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EU Enlargement and Institutional Development: How Far Away Are the EU's Balkan and Black Sea Neighbors?

by

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Abstract:

Institutional development in new and potential member countries determines the success of both the catching-up of developing European countries and the deepening of the European integration process. This paper argues that the timing of future enlargement should depend on institutional convergence between the EU and potential accession candidates. Therefore, the paper looks at institutional quality in the EU, in the EU's neighboring Balkan and Black Sea regions, and especially in Bulgaria, Romania, Croatia, Turkey, and Ukraine, i.e. the next countries in the queue for entry or likely to lobby for entry into the EU. Three dimensions of institutional quality—legislative, administrative, and judicative institutions—are analyzed on the basis of the World Bank Governance Indicators using institutional quality in EU member states as a benchmark in order to reveal institutional deficits.

Keywords:	Institutions, Transitional Economies, EU Enlargement, Regional Integration, Economic Development
JEL–classification:	P20, F15, O10

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I. Introduction

With the accession of Bulgaria and Romania scheduled for 2007, the European Union (EU) is certain to grow to 27 member states. Additionally, negotiations have already started with Croatia and Turkey. The remaining Balkan nations will continue to be regarded as potential members. For the other Black Sea neighbors, the European Neighbourhood Policy provides a framework for privileged relations with the EU (EC 2003, 2004). However, after the "Orange Revolution," Ukraine will opt for the European perspective and is likely to apply for membership (Vinhas de Souza et al. 2005).

At the same time Eurosceptics got the upper hand in some of EU's old member states. The project of a European constitution agreement, which has just been stopped short of a complete disaster, is intended to deepen European integration by means of common domestic, foreign, and security policies. By making central EU institutions more efficient, stronger, and more democratic, the constitution should allow the handling of an increasing and increasingly ambitious community (Varwick 2004). As long as this project is not successful, European matters will have to be settled through the "Flexibility Clause" of the Nice Treaty, in which the member states have been allowed to proceed further in certain political areas provided that they use the common institutions. The currency union and the Schengen Accord are two examples. With more and more member states this auxiliary solution bears formidable risks for the progress of European integration.

Chapter II gives the basic reasons for the critical role of institutional development in EU enlargement. In Chapter III, we ask whether or not the institutional development of current and potential accession countries is adequate to master the challenges of the integration process. We measure institutional development by the World Bank Governance Indicators (WBGI in the following; Kaufmann et al. 2005) and evaluate institutional development in the EU's Balkan and Black Sea neighbors relative to different EU country groups. This benchmarking allows us to analyze the current state of development in potential next-round accession countries and future EU neighbors (Chapter III). Chapter IV has the implications for the continuing accession process.

II. The Importance of Institutional Development for the European Integration Process

Institutional development is a precondition for entry into the EU. The process of EU enlargement is tightly bound to the concept of convergence. Membership to the EU demands the fulfillment of a series of political, legal, and economic criteria (Foders et al. 2002). The member candidates must demonstrate political stability as a guarantee for a democratic and lawful order, including maintaining human rights standards and insuring the protection of minorities (political criteria). Furthermore, potential members must fully implement the Acquis Communautaire (the entire body of EU law) into national legislation, and adopt the goals of the political, economic, and monetary union (legal criteria). Finally, the candidates must have a fully functioning market economy with the ability to maintain competitiveness in the internal market (economic criteria). These so-called Copenhagen criteria for EU membership insure a certain level of institutional development. They imply that a steady progress in political, legal, and economic institution building in Europe’s southeast will be extremely important for potential accession candidates in order to increase their chances for entry into the EU.

Accession candidates, like other emerging market economies, will also benefit directly from institutional development (Schweickert and Thiele 2004). Empirical studies clearly show that institutions are an important explanatory variable for differences in economic performance (Edison 2003). Some authors even suggest that institutional weaknesses are the only fundamental reason for development failures, i.e., that long-run differences in income levels are solely determined by differences in institutional quality (Acemoglu et al. 2001; Easterly and Levine 2002; Rodrik et al. 2002). The link between institution building and economic development is even reinforced by the formation of social capital and the convergence of values.[1]

Enlargement also increases the relevance of heterogeneity. Alesina et al. (2001) demonstrate in a political economy model how a larger union, made of countries with heterogeneous preferences and/or economic fundamentals, decreases the willingness to agree on common policies. The EU always followed a top-down approach based on ex-ante harmonization. In this respect the rule of law always played a decisive role in governing an increasing deepening of integration in Europe (Langhammer 2002; Pelkmans 2000). This will become even more important in the final stage of the completion of the single market. Achieving a well functioning single market in services requires choosing between mutual recognition of regulations or, if this would lead to excessive regulatory competition in a larger EU, abandoning national regulation in favor of centralized regulation at the level of the EU (Tabellini 2003: 67).

Therefore, it is rational for the EU to demand for institutional convergence, which can be expected to make the EU more homogeneous both economically and politically and, thereby, to decrease the costs of decision making. Efficient decision-making procedures will be important for the EU in order to jump start the ambitious project of a political union. Any delay in the catch-up process runs

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[1] Economic development shifts the values of a society from ‚survival’ to ‚self expression’ which, in turn, fosters the process of institution building, especially the demand for democratic structures. See Inglehart et al. (2001).

the risk of conflicting assessments of political and economic problems, thus undermining the integration process and making agreement more difficult. Any delay in the catch-up process will also put great stress on the EU budget in the form of transfer payments and agricultural subsidies.

III. Institutional Quality in Balkan and Black Sea Europe

1. WBGI as a Measure of Institutional Quality

In a comprehensive project, which started in 1999 (Kaufmann et al. 1999), the World Bank compiled data for a large country sample from many different sources (e.g. the Global Competitiveness Report of the World Economic Forum and the country reports of the Economist Intelligence Unit) and came up with an assessment of six indicators, which are aggregated in this paper to three dimensions of institutional quality:

- *Legislative Institutions*
  - Voice and accountability
  - Political stability and absence of violence
- *Administrative Institutions*
  - Government effectiveness
  - Regulatory quality
- *Judicative Institutions*
  - Rule of law
  - Control of corruption.

The first indicator, legislative institutions, captures various aspects related to the political process such as political, civil, and human rights and the likelihood of changes in government through extraordinary, i.e., non-constitutional, events. The second indicator, administrative institutions, measures the effectiveness of the public administration such as quality, independence and accountability of the bureaucracy and the quality of the institutional framework required for economic activities in the private sector as well as the absence of market-unfriendly policies. The third indicator, judicative institutions, focuses on the trust in the police and the courts, the quality of contract enforcement, and the extent of corruption. The indicators are normalized to a scale from –2.5 to +2.5, where higher values correspond to better outcomes.

Notwithstanding technical and conceptual deficits of these indicators,[2] institutions have proven to explain economic development. Additionally, the monitoring of the EU according to the Copenhagen criteria looks at institutions, which also figure prominently in the WBGI: human rights, participation, rule of law, effectiveness of government, and control of corruption. Therefore, the WBGI provide a good basis to analyze from a bird's eye view the institutional development in the countries of the Balkan and the Black Sea regions and

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[2] On the technical level, one has to keep in mind that the data are based on interviews with local experts and thus include a strong subjective element. On the conceptual level, the problem is that despite a general consensus on the institutions, which have to be analyzed, a number of questions about details—e.g. finding the right balance between competition and regulation—do not have a unique answer. In his programmatic article, Stiglitz even argued that with respect to competition policy a consensus is neither possible nor desirable, because economic research will not be able to identify a competition policy that is optimal for all countries at all times. See Stiglitz (1998).

compare their progress with the standards set by old and new members of the EU.

2. The Quality of Institutions in Neighboring Europe

Figure 1 shows the quality of overall, legislative, administrative, and judicative institutions calculated as simple averages on the basis of the six WBGI on institutional development for seven regional groups. These country groups are ordered according to their average per capita income.

As predicted by the empirical literature, Figure 1 reveals a strong positive relationship between institutional and economic development. At the same time, it is evident that the current enlargement already has made the EU significantly more heterogeneous than before not to speak of future enlargement rounds ahead:

- While the southern European countries (EU-South) that joined the EU in the 1980s succeeded to close the institutional gap to the EU-15 considerably, the member states of the May 2004 accession (EU-Central and EU-Baltic) still reveal a significant institutional gap. This gap applies to all dimensions of institutions measured by the WBGI.[3]

[3] For a discussion of institutional development in the new member states see Roland (2005).

- For the non-member states in Central Europe (NMS-Central), Bulgaria and Romania, institutional development is somewhat away from EU standards.

- Institutional development in the non-member states in the Black Sea, including Ukraine, (NMS-Black Sea) and Balkan regions (NMS-Balkan) is comparatively worse. Especially the Balkan countries, still suffering from disintegration and violent conflicts of the recent past and just beginning their nation building, urgently need institutional development.

However, the Baltic countries also provide some encouraging counter-evidence. In 2002, institutional development of the Baltic countries was still considerably worse than in the richer EU-Central countries. This picture changed dramatically. Within two years, progress in institution building has placed the Baltic countries between EU-South and EU-Central. This outcome is a first indication that institutional development can be quite fast if there is a clear perspective, i.e., EU accession. According to the empirical evidence reported above, this institutional progress driven by accession should help the Baltic countries to narrow the income gap to their neighboring countries.

Figure 1 also shows a clear pattern of institutional development with respect to the three dimensions. Different to the EU-15 member states, the development of legislative institutions is generally more advanced than administrative and judicative institutions.[4] To some extent this seems to be quite natural given the rather fast transition from socialism to democracy and integration into a community with an internationally high quality of political and economic institutions, yet the formal introduction of laws has still to be backed up by their implementation. Neglecting the assessment of actual implementation implies that problems of integration may show up in the next years with potential negative implications for the willingness of EU member states to allow for further enlargements.

Comparing the results for the five countries which are next in the queue for entry, Bulgaria, Romania, Croatia, and Turkey with Ukraine, reveals that these countries are significantly less developed institutionally when measured by EU-15 standards. Additionally, there are pronounced differences between these five countries.

With respect to legislative institutions Bulgaria, Romania, and Croatia perform far better than Turkey and Ukraine (Figure 2). This result is interesting for two reasons. First, Croatia, notwithstanding its initial difficulties, surpassed Bulgaria, which, again, demonstrates that progress with institutional reforms is possible even in a short time period. To the contrary, Turkey made some progress since 2002 when the country even ranged *below* Ukraine. Although the progress made in Turkey during the recent years is evident, the fact that Turkey,

[4] With the exception of administrative institutions in the Baltic countries.

according to the EU, has already fulfilled the political criteria demonstrates that the start of accession negotiations primarily depends on the political will of EU member states.

A different picture is drawn by the indicator on administrative institutions (Figure 3). As was to be expected on the basis of the comparison of country groups, the development of administrative institutions lags behind the development of legislative institutions in Bulgaria, Romania, Croatia, and Ukraine. Turkey is an exception because administrative institutions clearly perform better than legislative institutions. Although the difference from the EU standards is significant in all cases, Turkey, together with Bulgaria, Croatia, and Romania form a group of countries that comes closest. Ukraine is still far behind.

Finally, the indicator on judicative institutions (Figure 4) reveals that the five countries perform worse relative to the other institutional indicators. Again, Croatia outperforms the other countries. This result should have an impact on the prospects of Croatia to join the EU. If negotiations progress smoothly and the chapters will be closed quickly, it is at least difficult to argue that Croatia should wait longer than Romania, a country where administrative and judicative institutions even deteriorated since 2002. Once more, Ukraine still has a long way to go. Its judicative institutions are far behind Turkey.

Figure 5 summarizes the results of the three dimensions by showing the overall institutional performance in Balkan and Black Sea Europe. It is evident that Ukraine, together with Moldavia, holds the red lantern among the sample countries. The Kutschma heritage was clearly disastrous. There is, however, some hope. With respect to macroeconomic stability, Ukraine outperforms most of its competitors for EU entry. This implies that Ukraine can concentrate on institutional reforms in order to bring the country closer to Europe. Especially the case of Croatia—and to some extent also the case of the Baltic countries—demonstrates that EU integration may help to focus the reform process of accession countries. Croatia even performs slightly better than Bulgaria.

Romania and Turkey form a second group with considerably worse institutions. This is not only true in a European perspective but also in absolute terms. In the case of Turkey, with negotiations still pending and open-ended, this has no repercussion for the EU. However, the results for Romania—EU entry scheduled for January 2007—should turn on some warning lights. Institutional deficits are clearly not likely to improve the support of EU enlargement among the EU population. This does not necessarily imply to stop the process of enlargement. It implies that institutional development in new member states as well as actual and potential accession countries should have a high priority on the EU agenda.

3. Institutional Development in Neighboring Europe

These conclusions might be criticized because they consider only the status of institutional quality as of 2004 and not the progress made in institutional development. The institutional development might be relevant for two reasons. First, institutions might have been very poor initially so that the status quo in 2004 underestimates the efforts made by European countries inspired by the chance to integrate into the EU. This should especially be relevant for Bulgaria, Croatia, Romania, and Ukraine which have been or are still transition countries.

Figure 6 reveals the progress in institutional development of the five countries under consideration. The six WBGI are available since 1996 and the differences between 1996 and 2004 confirm the argumentation above. In contrast to naïve expectations on the transition process not all countries' institutions improved over the years. By far the largest progress has been made by Bulgaria and Croatia. Croatia shows in fact positive developments in all indicators.

Again, Romania and Turkey reveal a rather mixed performance. In the case of Romania there is a strong deterioration of the indicator of Political Stability, no progress with respect to Control of Corruption and only little progress with respect to Rule of Law. The indicators for Voice and Accountability, Government Effectiveness and Regulatory Quality improved considerably. In the case of Turkey there is a strong deterioration of Regulatory Quality and Control of Corruption and no progress with respect to Government Effectiveness and Rule of Law. Moreover, the promising improvement of Political Stability in Turkey took place until 2002 but has not been continued in recent years, whereas at least Voice and Accountability improved steadily over the years (see Table A1 which shows the results for all years). In Ukraine the quality of virtually all institutions deteriorated before the Orange Revolution. Up to that point the transition process did not continue towards better institutions.

Second, even if improvements of institutional quality are lacking, the quality of institutions might be relatively high when adjusted by the income level. As shown in Figure 1 there is a high correlation between institutional quality and income as country groups are ordered by income level. In Figures 7a-f, the income-adjusted institutional quality in the five accession countries is compared with that in a new member state of the EU (Slovak Republic) and two old member states with low and high income (Greece and Germany). The regression line, given by the full set of 204 countries, provides a benchmark for an average performance to be expected for countries with similar income levels.

While it was to be expected that the differences in institutional quality become smaller with rising income because of the strong relationship between institutions and income, some significant differences still remain. In almost all cases, EU member states perform on average better than countries of similar income levels while accession countries tend to perform worse than countries just at the benchmark regression line in terms of Government Effectiveness, Rule of Law, and Control of Corruption. Turkey (in all cases) and Ukraine (with one exception) perform worse than the benchmark. Romania, Bulgaria, and Croatia perform better with no clear pattern of one country outperforming the other two.

Overall, some of the absolute differences shown in Figures 2–5 are actually explained by income differences. However, it is not the case that the process of European integration governed by the Copenhagen criteria leads to a general harmonization of the quality of institutions, which would imply that new member states and accession countries would outperform the benchmark regression line more the lower their income level. Hence, differences in absolute values are likely to remain or depend on individual reform efforts of single countries.

IV. Implications for Further Enlargement

The analysis of institutional development in Europe has demonstrated the challenges of European integration:

- Institutional development is of central importance for the process of integration.
- The countries in the Balkan and the Black Sea regions are still far away from the EU in terms of institutional development.

- The EU, which has become considerably more heterogeneous by the recent enlargement, becomes even more heterogeneous in case of additional rounds of enlargement.
- Notwithstanding positive evaluations by the European Commission, institutional deficits are still evident particularly in Romania and Turkey.[5]
- For Ukraine, the Kutschma heritage was clearly disastrous in terms of institutional development.

One implication for the process of further enlargement is that Croatia should have good prospects to join the EU rather soon. Compared to the other countries institution building in Croatia was rather intensive and sustainable. Unfortunately, the EU so far always favored the regatta principle, i.e., that a group of countries rather than single countries join the EU at the same point in time. This regatta principle reduces the costs of an adjustment of negotiation weights, job allocations, and financial funds. Hence, Croatia may have missed a good chance to catch up and join the EU together with Bulgaria and Romania by not cooperating with the UN war crimes tribunal.

While Croatia already has a perspective to join the EU, negotiations with Turkey will decide where the enlargement process ends and where the European neighborhood begins. The picture drawn by the World Bank Governance

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[5] For country studies on Bulgaria, Romania, Croatia, and Turkey, see Gawrich and Schweickert (2004: 153–186).

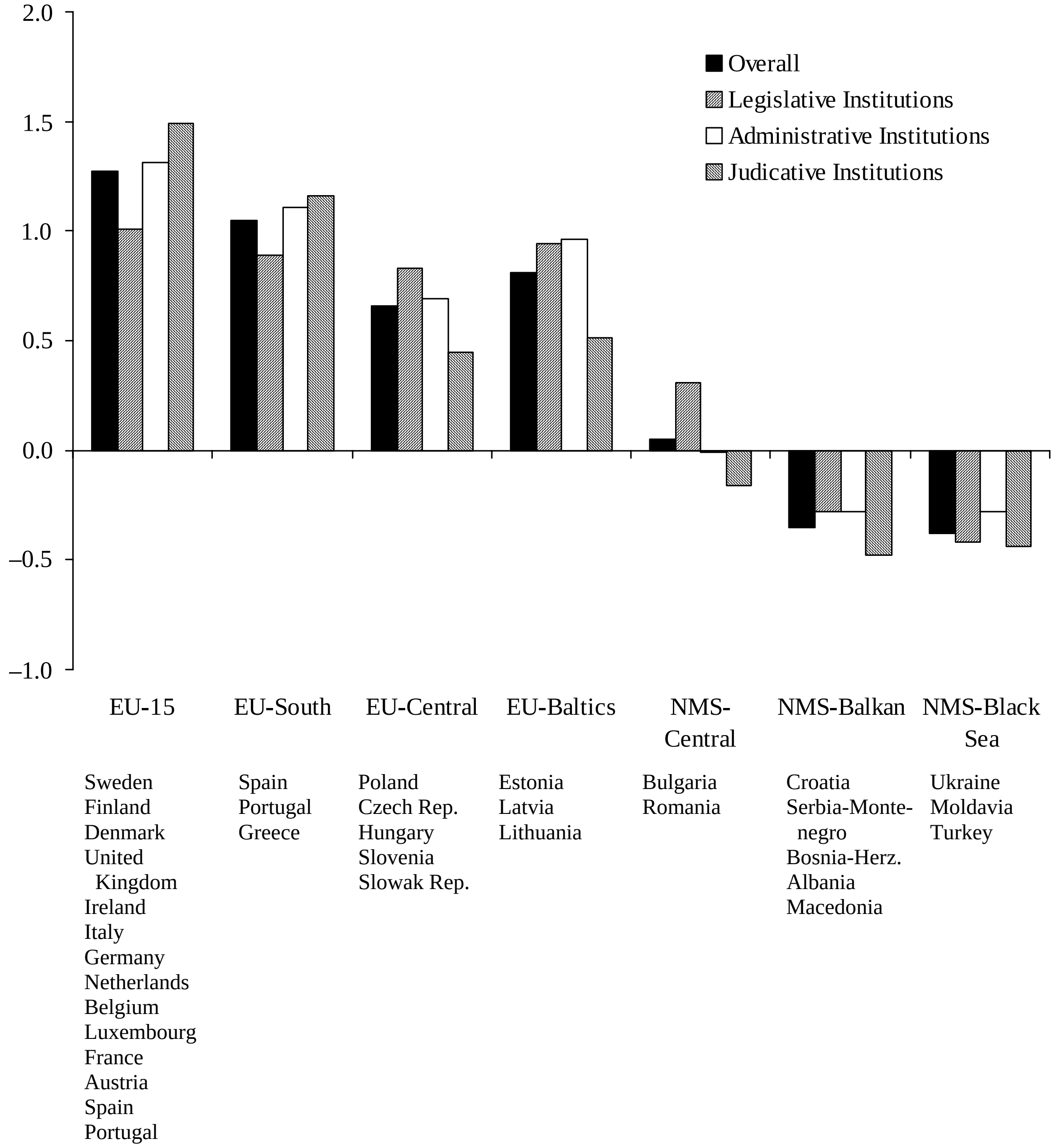
Indicators is not encouraging but, at the same time, does not speak against membership of Turkey. The examples of Croatia and other transition countries suggest that even large institutional deficits can be overcome in relatively short time. This provides hope for the Ukraine to join Turkey in the process of EU accession.

The EU-South enlargement and the following convergence in institutional quality as well as income levels reveals that integration with EU's core countries (e.g. Benelux, France, Germany, Italy) and importing their institutions is the road towards political stability and economic prosperity. Recently, the new member states in central Europe and the Baltic followed this example. Bulgaria and Romania are to follow. These successful experiences give the European Commission a prominent role also in supporting institution building in its neighboring countries. The Balkans, Turkey and Ukraine are likely to benefit from continued EU assistance leading to economic growth and paying back current EU member states by delivering political stability in Europe.

Meanwhile, the further process of political integration is loosing support in some of EU's core countries, namely France and the Netherlands, putting stumbling blocks in the way not only towards the constitution but also the likelihood of further enlargements. For many countries, full EU membership is to far out of reach in order to serve as a convincing perspective to motivate institutional change and the European Neighbourhood Policy is a highly imperfect substitute.

A viable option may be to revive the European Economic Area for EU’s neighbors. Such a strategy would avoid political integration with large transfers but still deliver the benefits of a common institutional framework.

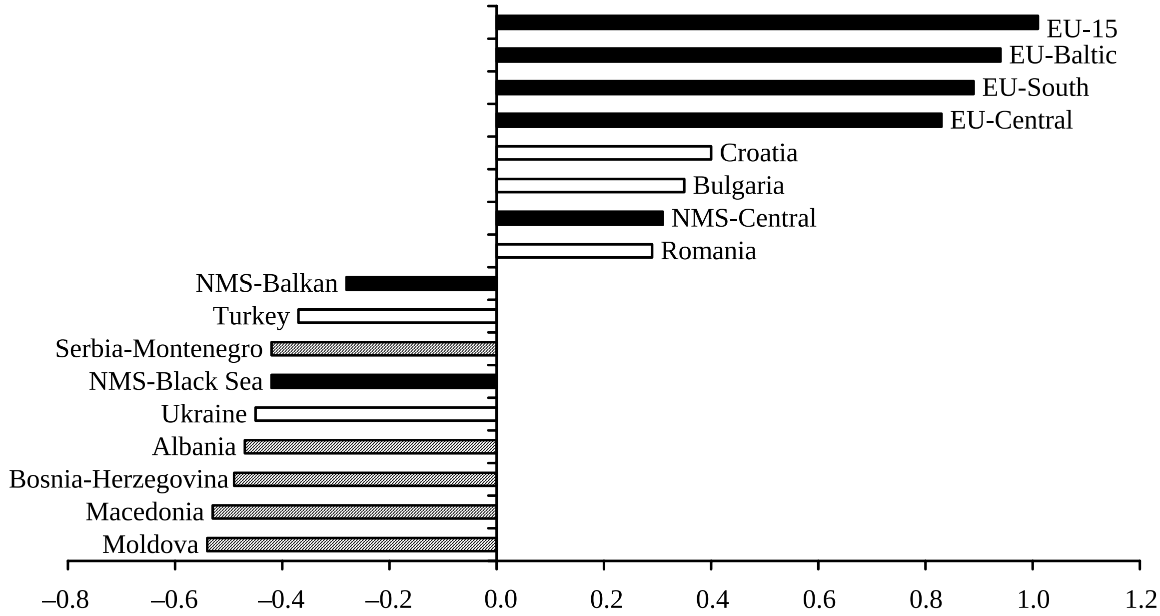
Figure 1: Overall Institutional Development in Groups of European Countries, 2004



Note: Country groups ordered by income level.

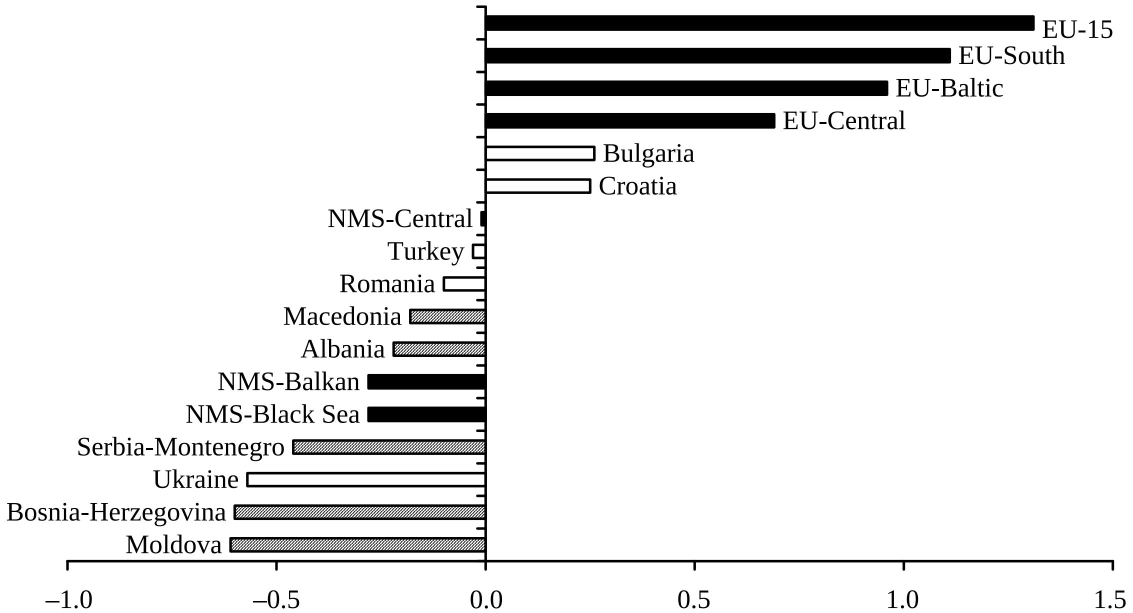
Source: Kaufmann et al. (2005); own calculations.

Figure 2: Legislative Institutions in Non-EU Europe, 2004



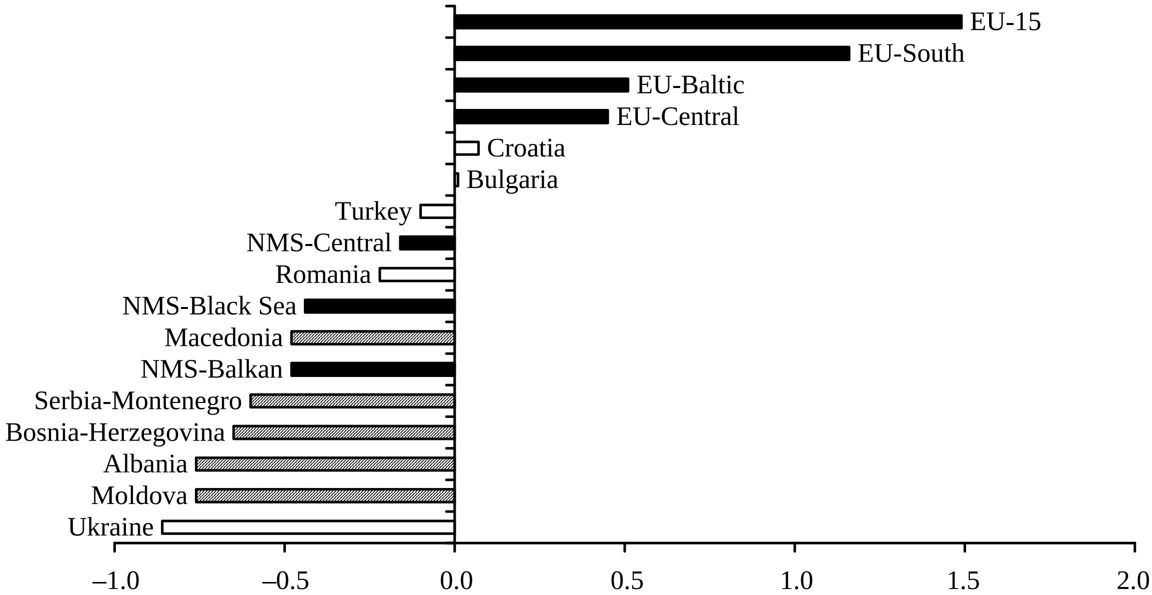
Source: Kaufmann et al. (2005); own calculations.

Figure 3: Administrative Institutions in Non-EU Europe, 2004



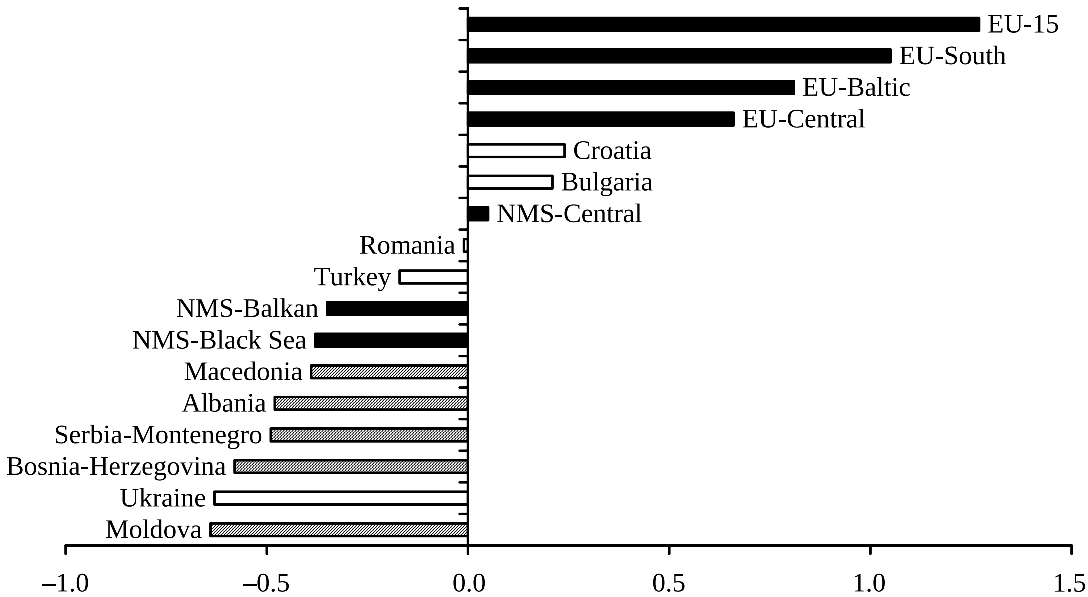
Source: Kaufmann et al. (2005); own calculations.

Figure 4: Judicative Institutions in Non-EU Europe, 2004



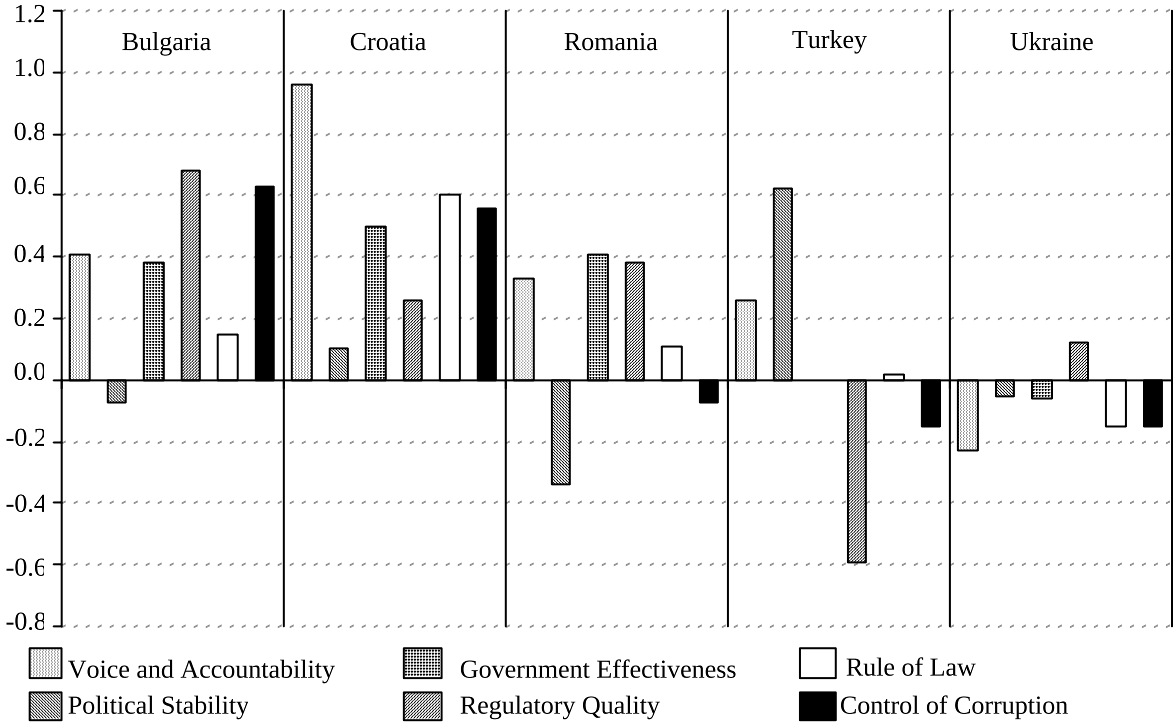
Source: Kaufmann et al. (2005); own calculations.

Figure 5: Overall Institutions in Non-EU Europe, 2004



Source: Kaufmann et al. (2005); own calculations.

Figure 6: Institutional Progress in Non-Member Countries, 1996–2004



Source: Kaufmann et al. (2005); own calculations.

Figure 7a: Voice and Accountability

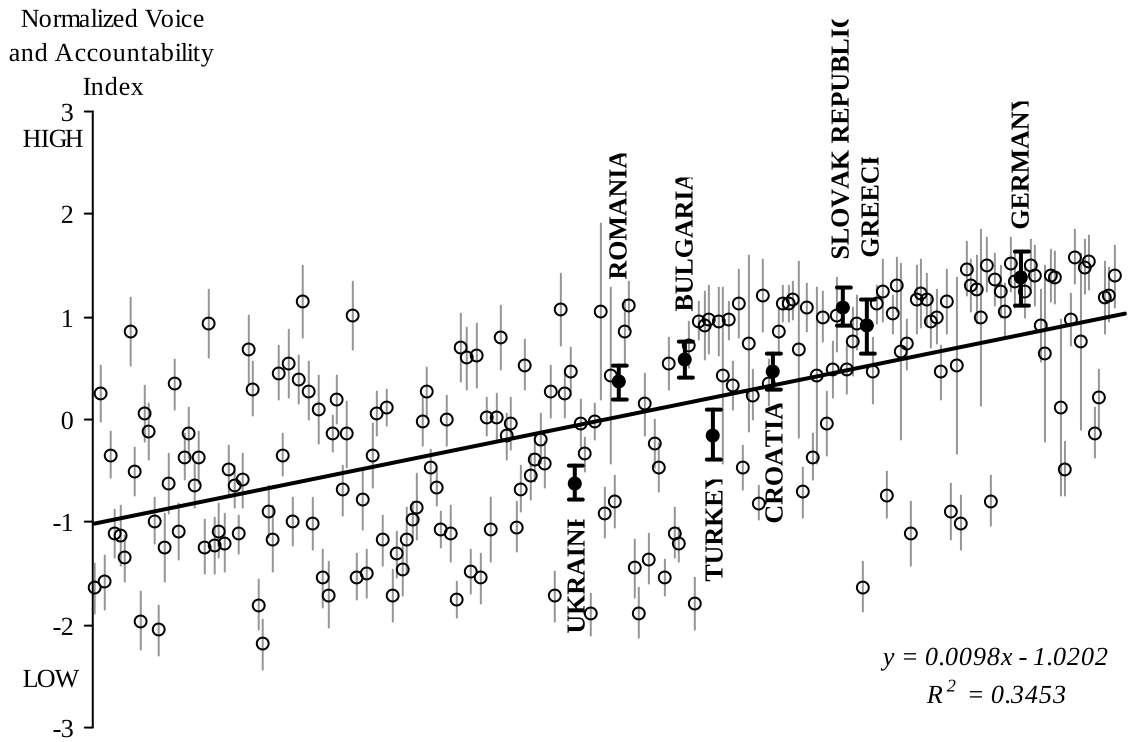


Figure 7b: Political Stability

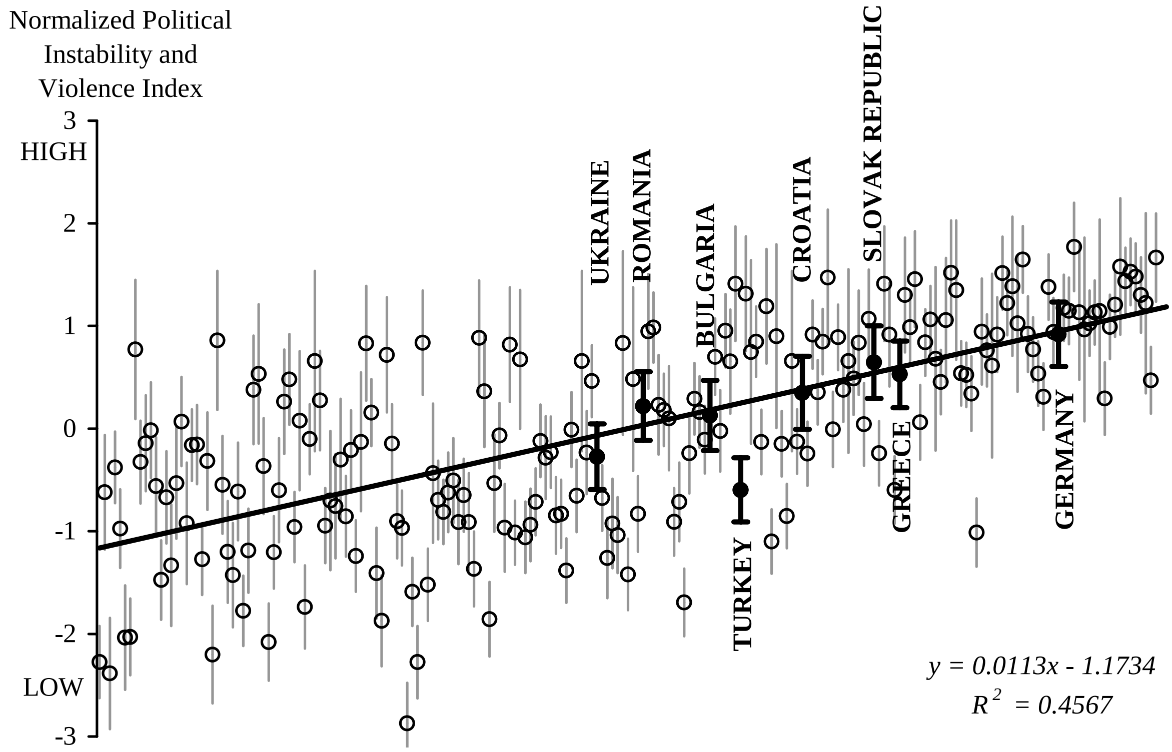


Figure 7c: Government Effectiveness

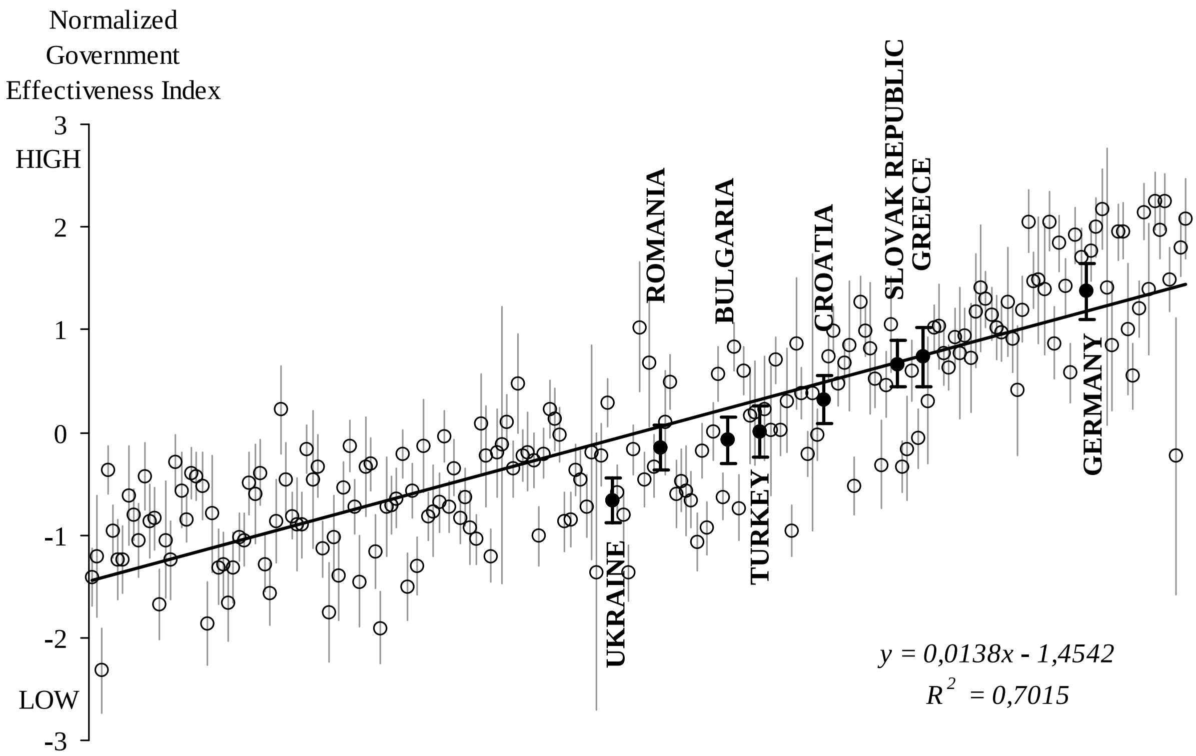


Figure 7d: Regulatory Quality

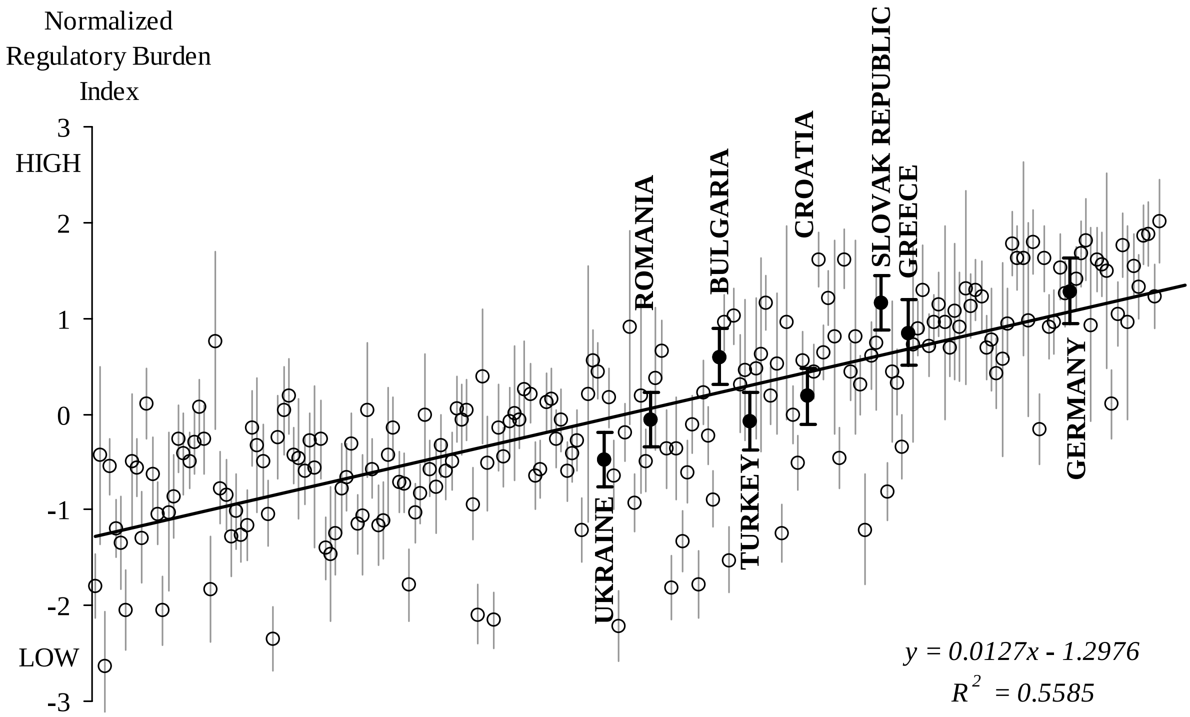


Figure 7e: Rule of Law

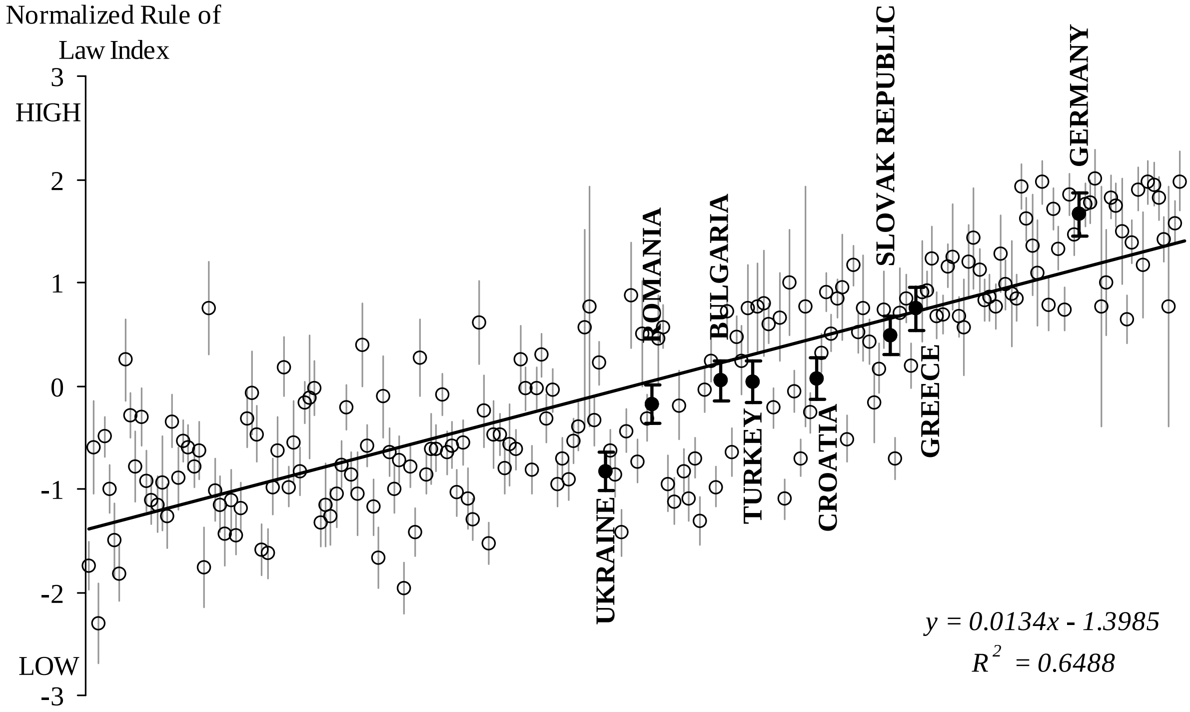


Figure 7f: Control of Corruption

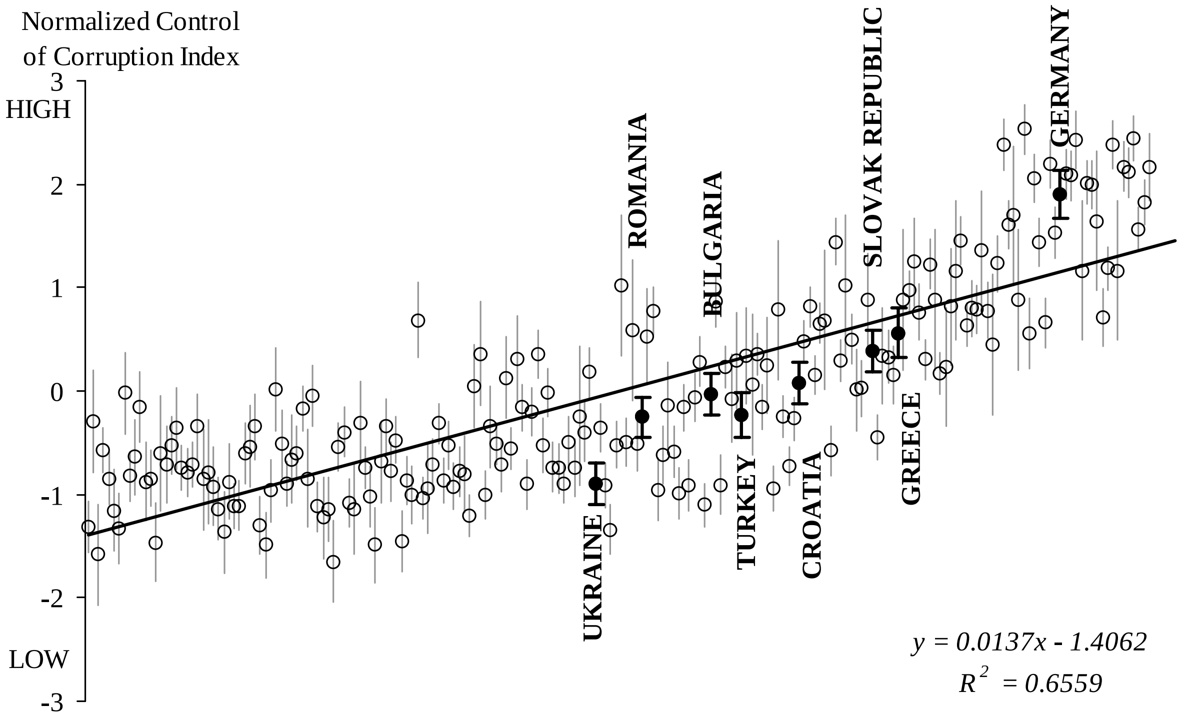


Table A1— Institutional Progress in Actual and Potential Accession Countries, 1996–2004

Country	Estimated					Diff.	Estimated					Diff.
	2004	2002	2000	1998	1996		2004	2002	2000	1998	1996	
	Voice and Accountability						Political Stability					
Bulgaria	0.58	0.56	0.51	0.40	0.17	**0.41**	0.13	0.56	0.30	0.44	0.19	**-0.07**
Croatia	0.46	0.49	0.38	-0.30	-0.50	**0.96**	0.35	0.48	0.49	0.46	0.24	**0.10**
Romania	0.36	0.41	0.43	0.24	0.03	**0.33**	0.22	0.34	0.01	0.20	0.56	**-0.34**
Turkey	-0.15	-0.47	-0.65	-0.92	-0.41	**0.26**	-0.60	-0.66	-1.01	-1.10	-1.21	**0.62**
Ukraine	-0.62	-0.64	-0.39	-0.14	-0.39	**-0.23**	-0.27	0.12	-0.48	-0.19	-0.22	**-0.05**
	Government Effectiveness						Regulatory Quality					
Bulgaria	-0.08	-0.02	-0.16	-0.94	-0.45	**0.38**	0.60	0.62	0.22	0.47	-0.08	**0.68**
Croatia	0.32	0.23	0.15	0.30	-0.17	**0.50**	0.19	0.19	0.31	0.34	-0.08	**0.26**
Romania	-0.15	-0.30	-0.59	-0.61	-0.55	**0.41**	-0.06	0.04	-0.27	0.30	-0.43	**0.38**
Turkey	0.01	-0.16	-0.07	-0.31	0.01	**0.00**	-0.07	0.05	0.24	0.86	0.51	**-0.59**
Ukraine	-0.67	-0.76	-0.78	-0.97	-0.61	**-0.06**	-0.48	-0.62	-1.22	-0.89	-0.59	**0.12**
	Rule of Law						Control of Corruption					
Bulgaria	0.05	0.01	-0.13	-0.22	-0.09	**0.15**	-0.04	-0.15	-0.13	-0.50	-0.67	**0.63**
Croatia	0.07	0.09	0.14	-0.04	-0.53	**0.60**	0.08	0.25	0.04	-0.33	-0.48	**0.56**
Romania	-0.18	-0.15	-0.22	-0.25	-0.29	**0.11**	-0.25	-0.32	-0.45	-0.38	-0.18	**-0.07**
Turkey	0.04	-0.05	0.05	0.19	0.03	**0.02**	-0.23	-0.40	-0.28	-0.01	0.08	**-0.31**
Ukraine	-0.83	-0.84	-0.72	-0.76	-0.67	**-0.15**	-0.89	-0.97	-0.96	-0.89	-0.74	**-0.15**

Source: Kaufmann et al. (2005); own calculations.

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