candidate country in June 2004 and the negotiations could only start in 2005, mainly because of the delay in cooperation with the ICTY. The aim of Croatian membership was still overwritten by the national interest, which was threatened by The Hague. The unprecedentedly high level of Euroscepticism in Croatia has also burdened the integration process and the response 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 has shown that the mainly negative conditionality of the EU and also other international actors played a highly important role at several crucial steps in the Croatian policy.

Schimmelfennig and Sedelmeier’s (2004:670) suggestion 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 linked to positive or negative sanctions. On the one hand, an example of a negative sanction was the suspension of assistance to Croatia under the PHARE program. This 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 a 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 The 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 the case of a 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 as recognizing that the main motivator for 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 were in principle eligible for membership but the relevant conditions had 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 had been regularly delayed. The EU perspective was still complicated by unresolved 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 was limited in Croatia. The country kept its distance from the EU after 2000 as well. Despite Croatia’s resistance, the evidence shows 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 structural reforms are necessary in Croatia regardless of the conditions of the EU. First of all, improvement is the interest of the country and the interest of the EU is only secondary. 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 has shown that the (mainly negative) conditionality of the international actors has played a highly important role in several crucial steps in Croatian policy.

Regardless of politics, the Europeanization of economic relations was significant. The EU had already become the most important trade and investment partner of Croatia during the “nationalist” period. The evidence shows that geographical proximity most determines the economic relations of the country. From a 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 lagging behind in several fields.

3.4.2 Europeanness and war

The two constraints mentioned in the previous section (the war and national identity) have still been valid in the “Europeanist” period, even though their intensity has decreased.

The perception of “Europe” did not change principally after 2000 in Croatia. The political elite still did not feel the need for their “Europeanness” to be proved by accepting EU conditionality. This feeling only changed 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 commonly accepted wisdom. The membership of the latter two countries “opened eyes” in Croatia and brought to both the population’s and the political elite’s attention that Croatia had missed the boat 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 passing years. In the second half of the 2000’s 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 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 (the war and Balkan nationalism on the one hand and crony privatization and the insufficient degree 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 the 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 cause growth to accelerate. At the same time, crises are not unequivocally beneficial for reforms and also the eruption of a 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 an 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 then. In Croatia another economic success story - the restructuring of the banking sector - also occurred as a consequence of a financial crisis in 1998-1999. However, neither the restructuring of the financial sector nor the post-hyperinflation stabilization package was followed by an overall restructuring of the economy. In other words, there was no “life-threatening” crisis in other sectors – neither were there any accompanying benefits. The crisis of e.g. the shipbuilding sector was not enough deep to shift 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 helped to maintain the possibility of policy making in favour of vested interests. As a result it has not enforced any radical structural changes. Croatia locked itself into - and became the subject of - institutional inertia.

3.4.4 What would Croatia gain by EU membership?

There is a wide consensus among researchers that there is no other choice for Croatia but to join the EU; in the long term there is no life outside the EU. But what about the short term? The classical problem arises: the costs are to be paid in the short term, while the benefits will appear in the medium or long term. There is no doubt that the 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; Croatian society and economy will benefit from the EU (Švaljek 2007). The experience of Slovakia demonstrates that an effective and efficient package of economic reforms is able to generate economic results and political benefits even in the short-term. However, there will be both winners and losers on an individual level and the winners somehow have to compensate the losers.
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 a weighted average if Croatia joins the internal market. The increase in agricultural and food processing products and in trade services are the highest at over 100%. The 34% 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 regulations is considered as a technical barrier to trade which could lower costs but also eliminate rents. These trade costs are highest in agriculture, in business services, in food processing and in trade services (Lejour et al. 2007:22-24).

Dealing with the delay in institutional reforms is one of the highest priorities on Croatia’s transformation agenda. The EU-membership can provoke institutional reforms in Croatia and reduce bureaucracy and the lack of transparency in 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 carried out. 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 Ekonomski institut, Zagreb (EIZ), EU membership will be beneficial for Croatia to an increasing degree. The EIZ started from the presumption that Croatia will be a member of the EU in 2009. Croatia’s net position regarding payments to and from the EU budget has been increasingly positive since 2009. At the same time, the EU agenda has put considerable pressure on the Croatian budget (1.4% of GDP in 2009), even if the EIZ predicts a decrease in this pressure.

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 relatively high level compared to the EU-27 average (1.8% in 2007) and comparable with Romania (6.4% in 2007) and Bulgaria (6.2% in 2007). Because of the large agriculture sector, funds from the Common Agriculture Policy would also be considerable. Lejour et al. (2007:27) have calculated a total amount of funds to Croatia of about 1 billion euro per year. Švaljek (2007:36-37) predicts a lower amount of funds, 512 million euro in 2009 and 1,954 million in the first three years. The reform of these funds are continuous, therefore it is difficult to predict what they will look like at the time of Croatia’s accession.

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\(^{90}\) 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
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 the 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 proportion of emigrants was 16% of the population in 2006 (compared to 10% of the population in Europe and Central Asia). The officially recorded remittances accounted for 3% of GDP in 2006. The emigration rate of the population educated to tertiary level was 29.4% in 2000, which was the highest level in the region. Croatia is also a popular destination for immigrants; the proportion 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 has 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, while the restructuring program was 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). HVB’s Global Shipping plan cost 2.5 billion euro and the EU rejected it. The second government plan also faced opposition from the EU. The government’s plan was to fund the shipyards in the form of indemnification for land, so called marine demesne, on which the shipyards are situated and which had illegally become part of their equity capital during the 1990’s. 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 losses (8.4 billion kuna), this 40% would present further difficulties. However, what makes Nacional92 suspicious is that the total indemnification amounts to 1.65 billion kuna and the total amount of restructuring stands at 4.1 billion, while the indemnification exactly covers the required 40% (Nacional 2008). The latest Progress Report of the Commission (2008b:49) stated that Croatia had taken the decision to privatize the shipbuilding industry, but further significant efforts would be needed to fully restructure it.

The tourist sector contributes to a great extent to economic growth and it partly compensates the huge merchandise trade deficit. Following EU accession, the country is likely to become a more attractive tourist destination. The accession could stimulate inward FDI in the sector as well. Membership of the Schengen area and the acceptance of the euro could further improve the image of Croatia (Lejour et al. 2007:28).

92 Croatian weekly newsmagazine
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, and 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 transformation in CEE countries demonstrates that the knowledge and 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 the 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 needs 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 to inward FDI. EU membership (and the required measurements associated with it) usually strengthens the confidence of foreign investors and we could assume that this would happen in the 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 return of freedom, independence and democracy after communist rule is particularly connected to the involvement in the European integration process among the Eastern European countries. In the case of Slovakia and Croatia the acceptance of the newly independent state was also an issue. In the 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 it exists in the context of a 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 “proper” (i.e. “sovereign”) states.

3.5 Slovakia during the Mečiar-years

The misfit between domestic and European institutions, policies or processes was undoubtedly present in Slovakia. However, the misfit was only partly perceived. On the one hand, the Slovak government saw the country as a newly independent democratic state that could 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 in the form of demarches. The main elements of the misfit
were the undemocratic political style, the instability of Slovakia’s institutions and the abuse of minority rights.

The existence of factors that foster a response to the adaptation pressure were almost completely 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 was 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. Control by negative and positive sanctions played an important role during the Mečiar years. The most obvious example was the decision on candidate status. The shortcomings regarding the political criteria were sanctioned with the delay in the start of negotiations. Slovakia stayed out of the first wave (the Luxembourg group) of EU-candidate countries, while the neighbouring countries (the Czech Republic, Hungary and Poland) joined the Luxembourg group and continued 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 Slovakia’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 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 was highlighted previously, the new independence of Slovakia is not a significant distinctive factor. State- and nation-building connects to transformation in most cases.

At the same time, although new independence is not a distinctive factor, Slovak statehood is undoubtedly younger than most peer countries’. This feature differentiated Slovakia among the Visegrád countries; it left its mark on the Slovak national identity and on their feeling of “Europeanness” and served as a basis for an 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 to prove 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.

93 As Madelaine Albright US Secretary of State referred to Slovakia in 1995 (Haughton–Malová 2007).
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 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 path towards integration at half-steam and its refusal was less vigorous. The pressure from the EU and from other international organizations had some impact on 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 its adoption of EU-style institutions, policies and structures 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 a great impression on the population. The political goal of EU membership was maintained with the use of every means available. 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 it 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 had been created under Mečiar and gain credibility for the measures, the Dzurinda governments were ready to over fulfil the EU-requirements. The EU proved to be a strong anchor but the radical restructuring was less for the sake of the EU and 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 the 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 a destination as well. The integration process was the goal 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 the economy and that of national identity. The decision about the Luxembourg group made Slovakian people feel excluded and want to reclaim their own place among the European democracies. People considered their country culturally and historically part of “Europe” and they thought it was capable of the same level of international acceptance as its neighbours. The country realized in the second half of the 1990’s 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 for and this feeling was present both in the political elite (after 1998) and among the population. Unlike in the Croatian case, Slovakia had a more instrumental idea of “Europeanness”.

The perception of economic crisis worked as a motivating factor as well, to which the political elite answered with deep structural reforms.

3.6.2 The EU as an anchor

The role played by the EU in the transformation of Slovakia is understood very differently by different authors. Malová (2004:1-2) stands at one extreme, noting somewhat 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 the 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 also gave 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 an influence on the donors’ agenda. The conditions represented by the acquis communautaire had a significant role in the deep Slovak reform agenda. At 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 first appearances, the two analyses are not contradictory. At the beginning of the Dzurinda-turn the EU-anchor was extremely important since that was the factor that kept the often unstable governing coalition together. The anchor was also important as it was the basis for building external credibility for the “new Slovakia”. In order to gain an 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. There is no doubt that EU accession anchored the Slovak transformation.

The reforms of the first Dzurinda government were far from popular. However, the government regained the confidence of the international community which also helped it 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 drastic state reform was not among the requirements of the EU. The
performance of the second Dzurinda government supports the reasoning of Haughton (2007); that is that 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 there at the right time, in the right place and grasped the opportunity (Győrffy 2008a:19). The external incentive plays a special role when it lessens or even hinders reverse efforts. Altogether, the success of the Slovak reforms points beyond the success of Europeanization.

3.6.3 From external to internal

Slovakia changed its direction of development on time and the reorientation was quick enough not to miss the 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 an 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 had already been given. At the same time, many expected that the new members would 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 of countries actually fulfilling the euro-zone entrance conditions and thus continuing to fulfil EU conditions. In these two countries the accent shifted from external to internal persuasion.

3.6.4 What did Slovakia gain from the EU entry?

EU integration played a very important role in Slovakia’s transformation. The fact of the EU entry increased the confidence of foreign investors, which was 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 in the labour market, there is a lack of a sufficiently skilled labour force, and the young and unskilled unemployed do not really benefit from the strong employment growth. The public education system does not ensure sufficient skills for everybody 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 ambition 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 second Dzurinda government, the character of Slovakia had 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 economies and the process of privatization and marketization of the former planned economies has led to a 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

The puzzle of our research has been that two small and open economies typically and permanently react differently to the same external impulses. We saw that the two countries share deep initial conditions, which created the starting point of our comparison. Of course, the countries possessed several different characteristics during the period examined. Based on these characteristics we have formulated our hypotheses: Croatia was expecting a quick and smooth Europeanization process, while Slovakia was expected to lag behind. Both countries “behaved” differently to 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 on the theory of Europeanization.

3.7 External and internal factors

In order to reach successful Europeanization, internal conviction is indispensable; as is external pressure. The impulse from outside is able to put domestic processes and structures into a new context, and move them out of 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 the costs are lower than the benefits for the elite.

Our results show that the outside pressure of the EU and other international organizations cannot induce deep reforms without the internal will of the political elite and the population, i.e. without sufficient responsive capacity. The external incentive is a necessary but not sufficient condition of change. 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 state is captured and vested interests block important reform steps, outside pressure is often the only chance to break this dead-lock, even if these countries seem resistant at first.

The experience of Slovakia shows both the importance of an 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 along with an internal will to change. 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 a new context, and move them out of dead-lock. Examining the policy turn in Slovakia, Fisher, Gould and Haughton (2007:996) describe the most commonly accepted view of Slovakia: “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, in both 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, be it Europeanization pressure or something else, is able to play

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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.
only a secondary role. On the other hand, Europeanization theory tends to explore how domestic structures are influenced by European pressure. The case studies have shown that both countries have been influenced. However, we have also seen that the 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 attitudes.

“Real change comes from within” – from the political elite. As Dollar and Svensson (1998:4) point out regarding World Bank-supported reform programs, governments willing to reform cannot be created but only identified. Some countries do not see Europeanization as a beneficial opportunity and thus do not grasp it. The decision whether to grasp the opportunity or not is the result of a decision taken by the political elite. However, this cost–benefit balance of the political leadership is often different from that of the economy and society as a whole. The determination of the elite depends greatly 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).

3.8 Rethinking the theory of Europeanization

3.8.1 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 in which the misfit is perceived.

The initial misfit was much larger in Slovakia than in Croatia. However, this relative position soon changed. The misfit grew enormously and the Croatian situation became totally incompatible when the war broke out. It is also visible from 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 favourably positioned 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 represented the main obstacle in 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 large enough in 1998 to work as a stimulus. That is it confirms the suggestion that “the greater the misfit, the more likely Europeanization is 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 exclude but rather complement each other. The often contradictory behaviour of these countries cannot be explained by one single theory.
3.8.2 Misfit versus adaptation pressure

Misfit in itself does not induce adaptation pressure in economic, political and social structures unless the misfit is perceived and acknowledged.

As 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 response to the adaptation pressure.

Our cases showed that this is far from being automatic. The European and domestic structures may be compared in 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 induce adaptation pressure. On the contrary, if the elite is counter-Europe, the misfit may appear as an undesirable external influence and induce 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.Both countries show evidence for the “leader matters” concept. 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

95 I am grateful to my opponent István Benczes for calling my attention to this fact.
Mesić in Croatia, and Vladimír Mečiar, Mikuláš Dzurinda, Ivan Mikloš and Robert Fico in Slovakia played determining roles in their countries’ changes of direction. Although they were connected to parties and movements, their personalities determined the frame of reference for their countries.

To sum up, we argue that adaptation pressure only appears 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 response to the adaptation pressure.

3.9 EU membership vs. Europeanization

The presence of a Europeanization impact is inevitable; the countries under Europeanization pressure have to deal with it whether they choose a positive or negative response. Europeanization pressure does not appear ineffective even in the absence of an internal response. This indirect Europeanization impact possesses different degrees of efficiency, sometimes even opposite to the intended impact.

The rules of the European Union are relevant and important whether the country does or does not intend to join the club, and even more so when it is a member already. The regulations of the European Union also affect those who are not members of it. This external barrier plays a stronger or weaker role in the behaviour of every actor which comes into contact with the EU.

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 political lines. Our arguments are based on the fact that politics and the economy are highly interrelated. The two determine each other, usually the former determine the latter. That is why economic cosmopolitanism and political nationalism do not match each other. In other words economic cosmopolitanism requires the surrender 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 economics 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’s trade reorientation towards Western Europe has been driven by market forces and politics only give an institutionalised framework to trade structures that were

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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 the case of the Eastern European countries, the relationship between internal commitment and external pressure is different from in the old member states described above. Unfortunately we do not have the chance to examine the development of these countries in the absence of EMU regulations. Only in this case could we disregard their effect. 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 rules as well.

97 Piazolo examined the ten “Europe Agreement countries”. Sigér (2006) found similar results for the Western Balkan countries.
created by market dynamics. Therefore, the political actions towards 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 decisive in extent and it did not move in close association with politics and international relations.

Continuing the previous argument, “geography matters” (Krugman 2003). Geographical proximity determines the scope of action of a country. In the case of Croatia this proximity strengthened the feeling of “being European” without being an EU member and it counter-motivated the country towards reforms. In the case of Slovakia 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. That is probably why sooner or later most political actors see the benefits of moving their political agenda in a direction that makes the country compatible with EU membership. The author concludes the above mentioned debate by examining six countries98, including Slovakia. Fisher (2006:20) extends this reasoning to Croatia. Furthermore our examination tends to confirm it as well.

### 3.10 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 an EU anchor is necessary for democratic transformation to a 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.

The transformation paths of the two countries highlight that price stability is a 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 lead 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.

Transformation and European integration are two overlapping processes which enhance each other. Croatia and Slovakia made an attempt to be exceptions. However, the success of their decision was not confirmed. The experience of these countries also highlight that even the possibility of separating the two processes is rather limited.

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98 The Czech Republic, Hungary, Poland, Bulgaria, Romania and Slovakia
3.11 The power of initial conditions

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 reflecting 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 were rooted 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 decisions 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 predicted 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 of socialism. Croatia has had to deal with the legacy of Yugoslavia: an insider approach, crony capitalism, openness in trade but closeness in institutions. Croatia also has had to deal with the legacy of the Balkans: the predominance of national consciousness and corruption. The Croatian experience was also determined by an armed conflict. Slovakia has had to deal with the Czechoslovak legacy: a high level of etatism and redistribution, and a strict socialist economy. Slovakia also has had to deal with the lack of experience of independent statehood, and the impact of this on national identity.

The predominance of national consciousness is experienced in both countries but in Slovakia it does not act as a burden on European Union membership any more. The Habsburg legacy existed in the subconsciousness of Slovakia and the experience of a 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 Croatia’s identity, and its 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-term prospects of a country. As 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.

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 longer-lasting. In Slovakia the detour did not interrupt the organic development so much and the Dzurinda administration was able to activate the dynamism and the trend towards the path of transformation and Europeanization. The country was able to change fairly quickly and deeply. Croatia was locked in a stagnating and inertial path and the motivation to change was rather ambiguous and came relatively late.

3.12 Timing

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: either there and then, or the possibility may drift 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 the 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. Without the European Union’s ability to receive a new member state, the preparedness of a candidate is worth nothing. Fulfilling the fourth Copenhagen criterion has become more fragile than ever before.

3.13 The importance of an armed conflict

War matters for economic, political and institutional dynamics. An armed conflict changes the fundamental rules of society, and 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 do armed conflicts matter, 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 a different costume. In other words, war can create special burdens and path dependences.

99 Hodgson identifies among others ethnic fractionalization, western Christendom and limited historical and cultural legacy of nationhood as long-term determinants.
Still, the long-lasting impact of war is not universal; it depends on the context of the country.

Porter (1994:3) summarizes the basic characteristics of 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 should not be seen as an exogenous force in states and societies, it derives from inside. To say that war causes given political effects is only a 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 society and the state often evolve at least partial independence from the war.

Concerning the development of the state, the effects of 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. A state waging war remakes, reinvents and reorders itself. It becomes more organized, more rational and more centralized. It becomes better equipped to exert power and dominion 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 defects of a given political system more intensely than in peacetime. Both defeat and a hard won 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 the creation or energizing of new groups in society such as veterans, war heroes or taxpayers (Porter 1994:11-19).

The effect of nationalism spans 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 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 war as a wilful 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 of the formative and organizing effects of war. The new state of the 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 (the former Yugoslav National Army). The Serbian enemy unified state and society. This process was accompanied by centralization and the growth of the government. That “war makes death and taxes” (Porter 1994:14) was certainly true in the 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 a “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 the “ratchet effect” by Porter (1994:14). A ratchet effect occurs when the fast growth of government and large scale tax increases, which appear during the war, level off in post-war times at much higher levels 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 at a higher level. The population accepts centralization, a large government and high taxes during the period of the war and the acceptance remains after the crisis as well.

The Yugoslav war of secession serves also as an example of 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 shown rather the long lasting formative and organizing effects of the armed conflict alongside 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 – away from the Homeland War – 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) constituted the major obstacle in this process.

3.14 Finding the good mixture

The same external pressure may induce different internal responses and thus different outcomes. The same external pressure may fertilise 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 a 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 these 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 factors.

We have argued that the European Union offered clearly better solutions for transformation than any domestic solutions. Moreover, our cost-benefit analysis has shown that the potential benefits of European Union membership outweigh 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 the domestic ones; consequently when the
benefits of EU membership outweigh 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 confirmed that the external factors originating from the European Union can be considered as the same factors in the case of Croatia and Slovakia (and every other Europe Agreement country). 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 from the original impact.

Whether the original intention of the external actor (namely the European Union) results in successful Europeanization may depend on three factors. First, the original intention has to find a fruitful linkage point with the domestic factors. If the linkage point does not exist, or they “do not fit” each other properly, the original intention will be distorted and will not reach its aim. Second, the implementation of any external policy is the domestic arena of interests. As a result, the external factors will be able to find their way into this arena. They may face resistance in the form of the 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 thought about the impact mechanism of external and internal factors – that is, the impact mechanism of Europeanization – is also considered as valid in every segment of social science.
### Annex

#### Table 53: EBRD index of large-scale privatization

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Source: EBRD Transition indicators

#### Table 54: EBRD index of small-scale privatization

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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.
DIVERGENT DYNAMICS OF TRANSFORMATION: THE ROLE OF THE EUROPEAN UNION

Table 55: EBRD index of enterprise reform

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Source: EBRD Transition indicators

Table 56: Overall infrastructure reform in CEE and SEE countries

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### Table 57: Private sector share in GDP, as a percentage

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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

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Source: EBRD Transition indicators
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