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Institutional Competition And External Constraints of Transformation: Institutional Transfer and Institutional Imitation in the former GDR and in Central and Eastern Europe[*]

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Twelve years after the change of economic and political systems in Central and Eastern Europe indicators of economic performance and institutional development still point out that transformation is incomplete. However, the debate of transformation strategies, earlier focusing on 'shock therapy versus gradualism', changed. Recently, transformation theory focuses on factors influencing the success of transformation, including initial conditions, institutional arrangements and policy choices. In this paper, the external restrictions on institutional choice due to national (in the case of Germany) and international economic integration are analyzed. Especially the EU accession can be seen as a form of institutional commitment and restriction of institutional choice. Based on a brief outline of the theory of institutional competition, the strategies of institutional transfer in the former GDR, institutional imitation in countries aiming at EU membership and institutional innovation are discussed. While closing the 'window of opportunity' in transformation, institutional transfer or imitation can considerably reduce uncertainties surrounding transformation for business and state.

Keywords: ***Economic transformation, European integration, EU enlargement, Institutional competition***

1. INTRODUCTION

Twelve years after the revolutionary changes in Central and Eastern Europe (CEE) the direction of scientific interest in economic transformation theory changed.[1] While the initial debates about transformation strategies called 'shock therapy' or 'gradualism' lost much of their significance, now the literature focusing on reasoning about long-term successful and less successful transformation strategies is growing (for an overview see Seliger 2002). Among the factors discussed for successful transformation the relation between macroeconomic performances, initial conditions of transforming countries, institutional environment and transformation policies are cited. Especially the impact of EU accession and other external constraints is interesting.

Like the indicators of transformation, which are regularly compiled by research institutes and international organizations,[2] a comparison of output of CEE shows that the transformation recession is far from being overcome in most transformation countries (Poland and Slovenia being notable exceptions). Especially the Balkan region and the Former Soviet Union countries show clearly a performance lag.

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[1] In this study the notion 'transition' is used for a change from a well-defined state A to a well-defined state B, while 'transformation' (the process we actually experience in formerly centrally planned economies) is used for the change from an ill-defined ('fuzzy') state A to an unknown state B1...n.

[2] See Havrylyshyn & Van Rooden (2000: 26), for a (rescaled) synopsis of institutional transformation indicators by Heritage Foundation, Freedom House, EBRD, World Bank and Euromoney. On a scale from 0 (least successful) to one (completed transition) countries rank from only 0.26 (in the case of Turkmenistan) to 0.85 (the Czech Republic).

Table 1. Output Figures for Transformation Countries

Country	Level of real GDP in 1998(1989 = 100)	GNP per capita in $/ GDP in $ in Purchasing Power Parity	GDP per capita as % of Austrian GNP/ GDP in 1998
Albania	89	810/ 1490	3 / 6.5
Bulgaria	66	1220/ 4100	4.5 / 18.1
Croatia	78	4620/ 5100	17.2 / 22.5
Czech Republic	95	5150/ 11300	19.2 / 49.8
Estonia	77	3360/ 5500	12.5 / 24.2
FYR Macedonia	72	1290/ 1050	4.8 / 4.6
Hungary	95	4510/ 7400	16.8 / 32.6
Latvia	59	2420/ 4100	9 / 18.1
Lithuania	65	2540/ 4900	9.5 / 21.6
Poland	117	3910/ 6800	14.5 / 29.9
Romania	78	1360/ 4050	5 / 17.8
Slovak Republic	99	3700/ 8300	13.8 / 36.5
Slovenia	104	9780/ 10300	36.4 / 45.4
Russia	55	2260/ 4000	8.4 / 17.6

Sources: Column 1: EBRD, Annual report 1999; Column 2a (GNP): World Bank, World Development Report 2000, Column 2b (GDP/ PPP): CIA World Fact Book; Column 3: own calculations; for information: Austrian GNP/ capita in 1998: 26830 $; Austrian GDP/ capita (PPP) in 1998: 22700 $.

The explanation of these differences focused initially only on the success of introduction of a relatively well-defined set of transformation policies. Later, when these policies proved to be insufficient as guidelines of transformation, the roles of sound institutions and of good governance were explored.[3] However, institutional transformation was constrained by an internal and an external constraint. Internally, path dependency and the misfit between formal and informal institutions frustrated many attempts to introduce the sound institutions desired for the new market economies.[4] While internal differences

[3] See Mummert & Streit (1996); Herrmann-Pillath (1998). Institutions are all arrangements reducing uncertainty in society, i.e. formal institutions (like written law) and informal institutions (like customs and values). Like North (1990) pointed out they are decisive for economic performance.

[4] Transformation policies target (with other goals like macroeconomic stabilization) the change of formal institutions, however, the new formal institutions can misfit with the old informal institutions (s. Mummert 1998). The transformation of informal institutions and their cumbersome transformation became s a special study field see Mummert (1998), Rosenbaum (1999), Herrmann-Pillath (1999(a)) and for the case of the former GDR Seliger (1999(b)).A special problem was the simultaneous transformation of state and economy (see Shleifer 1997, Herrmann-Pillath 1999b). Public Choice theory could explain, why good governance generally could not be expected in Central and Eastern Europe (CEE); see Apolte (1992) and Klein (1995). Also, the cultural back

were important to explain variance in performance in early transformation, today the role of external constraints for institutional change, especially the role of EU accession, is growing in importance (see Piazolo 2001).

Externally, institutional choice in transformation countries was constrained to various degrees. The German unification process and acceptance of Western German institutions in the case of the former German Democratic Republic (GDR), the Copenhagen criteria for membership in the European Union for the CEE attempting to join the EU or the conditionality of IMF loans are examples for such constraints. Generally all transformation policies are constrained by institutional competition, the exit of factors of production and the voice of voters and pressure groups, potential investors and workers. The attraction of FDI, migratory flows of capital and labor, the influence of regulation on trade and investment are all determined by the interplay of internal conditions and restrictions to transformation and external conditions and restrictions. So, policy choices in transformation countries are policy choice in a competitive environment, shaped by internal and external constraints. The nature and the positive and negative effects of external constraints will be discussed in the following paper.

Models of institutional competition exist since more than a decade, especially analyzing locational competition and the federal design of states.[5] They are also appropriate models to apply to institutional choices of countries in transformation. In the second section of this paper a brief overview over institutional competition is given. The third section compares the choices of transformation countries, given the constraints of institutional competition. Especially the transfer of institutions in Eastern Germany is compared to the strategies of institutional innovation and imitation in CEE. A summary and some ideas for future empirical research are given in the outlook (4.).

2. THE THEORY OF INSTITUTIONAL COMPETITION – A BRIEF OVERVIEW

The theory of institutional competition postulates that the model of competition developed for markets for goods has *mutatis mutandis* also explanatory power for the development of institutional systems. Public choice theory since the 1950s tried to model a market for politics with a supply side and a demand side.[6]

However, not only parties and politicians are competing for power and office. The choice of voters for policies, the choice of investors between different investment possibilities and locations, and the voice of organized groups like labor also lead to competition among institutions. Different social security systems, tax systems, regulatory systems and even models of organization of the society are evaluated in this competition process and eventually considered to be in need of reform or abandonment. For example, the attraction of FDI as a major goal of economic policy (namely the extension of production possibilities beyond domestic investment) is a form of competition of immobile factors of production (a certain region with more or less immobile labor living in this

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[5] For an overview see Gerken (1995) and Seliger (1998 and 1999(a)).

[6] For an overview see Mueller (1989). On the supply side of the market for politics politicians and bureaucracy offer policies, for the supply of public (and publicly produced) goods, for re-distribution and regulation. On the demand side voters decide between different election platforms. Lobbyists provide information to the supply side, information which is often asymmetric, i.e. only available for lobbyists.

region) for mobile factors of production (investment capital). [7]

What are the effects of mobility? Firms can decide to change location to escape from institutional rigidities like strict environmental regulation. In border regions cross-border competition for consumers is fierce. Regions and nations try to attract FDI by changing tax codes, providing infrastructure and simplifying bureaucratic procedures (like the one-stop shop system for investors). Since there are choices for investors, consumers and tax payers, they can exploit 'institutional arbitrage', e.g. shift capital to low tax countries or import goods from countries with regulations favorable for production and therefore cheaper.[8] In cases where migration costs are lower than the benefits expected from migration, 'exit' is a possible strategy for citizens (or labor).[9] On a large scale, this leads to 'systemic conflict', where different political and social systems (like in the case of the Cold war) compete.[10]

Three possible answers exist to institutional arbitrage: First of all, new institutions can be introduced (institutional innovation). Second, institutions of foreign countries (or other regions) can be transferred, either through a joint offer of the institution or through transfer of the underlying regulation or law. Third, successful institutions can be imitated, without completely transferring them. Reviewing these three reactions, one can see more clearly the similarity between competition in markets for goods and services and institutional markets: First, institutional competition provides an incentive for innovation and works as a Hayekian 'discovery procedure'. Second, institutional competition controls the power of the supply side, i.e. the generally monopolistic offer of institutions. In democracies, offices are contestable and therefore office-holders are forced to react to institutional competition. Institutional learning (transfer or imitation of institutions and rejection of institutions which in other countries or regions failed) is an important argument for the desirability of institutional competition. The falsification of 'economic models' or systems (like the centrally planned economy) in other countries or in history provides arguments for decision making and makes it less expensive.[11] It should be noted that this view of institutional competition does not necessarily result in 'evolutionary optimism', i.e. the expectation of always better-adapted institutions. First, states can – again in analogy to competition in markets for goods and services – try to obstruct competition, for example by barriers to trade, or by cartelization (see Gerken 1995). Second, institutional innovations can lead to a dead end, when the environment changes.[12]

The emergence and change of institutions is not unconstrained.[13] Internally, path

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[7] Cf. Siebert & Koop (1993). The distinction between mobile and immobile factors of production is not easy: While capital in the form of financial capital is highly mobile, real capital has different degrees of immobility. The factor labour is technically mobile. However, social security systems (reducing the incentive for migration in the case of unemployment), social and cultural costs of migration (like learning a new language, abandoning family and friends), legal barriers to migration, and immobile wealth (like real estate in countries, where the real estate market is not very liquid) reduce mobility. Therefore, only highly skilled labour is also highly mobile, while middle and working classes often are immobile.

[8] Cf. Mussler & Wohlgemuth (1994: 6-7).

[9] The classical model analyzing this process described as ‚voting with the feet' is Tiebout (1956). For the processes of exit and voice see Hirschmann (1970).

[10] Cf. Kaltefleiter (1982: 21).

[11] Cf. Prosi (1991: 130).

[12] For example, it can be argued that the 'developmental state', which resulted in superior economic results before the 1990s, became in a more globalized world inferior to other institutional arrangements.

[13] This is a major difference to neo-classical economic and institutional models, which assume a

dependency ('history matters') constrains institutional development. Externally, the process of globalization and the membership in global or regional organizations like WTO or EU represent major constraints for innovations.[14] Institutional integration like the forming of a Free Trade Area or the application for membership in a Customs Union or Common Market are an important restriction for institutional development.[15] International or regional organizations might work as a competition system for institutional competition in that they guarantee the free circulation of goods, services and in the case of a common market also factors of production. Then, institutional competition is increased by membership. They might also harmonize economic policies (e.g. social or regulatory policies), thereby reducing the degree of institutional competition.[16]

Figure 1 summarizes the model of institutional competition outlined above. The impact of external constraints on institutional change is Janus-headed: The positive aspect is that institutions generally are aiming at reducing uncertainty and that rapid and frequent institutional change leads to a higher degree of uncertainty. For example, in transformation countries information about institutional development is weak and therefore, long term investment is rather avoided.[17] The negative aspect of institutional rigidity is the restriction of choices and the low degree of adaptability of institutions. However, in the case of transformation an entirely economic-political system might be change rapidly. In the next section the effects of such a change and its relation to institutional competition are discussed.

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free choice of optimal institutions.

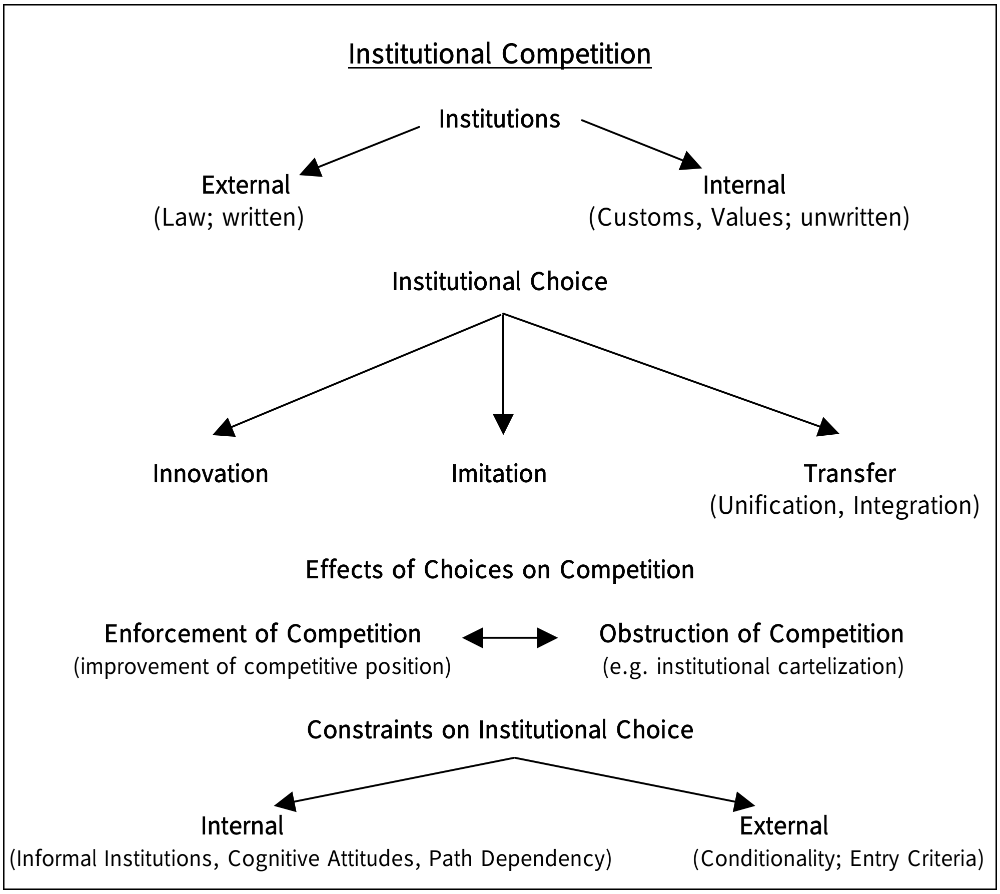
[14] Recently, Rodrik argues that despite the discussion about globalization national borders still represent important obstacles, referring to the Feldstein-Horioka paradox and the home bias in investment decisions; see Rodrik (2000: 178-179). However, while absolutely the degree of global integration might be still small, also marginal movements (like capital outflows or migratory movements) might present enough of political pressure to lead to changes in institutional supply. The intense discussion about economic models and economic policy prescriptions in the 1980s (after the Reagan-Thatcher reforms) and the 1990s (after the globalization hype) seems to justify such an evaluation.

[15] While it cannot be discussed here, it should be noted that the external impact is important for economic and also for political institutions, for the latter see the analysis of CEE and the EU in Vachudovva (2001).

[16] In the European integration process, since the 1950s there was a debate of integration as removing of barriers (favored by Ludwig Erhard, then German economic minister) or the introduction of common policies (favored for example by Etienne Hirsch, then planning commissioner in France). This debate is still today virulent in the discussion of subsidiarity and centralization in Europe; see Gordon & Seliger (1999).

[17] Walter Eucken in his 'Foundations of Economic Policy' names the 'steadiness of economic policy' as one of the founding principles of a market economy, since without steadiness rational economic decision making is not possible; see Eucken (1952: 285-289). The uncertainty in transformation countries can also be seen in socio-cultural adjustments like a sharp decline in marriage and birth rates.

Figure 1. Institutional Competition



3. TRANSFORMATION AND INSTITUTIONAL COMPETITION AFTER 1989

3.1. Transformation and Institutional Imitation – An Overview

Prima facie the case of transformation of an economic system seems to be a clear case of institutional imitation: The change from an unsuccessful economic system, coming under pressure from low growth and innovation rates, exit (mass migration) and voice (protestations in 1989) to a more successful model, the change from central planning to market economy. In a narrow sense of transition it was interpreted as the change of (relatively few) formal institutions of the economy. After the reform a market economy would spontaneously develop.[18] This in the beginning of transformation very influential view was developed in the Washington based international institutions and accordingly

[18] In this study the notion ‘transition’, characterizing a more restricted task, is therefore avoided and the more encompassing notion ‘transformation is used.

named the Washington Consensus model. First developed for the transition of Latin American economies in the 1980s towards more market oriented economies, it was due to the universal neo-classical model upon which it was based also applicable for CEE.[19] Starting and ending point of transformation are well defined, as figure 2 shows. Only timing and sequencing, in the political discourse reduced to the alternatives of "gradualism" and "shock therapy," are disputed.[20]

Figure 2. The Tasks of Transformation

Establishing a Market Economy – Two Alternative Views

The establishment of a market economy is often represented as the change of relatively few formal institutions, which were typically identified as institutions of centrally planned economies, towards those being institutions of the market economy.

The Washington Consensus includes the following institutional changes (Williamson 1990, 1997):

* Fiscal laxity → fiscal austerity
* Incoherent tax code →tax reform
* Closed markets → liberalization of trade and finance
* Official and black market exchange rate → unified exchange rate systems
* Closeness of economy to foreign capital → attraction of FDI
* Collectively owned firms → privatization
* High degree of regulation, esp. price regulation → deregulation
in the extended version: creation of property rights

Kornai (2000), in what he himself admits to be a minimalist characterization, points out the following changes:

* Undivided power of Marxist-Leninist party → Political power friendly to private property and the market
* Dominant position of state and quasi-state ownership → Dominant position of private property
* Preponderance of bureaucratic co-ordination → Preponderance of Market co-ordination
* Soft budget constraint/ weak responsiveness to prices → Hard budget constraint/ strong responsiveness to prices
• Chronic shortage economy/ seller's market/ labor shortage → No chronic shortage/ buyer's market/ chronic unemployment

A transformation so defined, largely the imitation of Western capitalism by transformation states, is incomplete for two different reasons. The first reason is the neglect

[19] Cf. Williamson (1990). In an extended version of the Consensus also the creation of property rights appears as a goal (cf. Williamson, 1997: 60-61) or even the inclusion of aspects of institutional economics (cf. Burki & Perry, 1998). Recently, Kolodko (1999) postulates the need to define a "post-Washington consensus". However, this cannot overcome the inherent shortcoming of the consensus, representing a model of closed, trivial transition.
[20] Cf. Dhanji (1991), Jens (1993), Falk & Funke (1993).

of institutional pre-conditions (including cultural and historical factors, informal institutions and cognitive models of actors of transformation and public choice considerations) for change; as a policy recommendation, the Washington consensus was a 'nirvana approach', i.e. practically impossible to be implemented. This criticism is dealt with elsewhere. The second reason is the need of transformation countries to decide not for an unspecified 'capitalist' or 'market economic' system (as a Weberian ideal type), but rather to implement from the numerous possible forms of market institutions those which (either for the utility maximizing politician implementing the institutions or in the sense of welfare economics for the country in question) are best adapted for the transformation country.

A closer look at the actual transformation processes reveals important differences between different countries and groups of countries in this respect. In the first years of transformation, many countries did experiment with numerous reforms, often due to their most influential advisors, ranging from Anglo-Saxon models of capitalism to more continental European one, due to geographic and historical proximity often the German model.[21] It should be reminded, that some countries – notably Hungary and the former Yugoslavia – had a long history of internal reforms, which also led to quite different starting conditions in institutional changes towards the market economy.[22] The early blueprints of transformation (like the Gaidar plan in Russia or the Balcerowicz plan in Poland) became, however, obsolete due to political pressure and frequent government changes. Also, the laissez faire approach chosen in the Czech Klaus government was often compromised in the same way. In the time between 1989 and 1991 the former GDR with its complete transfer of external institutions from Western Germany was the only country which could finish the task of establishing the external institutions of a market economy. And, more and more, institutional transformation was constraint by external policy conditions, as it is most clear in the case of Eastern Germany.

3.2. Institutional Transfer: The case of Eastern Germany

Eastern Germany followed a unique transformation path, which resulted after only half a year in the coming in force of the economic, monetary and social union in mid-1990 and reunification in October 1990.[23] This was a practically complete transfer of Western German formal institutions (laws, political institutions, economic institutions). Subsequently, also the economic structure of Eastern Germany became similar to the Western German structure.[24] Investment of foreigners was small as a part of Western German investment in the former GDR. Initial problems with enforcement of institutions were soon solved through a large transfer of Western specialists. This concerned not only civil service, especially the judicial sector, but all sectors of society, for example also universities and other educational institutions.[25] Through this massive and unique transfer

[21] For a presentation of these models there is no place here. Regular updates on transformation strategies of specific countries can be found in the transition report of the EBRD. See also World Bank (1996).

[22] See for an overview Adam (1993)

[23] For an overview, see Sinn & Sinn (1994) and for a discussion Seliger (2001) and Yoder (2001), who speaks of 'accelerated transition'.

[24] This does not mean a complete convergence given that Eastern Germany was characterized by 40 years of socialist allocation and given the effects of the elevated exchange rate. However, in many sectors (like the banking sector) the Western German industry structure is close to the Eastern German.

[25] Especially in the social sciences and in the management of universities and schools an almost

the problems, CEE countries because of the incompatibility of new formal institutions and weak enforcement mechanisms in relation to old informal institutions encountered, could partly be avoided.

But German reunification also shows the problems of institutional transfers: Together with the transfer of Western German market institutions, the rule of law and appropriate enforcement mechanisms the West also transferred its density and level of regulation in all fields to the East. Together with an exchange rate revaluating the Eastern German money by several times for political reasons, this led to grave consequences, especially for the labour market. Eastern German business had not only to adapt to a new, competitive environment and to face the loss of old, secured markets in Eastern Europe. It had also to adjust to a completely new and complicated set of regulations. Over night large parts of the former GDR's industries became obsolete, less for technical reasons (they could have combined low productivity with low production costs) but for a combination of high regulation and costs with low productivity.[26] Subsequently, de-industrialisation led to high rates of unemployment.[27] This again together with generous transfers of social security systems and the desire to overcome infrastructure deficits in a short time led to the high levels of monetary transfers which since unification amounted to more than 1,5 trillion DM until now.

Those monetary transfers are a problem in itself, given negative incentive effects linked to generous benefit levels, e.g. for unemployed. But is should be seen that they are not the cause, but only the effect of a policy transferring institutions to Eastern Germany without distinguishing those institutions which enhance competitiveness (like the reduction of uncertainty through introduction of the rule of law) from those which in Western Germany were introduced only after, and probably because, high levels of income were already reached.

From the point of view of institutional competition this is an example for cartelisation in the integration process: Neither Western German firms and managers, nor Treuhand managers responsible for privatisation (which either came from the West or expected to be sacked anyway after some time, if they belonged to the old socialist ruling class) nor trade unions (also directed by their Western counterparts) had interest in a low-cost–low-regulation-competitor in Eastern Germany. All agreed therefore easily on inappropriate regulatory and wage levels, neglecting the productivity problem in Eastern Germany.

3.3. Transformation and EU accession in Central and Eastern Europe

In CEE the Europe agreements of 1991 and the EU's summit of Copenhagen in 1993 changed the prospects of institutional transformation dramatically.[28] Those countries focusing on application for EU membership had suddenly a relatively clear goal, including

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complete exchange of personnel took place.

[26] According to official figures the productivity gap between East and West for the whole economy is more than 20 percent and is since 1994 only slowly decreasing; see Bundesministerium für Wirtschaft (1998: 89).

[27] For a discussion see Siebert (1995), chap. 6. Unemployment was in 1995 14 percent in average in the former GDR (compared to 8.3 percent in Western Germany), in 1996 15.7 percent (9.1 percent) and in 1997 18.1 percent (9.8 percent); see Bundesministerium für Wirtschaft (1998: 148). Not included are those de facto unemployed in public work ("ABM") or qualification projects.

[28] For an overview over the current situation see Dabrowski & Rostowski (2001), Piazolo (2001), Salvatore (2001).

technical advise on how to achieve it. EU membership was seen as a fast track towards political stability and economic prosperity – institutional imitation should be complemented by institutional integration.[29] Those countries not sure of membership or even where membership like for Russia and most CIS countries was clearly out of reach, still were free in their choices in transformation.

Trade and co-operation treaties concluded between 1988 and 1990 were soon obsolete, when transformation countries began to demand a perspective for full membership in the EC. In 1992 the EU Commission developed criteria for EU membership of CEEC, which were formally endorsed by the summit of Copenhagen in 1993.[30] Those criteria were partly political, partly economic. The political criteria stated that "membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities". The economic criteria concern the introduction of a functioning market economy and the capacity to cope with competitive pressure and market forces within the common market. Additionally, candidate countries have to accept the "*acquis communautaire*," i.e. the rules of the EU (including all treaties and all kind of secondary law by the European Court of Justice). This also includes the acceptance of the goals of political union and economic and monetary union. Candidate countries have no possibility of opting out of those policies like the United Kingdom and Denmark did.

While it can be said that the existence of a functioning market economy is a *conditio sine qua non* of EU membership, it is difficult to measure the success in introducing it. When is a market economy functioning? When do economies cope with competitive pressure? Is a measurement on a macro-level possible and rational? Should the competitiveness of single firms be the benchmark? Is regional specialization according to comparative advantage, e.g. the use of lower labor costs, enough for coping with competitive pressure or do the CEE have to develop intra-industrial trade?[31] All these questions have to be answered, if the criteria are taken seriously. Given the differences in per capita income, it would be difficult to wait, until CEE caught up with the rest of Europe. "Economic wealth" is less important for successful transition than "economic health," i.e. sound economic structures. The EU measures the existence of a functioning market economy by factors like the free interplay of market forces, price and trade liberalization, the absence of significant barriers to market entry and exit, a legal system preserving property rights, macroeconomic stability, a broad consensus about the essentials of economic policy and a sufficiently developed financial sector (cf. European Commission 1998).

The capacity to withstand competitive pressure and market forces within the Union is assessed on the basis of criteria like the existence of a functioning market economy, a sufficient amount of human and physical capital, trade integration, competitiveness and the proportion of small and medium enterprises (European Commission 1998). While the criteria used on the first glance seem to be well-defined, formulations such as "sufficient,

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[29] Welfens (2001) speaks of a 'transfer of security'.

[30] Cf. Commission of the EC (1992: 11); Presse- und Informationsdienst der Bundesregierung (1993).

[31] In a empirical study on Hungary, Slovakia, the Czech Republic and Poland Gabrisch and Segnana (1999) conclude that the trade structure is characterized by a specialization according to comparative advantage, i.e. CEEC are specialized in low quality production compared to Western Europe. They discuss the problem of a low catching up potential represented by such a trade structure. However, as a remedy to it they recommend a policy actively pursuing EU membership.

appropriate, adequate" and the fact that no benchmarks are given indicate that there is a broad room for discretionary evaluation of these criteria. Therefore, the decisions on EU accession have to be seen as political decisions, based partly on objective data, partly also on subjective, political criteria. Csaba (2001) even speaks of 'double talk', indicating different standards according to political expediency. Public choice theory is appropriate to study this problem as a political-economic problem(see Silarszky & Levinsky 2001).[32] In 1997, half a year after the treaty of Amsterdam was signed, membership negotiations began, first with the most advanced states, but soon with all CEE.[33]

The decision for accession to the EU completely changed the policy options of CEE. While support of the EU for transformation is one side of the process, on the other hand the possibilities to carry out an independent policy are radically reduced. More than 20.000 different laws of the EU, in their entirety the so-called '*acquis communautaire*', have to be adopted, in all spheres of policies changes are required by accession to the EU. EU law distinguishes regulations, which according to the EC treaty are 'general applications' and 'binding in its entirety and directly applicable in all Member States' and directives, which are binding but leave 'to the national authorities the choice of form and methods', i.e. directives have to be transposed into national law, usually by a deadline, and decisions, which are directly binding upon those to who they are addressed. While in the case of regulations and decisions the applicant countries have no choice, in the case of directives they have some possibilities to adapt EU law according to their national institutional preferences. Also, it should be noted that especially, where the EU itself fears competition from transformation states (like in the case of low skilled workers' migration or in the participation in the Common Agricultural Policy) possibly long transitional periods might delay the full participation in all EU policies.[34]

3.4. EU policies as constraints for EU accession of CEE

From the point of view of institutional competition the policies of the EU which the transformation countries have to accept can be divided in three groups. The first group of policies are those, where imitation of the EU can increase institutional stability in transformation countries. In particular, this concerns trade liberalization, the implementation of the rule of law and the commitment to the four freedoms (of trade in goods and services, capital mobility and migration). Here the imitation of EU rules and commitment to their implementation will increase investors' confidence, reduce risk premiums and thereby improve the outlook for long-term stability of countries applying for EU membership. This can lead to a virtuous circle, since increased confidence leads to increased foreign investment, which again changes the informal institutions of a

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[32] It should be noted that even in the case of successful transformation membership in the EU is not automatic, since the EU has to reform itself. This process began with the 'Agenda 2000' (European Commission 1997), but is far from complete, especially due to the financial burdens of enlargement.

[33] A somewhat different analysis applies to the two Mediterranean states Cyprus and Malta and to Turkey, which is not dealt with here.

[34] Recently, as the EU opened negotiations about migration, a request for delay of full freedom of migration from the side of the EU was negatively answered by transformation countries. Long transitional periods were for example negotiated in the two Southern enlargements of the EC in 1981 (Greece) and 1986 (Spain and Portugal). See for a discussion of the enlargement processes Tsoulakis (1981).

transformation economy. For instance, the problem of improving corporate governance has been identified as one of the main obstacles at the way towards a market economy. Foreign investment and attached transfer of management practices can help to solve this problem. This again means a better conformity of formal and informal institutions of the society, which again leads to more confidence and investment and so forth.[35]

Like the trades concerning FDI, the accession countries show a superior performance compared to other transformation countries.[36] FDI inflows per capita were in the period 1989-1999 four times as high in Central and Eastern Europe including the Baltic states (574 US$) as in the Commonwealth of Independent States (142 US$).[37] Inside the accession candidates the three best performers are Hungary, the Czech republic and Estonia. No direct link can be established to institutional performance, but among the factors determining FDI inflows institutions are known to be important.[38] So the imitation of EU rules including rules guaranteeing profit repatriation seem to have had a positive influence on FDI and might lead to a virtuous cycle.

A second aspect concerning liberalization is the importance of increased competition in transformation countries with often monopolized or small domestic markets. Problematic can be a the commitment to EMU and the eventual entry in the EMS II, as long as exchange rates as shock absorbers cannot be substituted by sufficiently flexible factor markets and as long as the probability of asymmetric shocks remains high due to a relatively low degree of intra-industrial trade in transformation countries.[39] However, this commitment can also work as an incentive for appropriate policy changes to prevent such problems. Here again (as with the Maastricht criteria of sound monetary and financial policies, which in the long run also apply to applicant countries) the EU can provide a benchmark for national policies.

The second group of policies concerns the regulatory policies of the EU, for example environmental and social regulation, labor market policy and consumer policy. In these areas the impact of institutional imitation is more dubious. For EU countries fearing competition from lowly regulated transformation countries, the application of EU standards works as a strategy of ‘raising competitors’ costs’. The transformation countries, today locations with relatively low labor costs but also low productivity, could loose their advantage without being able to compensate it sufficiently with increased productivity.[40] Even for countries long inside the EU, which did not suffer from the allocative distortion of a socialist system productivity differences are enormous.[41] Therefore, a convergence of

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[35] For the impact of FDI on corporate governance see Meyer (1998), who stresses the important of networking resulting from FDI in transformation countries.

[36] See Brenton et al. (2002), Kaminski (2001).

[37] Cf. EBRD (1999: 16). Given that the EBRD includes Albania, Croatia and the FYR Macedonia in the CEE countries, which are not yet applicant countries for EU membership and two of which (with the exception of Croatia, with relatively high FDI/ capita of 605 US$) had the lowest inflow of FDI/ capita, the picture is even more positive for EU accession candidates. It should be noted that FDI is only a part of capital flows to CEEC. For an overview over all capital flows see Claessens et al. (1998).

[38] For empirical results in the Romanian case see Radulescu (1996).

[39] The entry in EMS II will mean the pegging of the country’s currency with a central parity to the euro, probably with a wide fluctuation band of +/- 15%. However, as the Asian crisis showed, pegging in countries with differences in fundamentals (especially inflation rates) to the peg country can lead to speculative attack.

[40] For the impact of EU rules on labor markets in CEE see Belke & Hebler (2001).

[41] See Siebert (1998) for a European comparison. In 1991 the gap in hourly wage costs between the richest and poorest EC members was 1:4 and was almost the same like the gap in productivity; see

CEEC to European standards of labor costs or regulatory levels will need a long adjustment period and it is not clear if convergence is achieved at all. Extended regulations, e.g. environmental standards, can generally be described as superior goods with an income elasticity greater one. For low income countries in CEE the acceptance of these policies means a loss of competitiveness and might lead to a less favorable growth path in the long run. Nevertheless, citing the possibility of social or environmental 'dumping', an immediate adjustment to the EU levels is demanded (see for the environment Homeyer et al. 2001).

CEE countries can only accept this institutional cartel. An example is the need for Estonia to raise tariffs on agricultural products due to EU regulations (Wrobel 2000: 240-241). In the external relations of CEE countries this can lead to trade diversion, in the domestic policies to the acceptance of less flexible, more rigid EU regulation and regulation not in accordance with the preferences of citizen in a low income country. The monolithic form of integration of the EU not allowing for any exceptions (like opt outs) can be harmful for CEE. Also, the commitment to those policies will not necessarily enhance the credibility of transformation and investors' confidence. In the contrary, investors interested in long term cost advantages might rather avoid those locations which in the medium and long term will convergence on high regulation EU countries.

The third group of EU policies affecting transformation countries is the re-distributive policies, especially agricultural and regional policy.[42] The CEE countries can expect to benefit considerably from those policies, given their elevated share of agriculture and their low level of income.[43] Therefore, participation in those policies can reduce the social costs of transformation and structural adjustment and can lead to higher investment (like the cohesion fund's investment for infrastructure and environmental projects in Southern European countries) and so presents a major incentive to join the EU and adapt to its rules. But, this incentive is not unambiguous: The distorting effects of agricultural policy of the EU are long known and the effects of regional policies on the convergence process are at best mixed. From a point of view of institutional competition, re-distributive policies reduce the incentive to implement institutional change. The case of Greece is often cited as an example, where generous EU aid led rather to a delay of structural adjustment than to its enforcement.[44]

While the influence of institutional imitation according to the three groups discussed above is mixed for transformation countries, a second important aspect concerns implementation of policies. Here, institutional imitation seems to provide three advantages: One is the already cited commitment to already successful policies. Countries in preparation for entering the EU will have less credibility problems in a number of policies, e.g. macroeconomic stabilization, where confidence and expectations are important. The second aspect is the domestic impact of EU membership application: Those transformation

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European Commission (1994: 134). Peneder analyzed similarly the wage and productivity gap between Poland, Hungary, the CSSR and Austria for 1993, which was 1:10; see Peneder (1993: 52-53).

[42] For the impact of regional funds see Szemler (2001), for the CAP see Jensen/ Frandsen (2001).

[43] See Baldwin (1995), Achten (1996: 151-189), Pautola (1997). According to some estimations the annual transfers for the first group of accession countries (for example, Poland, Hungary, the Czech Republic, the Slovak Republic) might be as much as 60 bn. Euro. Given the annual difficulty to compromise on the EU budget even now, such a transfer seems to be highly unlikely. 'Re-nationalisation' is one of the possible and often cited solutions to this problem; see Rabinowicz (2002).

[44] Cf. Schäfers (1993).

policies which are politically costly like the hardening of the budget constraint and implementation of bankruptcy law with the following increase in unemployment can be justified by necessity of EU application.[45] The perspective and reality of market opening and increased competition is also an incentive to speed up corporate restructuring. This can be compared to those countries not applying for membership, where an alternative to corporate restructuring is lobbying for extended soft budget constraint (subsidies) and protective legislation.

The third aspect is more technical, but nevertheless important. Applicant countries through the structured dialogue, transformation partnerships and the negotiation process with the EU including regular monitoring constantly improve their administrative capabilities. One bottle-neck in transformation countries is the lack of sufficiently skilled administration to implement transformation steps. The enlargement process can widen the bottle-neck. Again, this is complemented by increased changes in the private sector, where FDI has a similar role (i.e. also the private sector has to be skilled in applying the new regulatory framework, which is easier with the management transfer linked to FDI).

To sum up, in the CEE countries applying for EU membership and in Eastern Germany similar problems arise: Institutional imitation (or transfer) is beneficial or problematic according to the policy area in which it is applied. The only difference is the immediate effect in the case of German reunification, while in the case of CEEC there is a longer time delay and maybe therefore the desire for cartelisation is less pronounced from the point of view of the current EU member states, which can prepare for accession.[46] Institutional competition, while closing the 'window of opportunity' opened by whole-scale transformation, also stabilizes expectations of market participants and political deciders. The '*acquis communautaire*' comprises institutions obviously inappropriate for transformation countries, but as a whole it works as a stabilizer for transformation countries.

The countries in the Commonwealth of Independent States and some of the other transformation countries are not (or not yet) applying for membership in the EU.[47] However, also they are not completely free in their transformation path. Restrictions arise especially from the conditionality of IMF programmes, which almost all transformation countries concluded. Fund arrangements include so-called structural benchmarks concerning structural adjustment and long-term macroeconomic viability as well as performance criteria, i.e. numerical floors or ceilings placed on various macroeconomics policy instruments or outcomes.[48] While these are restrictions, the character is quite different from those imposed by application for EU membership. The reason for IMF programmes is mostly financial assistance. Once initial financial assistance was granted or an immediate financial crisis is avoided, there is a certain incentive to 'free ride' and abandon

[45] In the early debate about political-economic aspects of transformation the problem of the social costs of macroeconomic stabilization and corporate restructuring were often discussed as major obstacle for governments; see for example Dewatripont & Roland (1992). While governments indeed frequently changed, all (regardless of being post-communist or liberal) did not reverse reforms. Commitments to EU membership may have helped. In at least one country not applying for membership, Belarus, a reversal took place and in others corporate restructuring was halted.

[46] Also, the longer the period of negotiations and before accession, the higher the probability that productivity and income convergence makes institutional competition with unrestricted flows of factors less intense.

[47] Some countries like the former Yugoslavian countries (with the exception of Serbia, for the time being) can be expected to apply. For the countries of the Former Soviet Union the probability of application is less certain, but at least possible.

[48] Cf. Mercer-Blackman & Unigovskaya (2000).

conditionality.[49] In EU application this incentive is absent, since membership means permanent obligations and commitments.[50] Therefore, countries not applying for EU membership are free in institutional choice. While it allows for innovation, it is linked to the problem that the absence of benchmarks and guidelines can leave countries without orientation in their transformation path.[51]

4. OUTLOOK – SOME RESULTS AND AN AGENDA FOR FUTURE RESEARCH

The comparison of institutional transformation in the former GDR, applicant countries to the EU and other transformation countries is difficult, since the institutional performance is not directly measurable. Also, the causality of results is not always clear: Is a superior growth performance linked to initial preconditions, to sound policies or to institutional imitation or innovation? Are countries applying for EU membership, since they already achieved considerable systemic change or is systemic change dependent on policies implemented for accession to the EU?[52] The same problem of causality arises in comparing single performance indicators. For instance, is a deep, but early transformational recession crisis a sign for fast institutional change (requiring old, unprofitable industries to disappear) and a mild recession a sign for delayed adjustment? Or did those countries avoiding a deep initial slump do a better job in implementing institutional change appropriate for their conditions?

Nevertheless, by now it seems to be more and more clear that countries applying for EU membership have reached a far more favorable position than those outside of the EU accession track. Further research on the link between institutional development and performance of CEE is until now difficult due to the lack of time series because of the relatively recent decision to join the EU and the not yet finished institutional imitation.[53] Especially, the impact of EU regulation on long-term growth cannot be established yet. Comparing the experience of Eastern Germany, the only transformation country already inside the EU and experiencing complete institutional transfer, the following preliminary conclusions can be drawn: Clearly, reunification and the massive transfers following it could avoid the social costs of transformation experienced in CEE. And, due to massive investment in infrastructure, some of the bottle-necks of transformation countries could also be avoided. This finds its expression also in the elevated GDP/ capita.[54] However, the

[49] For example, Belarus, Bulgaria, Kazakhstan, the Kyrgyz Republic, Romania, Ukraine and Uzbekistan had IMF programs going ‚off track'.

[50] This does not mean that countries with an application for membership always will honor their commitments and proceed in transformation. It only means that this could not be a successful strategy, since there is no such "free lunch" to gain like in the case of IMF assistance.

[51] See for the case of Russia compared to CEE Sutela (2000). Sutela maintains that missing commitment to reform is the main explanatory factor in the lagging performance of Russia compared to countries applying for EU membership.

[52] Empirically, both can be observed: In some cases like Albania or some successor states of Yugoslavia, political turmoil and economic backwardness obviously makes an early application seem to be futile. On the other hand countries early committed to reform also could use EU application for internal reforms and steps sometimes far beyond those of their neighbours, like in the case of Slovenia.

[53] For a long-run convergence study see Doyle et al. (2001).

[54] The net wages in Eastern Germany were in 1997 around 85 percent of the Western wages. The GDP/ capita in purchasing power was estimated at around 22700 $ in 1998 for Germany (East and

convergence process of Eastern and Western German income stopped in 1995. This might point to the long-term problems of institutional transfer, namely the acceptance of institutional cartels working to obstruct more favorable arrangements in transformation countries to reduce possible competitive pressure. The challenge for Eastern Germany consists in the resumption of the convergence process through a break up of those rigidities hindering it.[55]

Transformation countries cannot pick only those regulations that seem to be favorable for them, but have to accept the whole '*acquis communautaire'*. In the first years of transformation this might give them the advantage of a clear goal, a clear commitment and sufficient technical assistance to achieve superior results than transformation countries without such a goal. However, in the long-term they also have to expect a possible slowing of convergence due to these arrangements. To overcome these effects is the great challenge for convergence countries. Those countries not applying for EU membership suffer from the lack of credibility of their transformation programs. For them, shadowing the EU institutions aiming at establishing a market economy and announcing such a policy publicly might be a possible strategy to import some of the EU's stability while avoiding those policies reducing the flexibility of markets.

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West). In 1997 the GDP/ capita in the Eastern part was reported to be 54,3 percent of the Western German GDP.

[55] The massive exit of Eastern German employers from the employers association bargaining for wages far to high for the low level of productivity experienced in the former GDR is an example for a spontaneous reaction to such rigidities.

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