

KARSTEN STAEHR

Democratic and Market-Economic Reforms in the Postcommunist Countries

The Impact of Enlargement of the European Union

*ABSTRACT: This paper examines the impact of European Union (EU) enlargement on the process of political and economic reforms in postcommunist countries. The main result is that both prospective and actual membership have advanced democratic reforms, while the effect on market-economic reforms has been nonexistent or even negative. A measure of the intensity of negotiation of the *acquis communautaire* chapters shows no effect on political reforms, but likely a negative effect on market-economic reforms. The overall conclusion is that enlargement of the EU has borne out its promise of strengthening democracy in the postcommunist countries, but possibly at the expense of market-oriented economic reform.*

*[T]he most powerful and successful tool of
EU foreign policy has turned out to be EU enlargement.*
—Milada Anna Vachudova (2005, p. 259)

The communist societal model entailed strong centralization of political power through the one-party system and tight government control of the economy, often

Karsten Staehr is affiliated with Tallinn University of Technology, Estonia, and the Bank of Estonia. Address correspondence to Karsten Staehr, Tallinn School of Economics and Business Administration, Tallinn University of Technology, Akadeemia tee 3-486, 12618 Tallinn, Estonia; e-mail: karsten.staehr@tseba.ttu.ee.

The author thanks Mario Jametti, Maria Koidu, and Filip Novotny and the participants at conferences in Dresden, Vallendar, and Tallinn for many useful comments. All errors remain the responsibility of the author. The views expressed are those of the author and not necessarily those of the Bank of Estonia.

through central planning. With the fall of communism at the end of the 1980s and the breakup of two regional powers, the Soviet Union and Yugoslavia, a large number of governments were able to plot an independent course for their countries. The transition process saw reforms that changed both the political and economic topography of the postcommunist countries. The extent and speed of both types of reform have varied markedly across the group of almost thirty countries and across the twenty years since the reforms began.

As early as 1993 the European Union (EU) set out the Copenhagen criteria, which prospective EU member countries would have to satisfy in order to gain membership to the EU. The criteria stated that candidate countries should lie geographically within Europe, be democracies that protect the rights of their citizens, have functioning market economies, and comply with the *acquis communautaire*, the body of laws and regulations of the EU. Clearly, the contents of the transition process and the Copenhagen criteria overlap in important aspects.

This paper presents an empirical investigation of the impact on the political and economic reform process in the postcommunist countries of prospective and actual membership in the EU. The analysis may thus contribute to our understanding of the unique transition process that has taken place during the first twenty years of transition, with the main emphasis on one potentially important source of outside influence. The analysis may also provide insights of potential relevance for the EU's policies toward neighboring countries that still remain outside the EU (EC 2007).

The study has several affinities. The paper is related to the extensive literature that seeks to explain political and economic reforms in postcommunist countries. A main finding in the literature is that political and economic reforms are closely correlated; the underlying mechanism seems to be that political freedom has (Granger) caused economic reforms, while the reverse linkage cannot be established (Fidrmuc 2003; Staehr 2006). The initial economic and administrative starting points have been found to be important and so have a range of institutional and political factors, including the ideological orientation of the government (de Melo et al. 2001).

The paper is also related to the literature that discusses the effect of foreign aid tied to conditionality (Haggard and Webb 1993).¹ The ability of external actors to affect domestic policy outcomes using noncoercive ways of seeking external influence depends on the game being played out between the domestic and external players, and will generally depend on a number of factors, including the domestic governance structures (Haggard and Webb 1994). Spendzharova (2008) uses econometric analysis to show that International Monetary Fund (IMF) conditionality has stimulated banking sector liberalization in the postcommunist countries.

The paper most directly contributes to the literature that specifically considers the impact of EU measures on the political and economic reform process in the postcommunist countries. In many postcommunist countries, the EU was already seen at an early stage as the main vehicle for reintegration into the mainstream European political and economic landscape. Membership in the EU has consistently been supported by a substantial majority of the voting-age population in these countries.

Using a meticulous study of the new undivided Europe, Vachudova (2005) reaches the conclusion cited at the beginning of this paper that the process of EU enlargement has had substantial effects on the political and economic structures in the region.²

Grzymala-Busse and Innes (2003) argue that the Copenhagen criteria have exerted a substantial influence on the political and administrative landscapes of the candidate countries, and in many areas have restrained independent policy formulation. Georgiadis (2005) observes that from an early stage, economic reforms were more extensive in European transition countries than in non-European ones. Interviews and surveys conducted among negotiators from the EU and candidate countries suggest that the prospect of membership was a major driving factor behind economic reforms. Marktler (2006) discusses the Copenhagen criteria in detail and concludes that whereas the candidate countries have been successful in adopting the *acquis communautaire*, they have been less successful in actually implementing and enforcing the requirements in the *acquis*.

Grabbe's (2002) study discusses the *acquis communautaire* before the actual enlargements of the EU. She argues that the effect of the reforms cannot be equated with the number of chapters that are closed, since admission to the EU is essentially a political process where the readiness of the existing EU members to accept new members plays a key role. Hille and Knill (2006) use panel data to analyze the ability of countries to implement specific requirements of the *acquis communautaire*, and find that bureaucratic effectiveness was a major determinant, while political issues appear to have been unimportant. Toshkov (2008) also undertakes an empirical analysis of the implementation of different EU laws as part of the accession process of the candidate countries. He finds that both administrative capacity and political preferences have played a role in the proportion of laws implemented, but also that this proportion differs markedly across different policy areas.

Berger et al. (2007) focus on fiscal policy implementation and find that fiscal policies in the postcommunist countries in Central Europe were looser than in the Baltic states. The pattern is explained by the Central European countries' stronger bargaining position with the EU than the Baltic states had because of the position of the Baltic states in the geographic and political periphery of Europe. Finally, Bower and Turrini (2009) find that the actual EU accession in 2004 accelerated the process of income convergence of the new member countries from Central and Eastern Europe in part because of improved institutional structures within the legal system, trade policies, and regulation.

The papers discussed above relate EU policies, in particular the Copenhagen criteria, either to broad policy developments in the postcommunist countries using qualitative arguments, or to the implementation of specific policy measures using quantitative methods. This paper in some respects spans both these approaches. It examines how EU enlargement policies have affected the political and economic reform processes in the postcommunist countries. The analysis is based on dynamic panel data estimations using data from almost thirty postcommunist countries in Central and Eastern Europe and Central Asia from 1989 to 2008. The paper considers

the impacts of both prospective and actual EU membership, covering the promise of eventual EU membership, the award of candidate status, the progress of negotiation of the Copenhagen criteria, and the actual membership.

The Enlargement Process and the Copenhagen Criteria

The EU traces its roots to the European Coal and Steel Community, which was founded in 1957 with only six member countries. The purpose from the outset was to deepen the economic ties between European countries in order to promote peace and political stability on the continent. The EU, under several different names, has since been through several rounds of enlargements. The first enlargement in 1973 took in Ireland, the UK, and Denmark, the second enlargement in 1981 admitted Greece, and the third in 1986 let in Spain and Portugal.

The fall of the Berlin Wall in 1989 and the breakup of the Soviet Union in 1991 changed the European political landscape in fundamental ways. Many of the countries that emerged from communist rule sought to reestablish political and economic ties to Western Europe and saw membership in the EU as a means of doing this. Likewise, the neutral European Free Trade Association (EFTA) countries in Western Europe were eyeing the possibility of setting a foreign policy of their own choosing and strengthening their political and economic integration with West European institutions (Landaburu 2007).

The EU had already started supporting the region economically in 1989 through the PHARE (Poland and Hungary Assistance for the Restructuring of the Economy) initiative. After some dithering, the EU eventually committed itself to admitting any European country that adhered to the basic principles of the union. The sheer number of potential applicants among both the postcommunist countries and the neutral countries implied that an orderly and predefined accession procedure was needed.

At the meeting of heads of governments in Copenhagen in December 1993, the exact entry requirements were spelled out in what would later become the Copenhagen criteria. Besides being a “European state,” membership requires:

1. That the candidate country has achieved stability of institutions that guarantee democracy, the rule of law, human rights and respect for and protection of minorities.
2. The existence of a functioning market economy, as well as the ability to cope with the pressure of competition and the market forces at work inside the union.
3. The ability to assume the obligations of membership, in particular adherence to the objectives of political, economic and monetary union. (EU 1993, p. 1; see also EC 2009a and Christoffersen 2007a)

The first point sets out the political requirements, in particular, stable democratic institutions and the protection of individual rights. The second point sets out the economic requirements, in particular, a functioning market economy. The last point sets out the legislative requirements, and demands that the candidate country must

adopt—or at least commit to adopting—the *acquis communautaire*, the body of laws and regulations of the EU.³ The legislative requirements were subsequently spelled out in different “chapters” or policy areas, which were to be negotiated with the individual candidate country. The organization and number of chapters changed from enlargement round to enlargement round.

The new predefined accession procedure was first applied to the fourth enlargement round, which resulted in the admission of the neutral countries Finland, Sweden, and Austria in 1995. The negotiations were completed in a short time as these countries had long traditions of democratic rule and market economic systems and, as EFTA members, already observed the bulk of the *acquis communautaire* (Christoffersen 2007a, pp. 37–38).

The negotiations were bound to be more complicated for the postcommunist countries. These countries were offered EU association agreements, but the take-up, the timing, and the contents of the association agreements varied markedly across the twenty-nine countries. The Central and East European countries were offered the most wide-ranging agreements, which were seen as stepping stones toward eventual accession; these accession agreements were labeled Europe Agreements and demanded the removal of trade barriers for most commodities, but also offered substantial economic aid (Lavigne 1999, ch. 9). The first Europe agreements were signed with Poland and Hungary in 1994 and the last one with Slovenia in 1999. Other association agreements have been signed with a majority of the other postcommunist countries, including Croatia and FYR Macedonia, that is, countries that were candidate countries at the end of 2009.

The decision on whether and when to open negotiations with a country applying for membership is made by the European Council, following a recommendation from the European Commission. The recommendation is based on whether the applicant country satisfies the political requirements at the time of the negotiations, and is deemed able to satisfy the economic requirements before eventual membership (Christoffersen 2007a, p. 32). In 1997 five postcommunist countries, Estonia, Poland, the Czech Republic, Hungary, and Slovenia, were invited to start negotiations, together with the Mediterranean island of Cyprus. This group was informally called the Luxembourg group after the location of the council meeting where the decision was made.

The decision meant that five other countries of Central and Eastern Europe, Latvia, Lithuania, Slovakia, Romania, and Bulgaria, could not start membership negotiations, and they were encouraged to speed up their political and/or economic reforms. At the end of 1999, at a European Council meeting in Helsinki, these countries together with Malta were also invited to start membership negotiations (Christoffersen 2007b). Thus by the beginning of 2000 there were twelve candidate countries in active negotiations, of which ten were former communist countries.

The negotiations followed a relatively standardized procedure. Given that candidate status meant that a country was already deemed to have satisfied the political requirements, and that the economic requirements were in large part encompassed by the regulatory requirements, the negotiations essentially focused on the steps

required to ensure compliance with the *acquis communautaire*. There were in total thirty-one different chapters, or policy areas, which were negotiated separately (Christoffersen 2007b, p. 44):

- | | |
|---------------------------------------|---|
| 1. Free movement of goods | 17. Science and research |
| 2. Free movement for persons | 18. Education and training |
| 3. Freedom to provide services | 19. IT [information technology] and telecommunication |
| 4. Free movement of capital | 20. Culture and audio-visual policy |
| 5. Company law | 21. Regional policy |
| 6. Competition policy | 22. Environment |
| 7. Agriculture | 23. Consumers and health protection |
| 8. Fisheries | 24. Justice and home affairs |
| 9. Transport policy | 25. Customs union |
| 10. Taxation | 26. External relations |
| 11. Economic and monetary union | 27. Common foreign and security policy |
| 12. Statistics | 28. Financial control |
| 13. Social policy and employment | 29. Budget |
| 14. Energy | 30. Institutions |
| 15. Industrial policy | 31. Miscellaneous |
| 16. Small and medium-size enterprises | |

The contents of the last chapter, chapter 31, varied from country to country and thus did not impose any well-defined requirement. The vast majority of the remaining thirty chapters concerned economic issues, arguably as a consequence of economic cooperation being at the core of the EU. There were, however, also chapters that have only a peripheral relation to economics, such as chapter 20, Culture; chapter 23, Consumer protection; chapter 24, Justice and home affairs; and chapter 27, Foreign and security policy.

Generally the negotiations with the candidate country started out with the chapters that were perceived to be the easiest to conclude, while the larger and more complex chapters, such as agriculture, regional policy, financial control, and the budget, were dealt with subsequently. It became clear that Romania and Bulgaria would not be able to close all thirty-one chapters in 2002, and at the European Council meeting in Copenhagen in December 2002, it was decided after last-minute negotiations to admit the remaining candidate countries beginning in May 2004. Romania and Bulgaria received firm commitments about their admission and they joined the EU in January 2007.

As of the end of 2010, two postcommunist countries are candidate countries. Negotiations with them are following broadly the same procedure as those of the ten previous postcommunist countries, but the number of chapters and their contents have changed since the previous negotiation rounds. The negotiations with Croatia have made the furthest progress, while the negotiations with FYR Macedonia have been held back by disagreements about the official name of the country.

Data and Measurements

This section presents the data to be used in the empirical investigation in the following sections. We employ a panel data set with data for most transition countries from the very beginning of the transition process. Along the cross-sectional dimension, our sample comprises twenty-nine transition countries.⁴ A number of countries emerged from the breakups of the Soviet Union, Czechoslovakia, Yugoslavia, Serbia, and Montenegro, and for these countries, we have used the observations of the larger unit until data for the country itself become available. Along the time dimension, data are available for the period 1989–2009, but data for the period prior to the start of the reform process in the individual country are not included in the estimations.

A precondition for membership in the EU is that a country is geographically situated in Europe, but the exact delimitation between Europe and Asia is not fully clear. Moreover, some countries cover areas of both continents. The acceptance of Turkey as an EU candidate country suggests, however, that it is sufficient that part of a country lies in Europe in order for the country to be eligible for membership. For the purpose of this paper, Europe is taken to comprise the Baltic states, all the countries of Central Europe and the Balkans and Russia, Belarus, Moldova, and Ukraine. The countries in the Caucasus and Central Asia are taken to lie outside Europe and hence are not eligible for EU membership.

Dependent Variables

The collapse of communism meant that reforms of both political and economic structures became possible. We capture the degree of democratic governance from two Freedom House (FH) indexes that measure political rights and civil liberties, respectively (FH 2010). The indexes range from 1 to 7, with 7 as the lowest level of political rights or civil liberties. The two indexes are closely correlated and we compute a variable named *FH* as 8 minus the simple average of the two indexes. The variable *FH* takes the value 1 if the citizens of a country have essentially no democratic rights, while 7 denotes the highest level attainable. The variable ΔFH depicts the year-to-year change in *FH*; a positive ΔFH shows political reforms producing more political freedom in a country.

The structural and institutional state of the economy is captured by the market economic indexes published by the European Bank for Reconstruction and Development (EBRD 2009a). The eight main indexes quantify the structures and institutions within price liberalization, trade and foreign trade liberalization, small-scale and large-scale privatization, business governance, competition, bank restructuring, and nonbank financial sector restructuring.⁵ The indexes take values between 1 and 4.33, where 1 is the level in a tightly state-controlled economy and 4.33 is the highest level in a well-functioning market economy.⁶ An increase in an index represents market-economic reforms in the area covered by the index.

We use a simple average of the eight indexes, labeled *EBRD*, to represent the overall

level of market-economic conformity. The variable $\Delta EBRD$ is the year-to-year change in the overall index of market-economic conformity. A positive value of $\Delta EBRD$ indicates market-economic reforms bringing the country into greater conformity with the best performance among market economies. The bulk of our empirical analyses seeks to explain the extent of annual market-economic reforms, $\Delta EBRD$.

Figure 1 shows the simple averages of the *FH* and *EBRD* indexes for the ten postcommunist countries that joined the European Union in 2004 and 2007, and for the remaining nineteen countries. It is noticeable that the average *FH* increases very rapidly in the early stages for the ten countries that joined the EU, while there is little variation in the average *FH* for the other group of countries.⁷ Although less pronounced, the overall picture of the *EBRD* index of market-economic structure resembles the picture of democratic governance: The countries that eventually joined the EU reformed their economies earlier and faster than the other group.

There seem to be substantial parallels between the movements in the political and economic indexes in Figure 1. Figure 2 is a crossplot of the *FH* and *EBRD* indexes for 2008. There is a clear positive correlation between the degree of political freedom and the preponderance of market-economic institutions and structures in the economy. Viewed in 2008, Russia, Armenia, and Azerbaijan had more market economic institutions and structures than would be expected given the repressed political situation in these countries, while a number of Balkan countries had less market economy than would be expected.

EU Variables

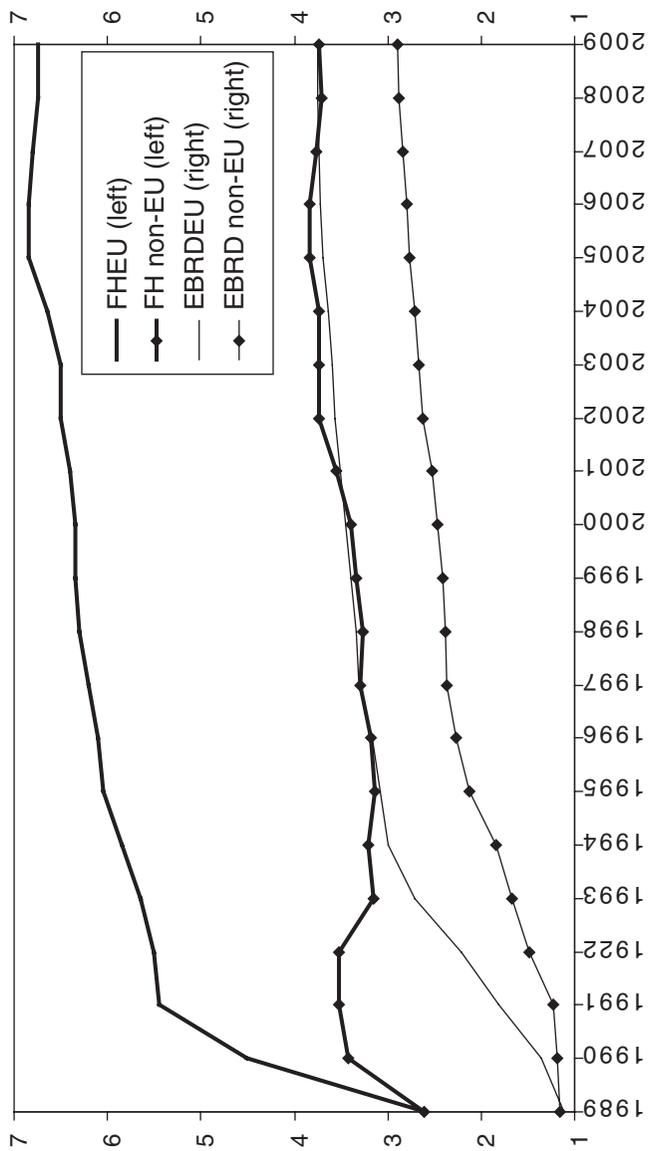
The discussion of the enlargement process and the Copenhagen criteria in a previous section suggested that it is possible to devise a number of variables to proxy prospective or actual membership in the EU. In large part, these variables are dummy variables denoting the timing of different policy measures.

The first variable is a dummy variable denoted *Copenhagen*. It takes the value 1 in 1993 for all European postcommunist countries that are not members of the EU, and 0 otherwise. The variable is meant to capture the effects stemming from the announcement that membership is open to all European countries that satisfy the Copenhagen criteria.

The dummy variable *Candidate* takes the value 1 for a country that has been accepted as a candidate for EU membership but is not yet a member, and 0 otherwise. The variable is 1 for the original Luxembourg group of candidates for 1997–2003, for Latvia, Lithuania, and Slovakia for 1999–2003, for Romania and Bulgaria for 1999–2006, for Croatia for 2004–9 and for Macedonia for 2005–9.

The dummy variable *Excluded* is 1 for 1997–98 for Latvia, Lithuania, Slovakia, Romania, and Bulgaria, and 0 otherwise. This variable aims to capture the fact that these countries were left out and not accepted as candidate countries in the first round, which may have had a feedback effect on political and economic reforms in the affected countries during the period.

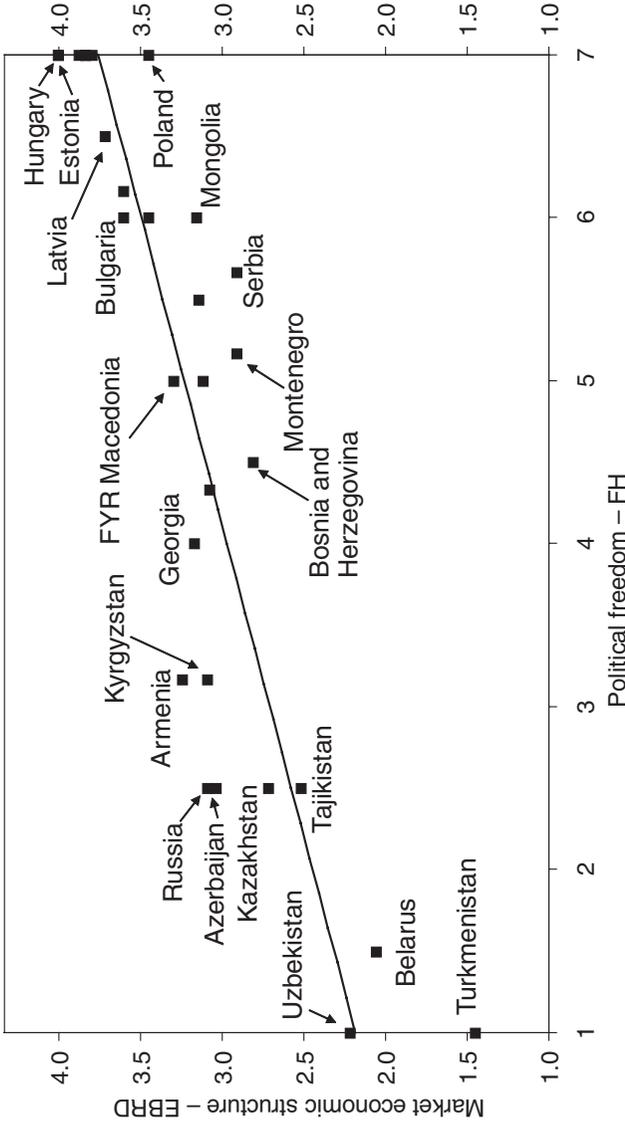
Figure 1. Political Freedom (FH) and Market-Economic Structure (EBRD), Average Indexes for Countries That Joined the EU in 2004 or 2007 and Countries That Have Not Joined the EU



Sources: EBRD (2009a); FH (2010); author's calculations.

Note: FH indexes on left axis, EBRD indexes on right axis.

Figure 2. Political Freedom (FH) and Market-Economic Structure (EBRD), Indexes, Averages, 2007–2009



Sources: EBRD (2009a); FH (2010); author's calculations.

Note: A total twenty-nine postcommunist countries are included, but labels are provided for only some of the countries.

The dummy variable *Membership* takes the value 1 in all the years a country is a member of the EU and 0 otherwise. Comparing the estimated effects of *Membership* with the estimates for *Candidate* may reveal whether actual EU membership has led to changes in the reform processes.

Besides the explicit political and economic requirements, the Copenhagen criteria also included the provision that a candidate country must adhere to the *acquis communautaire*, which meant agreements had to be reached on thirty different candidate-wide chapters, and on chapter 31, which comprised miscellaneous candidate-specific issues. From the data on the progress of the negotiations, we construct the variable *Chapter negotiations* computed as the *proportion* of the thirty candidate-wide chapters that is being negotiated in any given year. Chapters being negotiated in a given year are chapters that have been opened but not yet closed, and chapters that are being opened during the year.⁸ Since the negotiations with Croatia were still ongoing at the time of writing (November 2010), it is not possible to provide data on the share of chapters that have been negotiated in any given period. The variable for Croatia is therefore coded as nonavailable for Croatia 2006–9. The source of the data is EC (2009b).

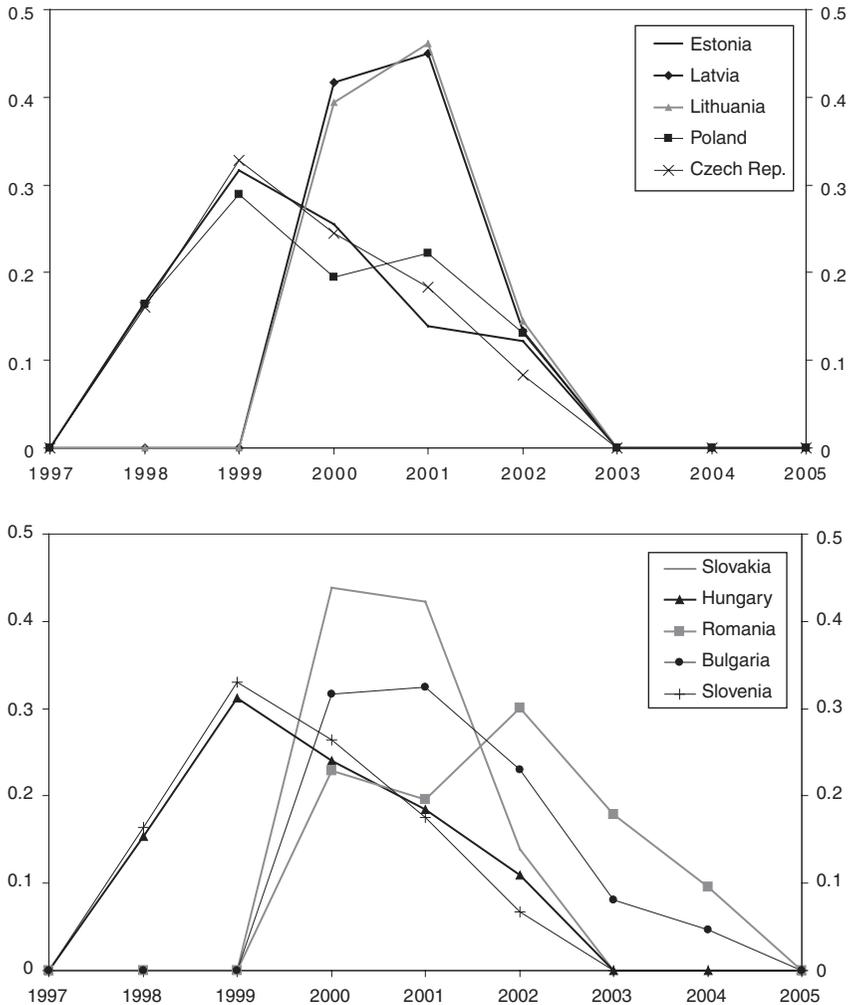
Figure 3 shows the variable *Chapter negotiations* for the ten countries that were admitted to the EU in 2004 and 2007. It is clear from this picture that the Luxembourg countries started the negotiations of the chapters earlier than the countries that became candidates in 1999. Within the latter group Latvia, Lithuania, and Slovakia negotiated and closed many chapters in 2000–2001, while the Romanian and Bulgarian negotiations made slower progress and were only completed in 2004.

Control Variables

A potentially important factor behind both political and economic reforms is the economic and administrative starting point of the countries in question. De Melo et al. (2001) used principal component analysis to derive common factors for a large number of economic and institutional variables around 1990 in order to characterize the initial conditions of the countries in a compact way. Among the variables used were income level, urbanization, natural resource endowment, number of years under communist rule, and administrative experience. The principal component analysis showed that a very large part of the variation could be explained by two principal factors, one reflecting the initial macroeconomic distortions and the degree of unfamiliarity with market economic processes, and the other reflecting the country's initial levels of industrialization, urbanization, and development.

The factors computed in de Melo et al. (2001) are time-invariant. This complicates their use in estimations with country fixed effects. Moreover, it seems unreasonable to assume that the impact of initial conditions should remain the same throughout a sample of twenty years; it is more sensible to assume that the effect is largest in the beginning of the sample and then subsequently fades. We therefore compute variables that allow the effect of the initial conditions to fade over time. The variable

Figure 3. Proportion of Chapters Being Negotiated in Any Given Year



Source: EC (2009b); author's calculations.

Initial distortion is the corresponding factor from de Melo et al. (2001) divided by the number of years since the individual country ceased to be communist, while the variable *Initial development* is the corresponding factor divided by the number of years since the country ceased to be communist.

We include a dummy for the first year in which the individual country was free to decide its own political and economic imperatives. The dummy *First year* is 1 in 1990 for the Central European countries, in 1991 for the Balkan countries, and

in 1992 for the rest of the countries, and otherwise 0. The exact starting year of the transition is somewhat arbitrary as reforms in many cases had already started when the country was still under communist rule.

Armed conflicts may affect both political and economic reforms. Based on Staehr (2006) and updated using Internet sources, the dummy variable *Armed conflict* takes the value 1 if a country is engaged in a major armed conflict internally or externally, and 0 otherwise.

Economic performance may influence the reform processes in postcommunist countries, and annual economic growth is included using data directly provided by the EBRD (see also EBRD 2009b). The very large negative growth rates in some postcommunist countries in the beginning of the sample and the extremely large positive growth rates in other cases risk distorting the results as the leverage of these observations will be unduly large. We have therefore defined the variable *Economic growth* as the logarithm of 1 + the actual growth rate, expressed in relative terms.

The Impact of the EU on Political and Economic Reforms

This section presents the estimation results that are the core of this paper. We model political reforms, ΔFH , and economic reforms, ΔBRD , as linear functions of the control variables and different EU-proxies defined in the previous section.

Data are available from 1989 until 2009. The paper seeks, however, to estimate the effect of prospective EU membership on political and market-economic reforms in the postcommunist countries, and the years in which a given country was under communist rule are therefore not included in the estimation sample. For each country the estimation sample includes only those years in which the country was free to decide its political and economic imperatives. This means that the sample starts in 1990 for the Central European countries, Romania and Bulgaria; in 1991 for the rest of the Balkan countries; and in 1992 for the rest of the countries.

The regressions for both ΔFH and $\Delta EBRD$ use the level variables lagged one year, $FH(-1)$ and $EBRD(-1)$, as control variables. The one-year lagged level of the dependent variable is included as the variables FH and $EBRD$ are bounded from both above and below.⁹ Reforms are easier to implement from a low starting level and more difficult to implement from a high level, which implies that the expected sign of the estimated coefficient is negative. Following the discussion in the data and measurements, we also include the lagged economic structure $EBRD(-1)$ in the political reform regression and the lagged democracy level $FH(-1)$ in the economic reform regression. In addition, a number of other control variables are included, that is, *First year*, *Armed conflict*, the two initial conditions, and *Economic growth*. The EU variables included in the regressions are the dummy variables *Copenhagen*, *Candidate*, *Excluded*, and *Membership* along with the continuous variable *Chapter negotiations*.

As always with panels—and in particular, dynamic panels—the choice of estimation methodology is challenging. On the one hand, possible time-invariant

country-specific heterogeneity may influence results unduly, though this may be addressed by the use of fixed effects (FE) estimation. On the other hand, much of the variation in the explanatory and dependent variables occurs along the cross-country dimension; several of the variables exhibit little variation across the time dimension. This may imply that FE estimation is inappropriate as it removes all time-invariant cross-country variation, possibly leading to type II errors in the form of estimated coefficients that are incorrectly statistically insignificant.

Moreover, the autoregressive structure of the model and the possible endogeneity of some of the explanatory variables, such as several of the EU measures, may lead to biases in the estimated coefficients (Nickell bias, endogeneity bias). These issues can be addressed using general method of moments (GMM) estimation methods, but possibly at the cost of a weak instrument problem. Among the GMM methods used for dynamic panels, the system GMM estimator devised by Arellano, Bover, Blundell, and Bond is the most efficient as it combines estimates from both difference and level estimations (Roodman 2009). Simulations suggest it performs well even in small panels with a low number of cross-sections (Soto 2009). In this context, the main advantage of system GMM estimation is arguably that a possible endogeneity of the EU variables is addressed through the instrumentation of the variables. This reduces the risk that the estimated coefficients will also reflect a possible effect from political or market-economic reforms to the EU variables.

It is clear that the choice of estimation methodology entails compromises. This paper adopts a Solomonic compromise and starts out by reporting the results of system GMM, standard ordinary least squares (OLS), and fixed effects OLS. This makes it possible to assess the impact of the estimation method on the results obtained.

Table 1 shows the main results of this paper, where political reforms ΔFH and market-economic reforms $\Delta EBRD$ are regressed on the variables $FH(-1)$ and $EBRD(-1)$, the other control variables and the EU variables. Columns (1.1)–(1.2) are based on system GMM, Columns (1.3)–(1.4) on panel OLS, and Columns (1.5)–(1.6) on country fixed effects. The system GMM is the one-step method and all explanatory variables with the exception of *Initial distortion*, *Initial development*, and *First year* are taken to be endogenous and therefore instrumented using expanding lags (limited to two to three years).¹⁰

The GMM estimations in Column (1.1) suggest that political reforms have been slower where the level of political freedom was already high, while they have not been affected by the market-economic index. The first year as a postcommunist country was a year with more political reforms than average. Unsurprisingly, armed conflicts have inhibited political reforms. Political reforms have also been held back by large macroeconomic and administrative distortions, but have advanced in countries with an initial high level of economic development. The economic performance in the form of lagged economic growth appears unimportant. These results regarding the control variables are broadly in line with earlier findings (cf. de Melo et al. 2001; Fidrmuc 2003; and Staehr 2006).

The coefficients of all four EU dummy variables are positive and three of them

are statistically significant at the 10 percent level or better. Taken literally, these results suggest that being a candidate country, being left out from the first group of candidates, and being an EU member are associated with more political reforms. The effects are generally substantial, suggesting that the effects are significant in more than a statistical sense. The estimated coefficient of *Chapter negotiations* is statistically insignificant, which may be unsurprising given that the negotiations on the *acquis communautaire* mainly centered on economic issues.

The results from the OLS estimation in Column (1.2) and the FE estimation in Column (1.3) are broadly analogous to the system GMM results, although some of the coefficients are estimated with greater precision, especially in the OLS estimation. The coefficients of the EU dummy variables are always positive and in most cases statistically significant, while the coefficient of *Chapter negotiations* is highly insignificant. Overall, it seems reasonable to associate the prospect of EU membership or actual EU membership with increased political reform.

The system GMM estimations of the market-economic reforms shown in Column (1.4), suggest that such reforms are held back by an already advanced market-economic structure but boosted by a high level of political freedom. Armed conflict reduces market-economic reforms. Initial distortions seem unimportant, while a high initial level of development is conducive to such reforms. There seems to be no clear link from economic growth to market-economic reforms; the estimated coefficient is imprecisely estimated.

The estimated coefficients of all five EU variables are negative in (1.4); the coefficients of *Excluded* and *Chapter negotiations* are statistically significant at conventional levels of significance. As shown in Column (1.5), the results are qualitatively similar when the model is estimated using OLS. All the coefficients of all EU variables are negative, although the significance levels vary somewhat across Columns (1.4) and (1.5). The inclusion of country-specific effects in Column (1.6) leads to the loss of statistical significance of all the EU dummies and in some cases the signs are also reversed. This suggests that the negative signs in Columns (1.4) and (1.5) reflect country-specific features. Interestingly, the estimated coefficient of *Chapter negotiations* is statistically significant at the 10 percent level. This variable is a continuous variable, which may explain why its estimated coefficient “survives” the inclusion of fixed effects. Overall, the conclusion appears to be that the prospect of membership, membership negotiations, and eventual EU membership have either reduced the intensity of market-economic reform or had no effect. The result is remarkable as it comes from five different variables spread out across both time and sample countries.

Finally, it should be noted that if the variable *Chapter negotiations* is leaded one period, then the estimated coefficients of the variable in Columns (1.4)–(1.6) retain their approximate size but become statistically significant at the 1 percent level (not shown). This may reflect an anticipation effect implying that countries have already adjusted their economic policies at an early stage before the negotiations take place.¹¹

Table 1. Estimation of Political Reforms, *FH*, and Market-Economic Reforms, $\Delta EBRD$

Dependent variable	(1.1) ΔFH	(1.2) ΔFH	(1.3) ΔFH	(1.4) $\Delta EBRD$	(1.5) $\Delta EBRD$	(1.6) $\Delta EBRD$
Constant	0.446** (0.181)	0.436*** (0.114)	1.542*** (0.269)	0.366*** (0.061)	0.342*** (0.044)	0.576*** (0.063)
<i>FH</i> (-1)	-0.114*** (0.043)	-0.097*** (0.026)	-0.341*** (0.048)	0.078*** (0.016)	0.070*** (0.009)	0.071*** (0.012)
<i>EBRD</i> (-1)	-0.005 (0.071)	-0.020 (0.051)	-0.089 (0.070)	-0.211*** (0.025)	-0.189*** (0.022)	-0.304*** (0.030)
<i>First year</i>	0.453* (0.258)	0.464** (0.253)	0.437* (0.222)	-0.054 (0.060)	-0.031 (0.055)	-0.109** (0.055)
<i>Armed conflict</i>	-0.387*** (0.146)	-0.443*** (0.154)	-0.658*** (0.138)	-0.167*** (0.040)	-0.164*** (0.038)	-0.166*** (0.037)
<i>Initial distortion</i>	-0.666*** (0.181)	-0.661*** (0.181)	-0.311 (0.228)	0.022 (0.038)	0.021 (0.041)	-0.005 (0.062)
<i>Initial development</i>	0.447* (0.252)	0.397* (0.238)	0.386 (0.286)	0.095* (0.055)	0.099* (0.052)	0.061 (0.065)
<i>Economic growth</i> (-1)	-0.089 (0.230)	-0.093 (0.249)	0.143 (0.255)	-0.048 (0.088)	-0.092 (0.098)	0.139* (0.076)

<i>Copenhagen</i>	0.109 (0.088)	0.084* (0.047)	0.337** (0.162)	-0.050 (0.034)	-0.046** (0.020)	0.038 (0.061)
<i>Candidate</i>	0.151* (0.081)	0.113** (0.053)	0.160** (0.078)	-0.013 (0.027)	-0.023 (0.016)	0.002 (0.025)
<i>Excluded</i>	0.241* (0.129)	0.236** (0.105)	0.159 (0.132)	-0.090** (0.044)	-0.048 (0.044)	-0.043 (0.049)
<i>Membership</i>	0.246** (0.100)	0.305*** (0.083)	0.673*** (0.205)	-0.085 (0.053)	-0.085** (0.024)	0.039 (0.075)
<i>Chapter negotiations</i>	-0.020 (0.129)	0.044 (0.103)	-0.061 (0.142)	-0.095* (0.051)	-0.062 (0.041)	-0.085* (0.049)
Estimation method	Sys. GMM ^a	OLS	FE	Sys. GMM ^a	OLS	FE
No. of observations	536	536	536	537	537	537
R^2	—	0.262	0.448	—	0.439	0.587
AR(1) in first differences	-3.36 [0.000]	—	—	-4.19 [0.000]	—	—
AR(2) in first differences	1.09 [0.276]	—	—	-1.62 [0.104]	—	—

^a One-step system GMM with endogenous variables instrumented using expanding instruments, lagged two to three years.

Notes: White diagonal robust standard errors are shown in parentheses; ***, **, * coefficient estimate is statistically different from 0 at the 1, 5, and 10 percent levels of significance, respectively. *p*-values are in brackets.

At this stage, the result regarding the effects of the five different EU variables can be summarized. The coefficients of the EU variables are generally positive in the estimations of political reform, but negative in the estimations of market-economic reform. This pattern has emerged in estimations with a very rich set of control variables and remains, irrespective of the estimation method. The prospect of EU membership and eventual membership seem to have strengthened political reforms and democratization in the countries concerned, while the intensity of the membership negotiations appears to have been unimportant. A different picture emerges for market-economic reforms, which seem to be set back by the prospect of membership, actual membership, and possibly also the negotiation process. The latter result may be surprising and is therefore the subject of a more detailed analysis in the next section.

A Closer Look at Market Economic Reforms

Most of the EU variables exhibit only limited correlation, but there are a few exceptions. Within the sample used in the estimations, the correlation coefficient between *Candidate* and *Chapter negotiations* is 0.65 and between *Copenhagen* and *Candidate*, 0.37. We have therefore repeated the estimation in Column (2.2), but instead of all five EU variables, the EU variables are used one by one. To save space, the full results are not reported here, but the main message is retained when the estimations are undertaken using OLS or system GMM. The coefficients of each of the five EU variables remain negative, and in many cases also statistically significant. Using FE, the coefficients of the EU variables are generally statistically insignificant as they were in Column (2.4), with the exception of *Chapter negotiations*, which attained a negative coefficient that was statistically significant at the 10 percent level. In conclusion, the results in Table 1 are robust to changes in the number of EU variables included in the regressions.

Table 2 shows the results of a number of other robustness checks. The estimation method in all cases is system GMM. Column (2.1) repeats Column (1.4) from Table 1 for easy reference. Column (2.2) shows the results when the dummy variable *Soviet* is included as an additional control variable; the variable takes the value 1 for all fifteen countries that were part of the Soviet Union until 1991 and 0 otherwise. The coefficient of the Soviet dummy is barely significant at the 10 percent level and its inclusion does not change the qualitative results for the EU variables.

We proceed by removing a number of control variables in order to assess their impact on the results. Column (2.3) shows the results when the lagged levels of the *FH* and *EBRD* indexes are removed. The qualitative results of the EU variables are unchanged, but the statistical significance levels have generally increased. Column (2.4) shows the results when all control variables are removed and the results of the underparameterized model are qualitatively the same as before. The conclusion is that the results found in the previous section in qualitative terms are robust to the addition and removal of control variables.

It is potentially interesting to split the sample into an early part and a later part, but the contents of many of the EU variables make this infeasible. Instead, the *EBRD* index has been decomposed into two parts. The “early reform” index comprises the average of the *EBRD* indicators for price liberalization, trade and foreign trade liberalization and small-scale privatization, as these measures can be undertaken with relatively little preparation and in most countries advanced rapidly during the early stages of the transition process. The “late reform” index comprises the average of the *EBRD* indicators for large-scale privatization, enterprise governance, competition, bank restructuring, and nonbank financial sector restructuring, as these measures typically are time-consuming and have been undertaken at a more gradual pace than the early reform measures.

The estimation in Column (2.5) repeats the one in Column (2.1) except that the *EBRD* variable is replaced by the early reforms index described above. Four of the EU variables are statistically significant at the 10 percent level, suggesting that the enlargement of the EU has had a major impact on the reforms that are typically seen as easy. The estimated coefficient of the *Membership* variable is unreasonably large (in numerical terms); the explanation may be that the early reform variable exhibits little variability during the part of the sample in which the *Membership* variable equals 1.

The estimation in Column (2.6) resembles those in Columns (2.1) and (2.5) except that the dependent variable is now changes in the index of late reforms, while the lagged value of the late reform index is an explanatory variable. It follows that only the coefficient of the *Excluded* variable is statistically significant. The coefficients of *Candidate* and *Membership* are positive, but far from statistically significant. Overall, the EU enlargement does not appear to have had a discernible effect on the late reforms in the postcommunist countries.

Final Comments

This paper has presented the results of an empirical analysis of the impact of the enlargement of the EU on the processes of democratic and market-economic reforms in the postcommunist countries. The analysis assessed the impact of: (a) the announcement in 1993 that any European country has the right to EU membership provided it satisfies the Copenhagen criteria; (b) the country’s being an EU candidate country; (c) the country’s initially being excluded from becoming an EU candidate country; (d) the country’s actually being an EU member; and (e) the intensity of negotiation of the *acquis communautaire* chapters.

The analyses were based on data from twenty-nine postcommunist countries in Central and Eastern Europe and Central Asia from 1989 to 2009. The estimations of the dynamic panel data models were mainly done using system GMM, but OLS and FE were used as checks of robustness.

The main result was that EU enlargement has had different effects on the processes of political reform and market-economic reform even though the indexes of these two parts of the transition process are closely correlated. Both prospective and

Table 2. Estimation of Market-Economic Reforms, $\Delta EBRD$, Different Specifications, System GMM

Dependent variable	(2.1) $\Delta EBRD$	(2.2) $\Delta EBRD$	(2.3) $\Delta EBRD$	(2.4) $\Delta EBRD$	(2.5) $\Delta EBRD^a$	(2.6) $\Delta EBRD^b$
Constant	0.366*** (0.061)	0.332*** (0.061)	0.136*** (0.018)	0.163*** (0.027)	0.733*** (0.123)	0.198*** (0.044)
<i>FH</i> (-1)	0.078*** (0.016)	0.087*** (0.015)	—	—	0.135*** (0.027)	0.054*** (0.010)
<i>EBRD</i> (-1)	-0.211*** (0.025)	-0.225*** (0.027)	—	—	-0.310*** (0.043)	-0.153*** (0.015)
<i>First year</i>	-0.054 (0.060)	-0.061 (0.058)	0.157*** (0.061)	—	-0.081 (0.124)	-0.094 (0.035)
<i>Armed conflict</i>	-0.167*** (0.040)	-0.153*** (0.037)	-0.206*** (0.039)	—	-0.217*** (0.079)	-0.112*** (0.036)
<i>Initial distortion</i>	0.022 (0.038)	-0.029 (0.049)	0.022 (0.053)	—	-0.009 (0.071)	0.015 (0.033)
<i>Initial development</i>	0.095* (0.055)	0.056 (0.054)	0.177** (0.052)	—	0.024 (0.112)	0.115*** (0.041)
<i>Economic Growth</i> (-1)	-0.048 (0.088)	-0.021 (0.089)	-0.508** (0.217)	—	0.071 (0.167)	0.078 (0.082)

<i>Copenhagen</i>	-0.050 (0.034)	-0.043* (0.034)	-0.005 (0.021)	-0.067** (0.027)	-0.147*** (0.057)	-0.010 (0.025)
<i>Candidate</i>	-0.013 (0.027)	-0.004 (0.031)	-0.057*** (0.020)	-0.047*** (0.011)	-0.081* (0.047)	0.006 (0.025)
<i>Excluded</i>	-0.090** (0.044)	-0.102*** (0.049)	-0.081*** (0.027)	-0.059** (0.023)	-0.098 (0.067)	-0.093** (0.041)
<i>Membership</i>	-0.085 (0.053)	-0.079 (0.054)	-0.092*** (0.018)	-0.139*** (0.027)	-0.325*** (0.091)	-0.012 (0.044)
<i>Chapter negotiations</i>	-0.095* (0.051)	-0.131** (0.053)	-0.047 (0.041)	-0.020 (0.041)	-0.144* (0.078)	-0.078 (0.057)
<i>Soviet</i>	—	0.048 (0.030)	—	—	—	—
No. of observations	537	537	537	537	537	537
AR(1) in first differences	-4.18 [0.000]	-4.19 [0.000]	-3.61 [0.000]	-4.00 [0.000]	-3.98 [0.000]	-4.21 [0.000]
AR(2) in first differences	-1.69 [0.091]	-1.62 [0.104]	-1.37 [0.170]	-1.12 [0.264]	-2.45 [0.014]	-0.46 [0.643]

^a Early market-economic reforms, average of EBRD indicators of price liberalization, trade and foreign trade liberalization, and small-scale privatization.

^b Late market-economic reforms, average of EBRD indicators of large-scale privatization, enterprise governance, competition, and financial sector restructurings.

Notes: White diagonal robust standard errors are shown in parentheses; ***, **, * indicate that coefficient estimate is statistically different from 0 at the 1, 5, and 10 percent levels of significance, respectively. *p*-values are shown in brackets.

actual membership appear to have had a positive effect on the political reform process, but an insignificant or possibly negative effect on market-economic reforms. Measures of the intensity of negotiation of the *acquis communautaire* chapters confirm the latter result; the negotiation intensity exhibits no effect on political reforms, but is linked with lower levels of market-economic reform.

The finding that the EU has not fostered market-economic reforms in the post-communist countries, when the reforms are measured by the changes in the EBRD market-economic indicators, may be surprising. The results may not be inexplicable, however, given that much of the EU *acquis communautaire* comprises measures that regulate and unify markets across borders. In other words, a possible conclusion is that the EU has influenced the economic reform process, but that the effect has been toward less market-economic governance.

The results in this paper may be seen as confirming the overall finding in the literature that the European Union has been a major point of attraction exerting great influence over the European postcommunist countries. This paper, however, nuances this view by considering the effects on political and economic reform separately, and by finding that the economic integration might have led to less market-oriented economic structures than may have been the case in its absence.

The intriguing conclusion may be that the process of accession of the postcommunist countries follows a historical precedent. The institutions that eventually became the EU were to a large part put in place to foster peaceful and democratic development in Europe after World War II (Eichengreen 2007, ch. 6). The means of achieving this was economic integration that tied together the European economies, initially the coal and steel sectors. This pattern may also be found in the case of the postcommunist countries, where prospective and actual EU membership have strengthened democratic reform in the postcommunist countries, but most likely at the cost of less market-economic reform.

Notes

1. The prospect of EU membership opened the way for economic aid, but the aid was contingent upon satisfaction of the Copenhagen criteria by the receiving country.

2. The *Economist* (2010) notes that EU membership is much sought after and the EU therefore exerts substantial influence on the policymaking in countries prior to their entry. However, the EU has only limited levers to influence policy-making in countries after they have become members.

3. A fourth criterion regarding the administrative capacity of the candidate countries was included in 1995 after a European Council meeting in Madrid.

4. The countries are, in alphabetical order, Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. No data are available for Kosovo, which only became de jure independent in 2008.

5. The Czech Republic does not appear in EBRD data from 2008. We have used data downloaded previously and updated it for 2008 and 2009 using own estimates.

6. Each index reflects the EBRD estimate of both the extensiveness and the effectiveness of the policy measure. For a detailed description of the methodology of the construction of the economic reform indexes, see EBRD (2008, pp. 204–211).

7. The relatively constant average value hides substantial movements within the group as the Balkans have become freer over time and Russia, Belarus, and the Central Asian countries less free.

8. The time span of negotiations of a given chapter is taken from the year in which the chapter is opened up to and including the year in which the chapter is provisionally closed or finally closed, whichever comes first. If the time span of a negotiation is longer than one year, then it is assumed that each year the inverse of the time span is completed. Thus, if the time span is x years, then it is assumed that $1/x$ of the chapter was closed each year.

9. The variable of political freedom (FH) is bounded by 1 from below and 7 from above. Likewise, the variable of overall market-economic conformity ($EBRD$) is bounded by 1 from below and 4.33 from above.

10. The system GMM estimations are undertaken in Stata using the `xtabond2` command.

11. It may alternatively reflect reverse causality, namely, that a given chapter will not be opened before the country has undertaken preparatory steps, which in our regressions would show up as less market-economic reforms.

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