Economic convergence and the EU integration process: 
The case of post-communist Balkan countries

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Abstract

Recognizing the lack of full economic convergence of the post-communist Balkan countries, Slovenia and Bulgaria, with the EU-15 and EU-27, as well as different levels of convergence between these two countries, this study sought to examine the reasons for such developments. These developments are puzzling, because economic convergence has been one of the main goals of the European integration process, and because the neoclassical growth models expect economic convergence among integrating states.

Combining insights from the theory of integration maturity as well as the prevailing argument in the literature that convergence cannot be fully explained as being only a spontaneous process, but also a deliberate outcome of economic policies, this study presents a theory that explains the level of achieved convergence as a function of integration maturity. Further, this study presents factors that constitute the integration maturity of a given country - initial conditions and government policies, and explains how these factors can be operationalized.

The theory was tested against two case studies, Slovenia and Bulgaria. The evaluation of these two case studies, individually and in comparison to each other, confirmed the proposed relationship between the integration maturity and economic convergence, and generated two important findings. First, even though the initial conditions are important, their influence on economic growth decreases over time, and other factors, such as structural reforms, become increasingly important. Second, if the goal of a given country is to catch-up with the economic development in the most developed countries, there is no long-term benefit in delaying structural reforms, and the longer the delay, the deeper the crisis hits.

The examination of factors for economic convergence is particularly relevant today, given the desire of the Western Balkan countries to accelerate and deepen their process of integration into the EU. Considering the huge differences in the respective development and the number of these Western Balkan countries, the enlargement of the EU will have far-reaching consequences for the development of the whole union. On the other hand, the state of preparedness and analysis of the effects of continued integration can provide important information for policy makers and can influence public opinion. After all, broad based public support is essential for integration success, which will require a well-informed citizenry that can understand the effects of integration and is able to take into consideration long-term societal interests.
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Motivation:

Between 1989 and 1991, after almost forty-five years of living under communism, dissatisfied with the inability of their communist governments to fulfill their promise of catching up quickly with the economic development and living standards prevailing in the developed market economies, the people of Central and Eastern Europe (CEE)\(^1\) stood up and discarded their failing communist systems. The collapse of the political systems in these countries coincided with the failure of their economic systems, well-known for being overwhelmed with shortages, macroeconomic disequilibria, structural rigidities, and for employing outdated technologies and producing goods and services of mediocre quality.

The fall of communism in these countries marked the end of the Cold War and drastically changed the European political and economic landscape. Each of these former communist countries undertook the series of reforms necessary to transform their failing political and economic systems from the vestiges of centralized planning and the inviolable political power of the Communist Party into market-oriented democracies. Recognizing that certain painful and unpopular, yet necessary reforms, could cause a great deal of economic pain and social dislocation, thereby risking a re-birth of a revitalized and re-clothed communist system, many of these countries looked for a role model which would provide a more structured path forward. For most of these countries, the European Community (now the European Union or EU) became that role model in terms of high economic development and quality of governance as the means to fulfill the promise of higher living standards and democratic reforms given to its citizens. Naturally, bringing their fragile states into the fold of modern Europe became a priority

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\(^1\) Central and Eastern Europe, a geopolitical term that usually includes the following countries: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Romania, Bulgaria, Croatia, Albania, Bosnia-Herzegovina, Kosovo, Macedonia, Montenegro, Serbia, Belarus, Moldova, Ukraine, and Russia.
goal for many of these countries. However, that was not the case for many of the post-communist Balkan countries.

In particular, there were only three countries in the Balkans (Slovenia, Bulgaria, and Romania) that officially proclaimed their intent to start the long and complex integration process into the EU, by which I do not mean merely EU membership, but the entire process of transforming their political, economic, and institutional systems to accord with the EU’s. Slovenia progressed the fastest through this process, joining the EU in 2004 with seven other CEE post-communist countries. Romania and Bulgaria followed, joining the EU in 2007. Other post-communist Balkan countries (Serbia, Croatia, Montenegro, Macedonia, Albania, and Bosnia-Herzegovina) experienced a more hectic approach, characterized by their greater focus on nation-building.

Since all of these countries that turned towards the EU as a role model had the same goal of catching up with the economic development and living standards in the EU, and since the convergence of development is one of the main goals of the European integration process, after more than two decades since the beginning of this process, one would expect to see concrete results. These countries share a communist past (despite certain qualitative differences in their communist systems), and each has been subject to the same requirements for admission into the EU, and for deeper integration with the EU core countries. In principle, one might expect that the effect of the EU integration process would bring a similar pattern of economic development. Finally, this is also consistent with the neoclassical growth models, which posit economic convergence among integrating states.

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2 Due to its similarity with Bulgaria, Romania is not included in this analysis. For detailed explanation, see page 22.
3 That is, wars that followed the breakup of Yugoslavia.
4 As early as the Treaty of Rome in 1957, member states of the EEC acknowledged that they were “anxious to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favored regions” (EUROPA 2014). The same goal was repeated in all subsequent treaties.
However, in case of the post-communist Balkan countries that advanced the farthest in the process of EU integration, Bulgaria and Slovenia, a closer examination of economic performance of these countries since the beginning of integration reveals a different state of affairs. Slovenia had a continuous and significant Gross Domestic Product (GDP) growth rate for sixteen consecutive years \(^5\) (Fig.1), with an average of 4.24%. On the other hand, the stable GDP growth rate of Bulgaria commenced later, but once it stabilized in 1998, it averaged 5.4%, for the period 1998-2008 (Fig. 1).

**Figure 1: GDP Growth Rates of Slovenia and Bulgaria (Annual %), 1991-2012**

![GDP Growth Rates of Slovenia and Bulgaria](http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG)

Contrary to the general claim about the positive effects of EU integration, there is no full economic convergence between these two post-communist Balkan countries with the EU-27 and EU-15 averages\(^6\) (Fig. 2 and 3). Slovenia seems to perform much better than Bulgaria in this process of catching-up with the economic development of the EU-27 and EU-15 countries. It achieved 84\% of the EU-27 per capita GDP in purchasing power standards (PPS)\(^7\) and 77\% of the EU-15, contrasted with Bulgaria achieving only 47\% and 43\% respectively.

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\(^5\) From 1993, which is the year when the growth resumed after a two-year long transition recession, until the financial crisis in 2009.

\(^6\) EU-27 denotes all the members of the EU before 1 July 2013, whereas EU-15 denotes EU member states prior to the accession of ten countries on 1 May 2004. For more explanation see page 28.

\(^7\) For more explanation about per capita GDP in PPS see pages 20 and 21.
Figure 2: Convergence level in volume indices of GDP per capita in PPS (EU27=100)

![Convergence level with the EU-27](image)

Source: Eurostat

Figure 3: Convergence level in volume indices of GDP per capita in PPS (EU15=100)

![Convergence level with the EU-15](image)

Source: Eurostat
Research question and outline:

Since the goal of the EU, as well as of the integrating countries Bulgaria and Slovenia, was the convergence of economic development, the most obvious question that arises after observing the inconsistency between the expected and actual outcomes of the EU integration process for these two countries is:

Why is there no full economic convergence of the post-communist Balkan countries with the EU-27 and EU-15?

In addition to this question, recognizing that Slovenia and Bulgaria are on a different level of convergence with the EU-27 and EU-15, one could also ask:

Why are there different levels of convergence of the post-communist Balkan countries with the EU-27 and EU-15?

In order to answer these questions, this study first introduces the theory of regional economic integration and explains why regional economic integration is expected to be beneficial for its members. After that, the study elaborates on the theories of economic convergence among integrating countries, as one of the possible effects of integration. In the same chapter, the study presents previous answers to these research questions as well as their shortcomings. Based on certain conclusions from the literature review and recognizing the shortcomings, two hypotheses are proposed (in the following chapter), followed by a theoretical explanation for the observed inconsistency between the expected and actual outcomes of the EU integration process for the post-communist Balkan countries. Following the theoretical approach, in the following chapter, the study provides an explanation for the choice of case studies and data.
as well as an explanation about operationalization of variables. Two case studies, Slovenia and Bulgaria, follow in the next two chapters. Finally, in the last two chapters, the study presents research findings from the two case studies, tests the hypotheses, and comments on possible implications of the research findings by briefly examining the case of Serbia.
Literature review:

The theory of regional economic integration:

The theory of regional economic integration has been developed since WWII. Studies are usually associated with the pioneering work of Jacob Viner, particularly his book The Customs Union Issues. He conceptualized the effects of economic integration as static, classifying them into two categories: trade creation effects and trade diversion effects. According to Viner, trade creation (diversion) occurs when trade shifts from a high-cost supplier member country (a low-cost supplier of a non-member country) to a low-cost supplier (high-cost supplier) member country in the union, with trade creation raising the home country's welfare and trade diversion lowering it (1950). There have been a number of reviews and expansions of this theory, but overall, until the mid-1970s, theoreticians were fairly skeptical about the impact of economic integration on economic growth and welfare. J.E Meade concluded that it is impossible to evaluate the custom unions in general, because “they may or may not be instruments for leading to a more economic use of resources” (1955). In general, economic integration was considered a second best solution compared to the theoretically more reputable absolute free trade environment. However, changes in international trade from the 1970s onwards, characterized by increasing interest in product differentiation, combined with a growing intra-industry trade, as well as recognized impacts of non-tariff barriers, stimulated new interest in and thinking about the impacts of economic integration.

According to these newer developments, the dynamic effects of integration are more significant than the static effects. Many scholars began to define different dynamic effects, such as economies of scale (Corden 1972, 465); technological change (Balassa 1965); and the impact of integration on market structure, competition, and productivity growth (El-Agraa 1982).
Studies by Dunning and Robson (1988) also introduced us to investment creation and investment diversion as an extension of Viner's theory of trade creation and diversion. Moreover, the increased importance of the private sector (Lawrence 1996, 19), the service sector (Lawrence 1996, 20), and foreign direct investment (Inotai 1991, 38; and Ethier 1998, 1150) have all contributed to a more positive view of the effects of economic integration.

These analytical efforts to understand a wider range of the effects of economic integration (static and dynamic) also shed light on past EU developments characterized by two general trends, a deepening and a widening of integration. Today, at least in the case of the EU, it is no longer possible to rely on only political and second best economic theories\(^8\) to support integration. Instead, theory and practice show that the integration effects, even though previously known as discriminatory trading arrangements, are, in fact, beneficial (welfare-increasing) for their members; and it is generally accepted that integration is actually the best solution. Given such a positive view of EU integration, it is not surprising that the majority of CEE countries were so eager to become part of the EU integration project, as soon as they broke away from communism in 1989-1991 period.

**Convergence among integrating countries:**

One of the possible effects of integration, economic convergence among the integrating countries, has been a recurrent theme in studies of European economic integration. The convergence of European regions has been a basic principle of the EU regional policy, and one of the main objectives of the EU, repeated in all the EU treaties. For example, Article 174 of

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\(^8\) The theory of the second best concerns what happens when one or more optimality conditions cannot be satisfied. Regional and gradual economic integration may be considered a second best solution. For example, the effect of regional economic integration is not only trade creation but also trade diversion. Gradual economic integration produces a degree of trade advanced according to stages of economic integration (gradual abolishment of customs tariffs, non-tariff barriers, etc.). According to this theory, the first-best option is free trade, with free competition and no trade barriers of any kind.
the Treaty of Lisbon states that “The Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favored regions…” (European Union Treaty of Lisbon 2007). Currently, 81.5% (€283.3bn) of the EU budget is devoted to fulfilling this objective, through projects such as improving basic infrastructure, helping businesses, water and waste treatment, high-speed internet connection, training, job creation, etc. (Regional Development Funds 2014). This emphasis on convergence and the consequent financial support\(^9\) has been one of the major attractions of EU membership to potential candidates, including CEE countries, because it promises a sustainable means to catch-up with EU living standards.

The literature on economic convergence (catch-up growth) with the economic integration is vast. Since 1950's, a neoclassical growth model, based on the Solow-Swan exogenous growth model, has dominated the literature. According to this model, open economies (ceteris paribus) should converge as long as the savings ratios are similar and technology is determined outside the economic system (exogenous). The level of output is determined by the quantity and quality of labor force and fixed capital\(^10\). However, since fixed capital is subject to diminishing marginal returns, each economy will converge on a unique, long-run stable growth path, \(^11\) which is determined by the growth of the labor force and technological progress. Given that poorer countries normally have capital/labor ratios that are below their long-run optimum level and are therefore backward in adopting the available technology, their rate of return on fixed investment should be higher than in richer countries (Solow 1956). Consequently, poorer countries should grow faster than rich countries until they have "caught up" with the level of development of the

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\(^9\) Through the Structural Funds and the Cohesion Fund.

\(^10\) Interacting within the framework of a given technology available to all and determined outside the economic system (exogenous).

\(^11\) The so-called "steady state."
latter. This tendency of poorer countries to grow faster than the rich ones until they reach the levels of the latter is the so-called “convergence hypothesis.”

Relying on this assumption, Martin et al. further argue that “opening up the country (region) in a way that it happens in the framework of an integration process, should trigger a convergence process, as capital should flow to capital scarce countries (regions) to take advantage from higher returns” (2001). Consequently, this should lead to “a more rapid capital accumulation and faster growth in poorer countries (regions) than in rich ones” (2001). Finally, along with capital/labor ratios, “labor productivity and per capita income would then converge across countries” (2001).

Given this neo-classical growth model, the apparent differences in per capita income between countries is a result of either difference in the quantity of factors of production or in the efficiency with which they are combined. In order to account for such difference, analysis focuses on the supply and quality of the factors of production; i.e., the supply of labor and its level of education, and the incentives to invest and to adopt superior techniques of production (Catching Up and Falling Behind 2000, 155). As a result, the policy recommendation of the mainstream neo-classical school is that “the best way to ensure both convergence of incomes per capita and steady economic growth over the long run is to allow market forces to operate as freely as possible” (155). Over the years, this has been the basis of policy recommendations to developing and transition economies, which have been expected to enable them to catch-up with the prevailing income levels in the world’s most developed economies.

However, the universal convergence hypothesis does not find empirical evidence in the literature.¹² For example, Barro and Sala-i-Martin (2004) argued that the only convergence that occurs is so-called conditional convergence, by which they meant convergence after controlling

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for differences in steady states. In fact, rather than convergence, the dominant feature has been one of diverging productivity levels and real per capita incomes between the group of advanced industrialized economies on the one hand and the developing countries on the other. Numerous critics challenged the basic assumptions of the neo-classical growth model, especially the assumption that all countries have the same access to exogenous technology. There were also those who disputed the claim that untrammeled market forces are capable of providing sustained growth and convergence in underperforming transition and developing economies. At the same time, these critics do not predict that convergence between rich and poor countries (regions) is the only possible outcome of economic integration.

One of the first critics of the neoclassical convergence hypothesis, Paul Romer, bases this argument on the assumption that the returns to capital do not have to be diminishing (Romer 1990). Consequently, once this assumption is relaxed, the impact of economic integration on convergence is not as clear as in the neo-classical models. In Romer’s model, technology, that was considered a public good and exogenous in the neoclassical growth model, now became endogenous and subject to decision-making processes at individual firms. As a result, enterprises have an incentive to invest in research, since the development of new technologies assures them of the possession of temporary monopoly power. Moreover, in the approach proposed in Lucas (1988), increasing returns on human capital are the main driving force of economic growth. Finally, some other proponents of the endogenous growth models, in the similar vein as Romer's (1990), emphasize the importance of commercially oriented Research and Development (R&D) efforts as the main engine of growth. In a separate argument, the literature around the new trade theory, pioneered by Krugman (1991) and reviewed in Ottaviano and Puga (1998), has put forward several reasons (i.e. the existence of agglomeration economies) to explain why
economic integration may lead to a pattern of increased income inequality, rather than convergence.

From an economic policy perspective, the issue of convergence or divergence is very important. In the case of spontaneous convergence, as in the neo-classical model, this would point to the existence of market forces that eventually will lead to similar living standards across countries. However, since the empirical evidence is more in favor of the new growth theories than the neo-classical theories, it seems there could be a need for economic policy measures, both domestic and international, to stimulate the catch-up process. This raises the question about the capabilities of domestic institutions to introduce and implement these kinds of economic policies (or reform the existing ones) in order to stimulate the catch-up growth process. This becomes especially important in transitional economies\(^\text{13}\), where newly established democratic governments face an extremely difficult task of building a market economy (usually from scratch) capable of delivering long-term economic growth and high living standards.

**The transition in CEE countries and their integration maturity:**

In essence, the long-term goal of the reforms in the transition economies is similar to market economic reforms elsewhere, but what distinguishes them from reforms in other low and middle-income countries is their starting point as centrally planned economies. Consequently, the depth of the required change is more prominent in the transition economies. It requires the dismantling of one system and replacing it with another. Fundamental reforms must penetrate not only to the rules of the economy and society as a whole but also to the institutions that shape behavior and guide organizations (Allsopp and Kierzkowski 1997, 5).

\(^{13}\) A transition economy or a transitional economy is an economy that is changing from a centrally planned economy to a free market. Therefore, all the CEE countries, including Slovenia and Bulgaria can be considered transition economies.
The transition literature (i.e., Blanchard 1996) as well as working papers and reports of various financial institutions involved in the transition process (i.e., Transition Report of the European Bank for Reconstruction and Development (EBRD)) have identified a number of factors that constitute a successful transition. The list usually includes macro-economic stability (i.e. low and stable inflation, low long-term interest rates, low national debt relative to GDP, and low fiscal deficits) and structural reforms (Transition Report 1994). The last of these usually consists of price/trade liberalization, restructuring/reform of the economic system, competition policy, banking sector reforms, etc.

Recognizing the importance of these reforms, as well as responding to the request of the transitioning CEE countries to become part of the EU integration project, the EU established its own set of criteria required for the accession of these countries in the EU\textsuperscript{14}. These, so-called accession criteria were established by the Copenhagen European Council in 1993 and, are therefore, known as Copenhagen Criteria. In the Article 49 and the principles laid down in Article 6(1) of the Treaty on European Union, these criteria are listed in three main groups:

- **Economic**: A functioning market economy; capacity to cope with competitive pressure and market forces within the Union;

- **Political**: Stability of institutions, guaranteeing democracy (rule of law, human rights, respect for and protection of minorities);

- **Legistative** or Acceptance of the Community legislation (*acquis*): Ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

\textsuperscript{14} Becoming a member of the EU can be seen as a deeper stage of integration.
Even though they are known as accession criteria, they can also be seen in the light of one of the ultimate goals of EU integration: the convergence and harmonization of development. Article 2 of the consolidated version of the Treaty on European Union clearly states one of the EU objectives:

"To promote economic and social progress and a high level of employment and to achieve balanced and sustainable development, in particular through the creation of an area without internal frontiers, through the strengthening of economic and social cohesion and through the establishment of economic and monetary union, ultimately including a single currency in accordance with the provisions of this Treaty."

These criteria can be seen as guidelines for transitioning countries with respect to the direction and desired outcomes of their economic policy reforms. However, they formulate only the minimum requirements for accession to take place and lose their importance after the accession. In fact, there are no further evaluations of these criteria after a given country joins the EU. Therefore, the Copenhagen Criteria cannot fully answer my research questions. They might be a good indicator of why post-communist non-EU and post-communist EU states did not converge, but cannot answer the question why two post-communist EU member states, such as Slovenia and Bulgaria, did not fully converge with the EU-15 and EU-27, and why each of them has a different level of convergence.

Tibor Palankai’s theory of integration maturity builds on this shortcoming of Copenhagen Criteria. He defines integration maturity of a country as the capability or preparedness of that country to exploit the maximum benefits of the given form of integration, while minimizing the costs and drawbacks (Palnkai 2003, 75). In another words, he views the assessment of maturity not only important as the conditions and requirements, as the Copenhagen Criteria do, but also as indicators of a capability of a certain country to exploit most advantages of the integration process. Having this concept in mind, the Copenhagen Criteria can be seen as a certain test of
maturity, but only to a limited extent, because these accession criteria are conditions that have to be fulfilled only at the time of joining the EU and later they lose their importance. The accession criteria formulate the minimum requirements for accession to take place, while the question of maturity goes beyond this, and in general examines the conditions for successful and effective integration, and the resulting economic convergence.

**Shortcomings in the literature:**

As can be seen in the literature review, a lot has been written about the economic convergence among the integrating countries as well as about reasons for the lack of it. For example, from the neo-classical standpoint, if market forces are allowed to operate as free as possible, the convergence among integrating countries should be expected, since all countries have access to the same exogenous technology and since fixed capital is subject to diminishing marginal returns. However, the empirical evidence does not support this expectation. Critics of the neo-classical growth models, mostly grouped around the endogenous growth model and new growth theories, proposed their ideas about what conditions are needed for the convergence to take place. Nevertheless, none of these theories is specifically related to the economic convergence (or the lack thereof) of the transitioning Balkan countries with the EU-15 and EU-27. The Copenhagen Criteria could be seen in this context, however they formulate only minimum requirements for accession into the EU to take place and lose their importance afterwards. They therefore cannot be seen as the explanation why there is no full economic convergence of the Balkan countries with the EU-27 and EU-15, since there are no evaluations after a given country becomes a member of the EU. Work of Tibor Palankai recognizes this shortcoming of the Copenhagen Criteria and sees the assessment of integration maturity as an indicator of the capability of a given country to exploit most of the advantages of integration,
and, consequently converge faster with the more developed countries of a given integrative entity. However, he does not operationalize his concept of integration maturity. Therefore, it remains unclear what factors constitute integration maturity of a given country. In other words, it remains unclear what conditions countries need to satisfy in order to have a successful and effective integration that will fulfill the goal not only of accession to the EU (like Copenhagen Criteria) but also of catching-up with the economic development and living standards in the EU countries. It also remains unclear how can these conditions be measured.
Hypotheses:

This study attempts to answer the questions why is there no full economic convergence of the post-communist-Balkan countries with the EU-27 and EU-15, and why are there different levels of convergence. Based on certain conclusions from the literature review introduced in the previous section, firstly, the study recognizes the prevailing argument in the literature that convergence, or the lack of it, cannot be fully explained only as a spontaneous process; it is also a deliberate outcome of government economic policies. Second, the study recognizes how difficult it could be for the newly established democratic governments in the former communist countries to introduce and implement policies, that can be very painful and unpopular in the short run, even though beneficial in the long run. Third, the study recognizes Tibor Palankai’s theory of integration maturity, which claims that the capacity of countries to exploit most benefits of the integration process may depend on the preparedness of that country to become a member of a particular integrating entity.

Having all this in mind, I propose the following hypotheses:

1. As opposed to the general expectation of the supposed positive effects of EU integration process, post-communist Balkan countries have not managed to converge with the EU-27 and EU-15, due to their insufficient maturity for integration.

2. There are different levels of convergence of post-communist Balkan countries with the EU-27 and EU-15, because of the very different levels of integration maturity that these countries have.
Theory:

Independent variable- integration maturity:

Even though Palankai’s theory of integration maturity suggests that the reason why there has not been a full economic convergence between the post-communist Balkan countries and the EU-15 and EU-27 might be due to their insufficient maturity for integration, it remains unclear what constitutes integration maturity of a given country. After an extensive reading of relevant literature, what I found to be critical for the integration maturity of transitioning countries is their initial conditions and policies their respective governments undertake. Initial conditions can be seen in political and economic terms, whereas, government policies can be subdivided into macroeconomic stabilization policies and structural reform policies.

1. Initial conditions determine the starting position of a country at the beginning of its transition. In principle, in terms of the desired level of economic development, a country with better initial conditions would be expected to catch-up/converge faster with the EU-15 and EU-27 than a country with worse initial conditions. This is because better initial conditions indicate that the country is closer to the desired convergence level and because unfavorable initial conditions lead to greater output decline in the beginning phase of transition as the country faces an abrupt shock following the breaking down of the prevailing political and economic institutions (Berg et al. 1999).

Initial conditions can be viewed in both economic and political terms. In economic terms, initial conditions determine the level of a country's economic and market development. They are intimately related with production factor endowment and the efficiency with which they are

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15 This literature includes various reports and policy advice from variety of international financial institutions involved in the transition and EU integration process of the CEE countries (International Monetary Fund, World Bank, European Bank for Reconstruction and Development etc.).

16 This is the so-called, transition recession.
processed (Paternalj 2005). In political terms, the initial conditions show the capability of government to implement its stabilization and structural reform policies, at the very onset of the transition period. If the government is not effective in implementing its policies, or regulating their quality and/or if it is saturated in corruption, then it would be meaningless to expect positive effects of government policies. Consequently, that country is not likely to be able to reap much benefit from the EU integration process, in terms of catching-up with the economic development and living standards in the EU. All things considered, countries with favorable initial conditions are closer to the desired convergence level, can overcome the initial recession sooner, and can implement government policies quicker.

2. As explained in the literature review (see page 12), government policies are important because they create an environment that stimulates catch-up growth. Importance of the stabilization policies comes from the initial bursts of economic variables at the start of the transition period. In particular, stabilization policies aim to avoid erratic changes in total output (as measured by GDP) and large changes in inflation and interest rate. Such policies also aim at keeping balanced budget, avoiding budget deficits, and the accumulation of public debt (Paternalj 2005). Altogether, stabilization policies aim at stabilizing key economic variables, in order to create a credible environment for structural reforms and economic growth. They can be seen as a prerequisite for overcoming the output decline caused by an abrupt shock to the system that follows the breaking down of the prevailing political and economic institutions (Berg et al. 1999).

Structural reforms determine the potential for economic growth in the long-run. Therefore, while establishing and preserving stability should be the focus of policy action, policy-makers in the transitioning countries must also restructure the economy. EBRD transition
reports repeatedly argue\(^{17}\) that the improvement in structural reforms should result in the improvement of a given country’s competitiveness\(^{18}\), a crucial element for the long-term economic growth and the capacity of a given country to cope with competitive pressure and market forces in the EU single market. In its annual reports, the EBRD always finds that reforms have a robust, positive influence on growth and that “a sustained commitment to reforms will bring substantial benefits over the longer terms” (Transition Report 2004). According to EBRD, a successful package of structural reforms can be divided into three components:

a) Enterprise reform: large-scale privatization, small-scale privatization, and governance and enterprise restructuring;

b) Markets and trade reform: price liberalization, trade and foreign exchange system, and competition policy;

c) Financial institutions reform: banking reform and interest rate liberalization, securities markets, and non-bank financial institutions

**Dependent variable- economic convergence:**

The concept of economic convergence among integrating countries can be interpreted and operationalized in many different ways. Following the observation about the goal of transitioning countries to catch-up quickly with the economic development in the most developed EU countries and recognizing EU’s goal to “reduce the disparities between the levels of development of the various regions and the backwardness of the least favored regions or islands, including rural areas,” (European Union Treaty of Lisbon 2007, article 174) for the

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\(^{17}\) I.e. in Transition Report 2013, 18.

\(^{18}\) According to Gutierrez (2006), competitiveness can be referred to as “price competitiveness” and “structural competitiveness.” Price competitiveness is associated with the level of the real exchange rate, and is therefore relevant in the short-run, whereas, structural competitiveness is related to the productivity of a given economy, and is therefore relevant in the long-run. EBRD transition reports refer to the structural reforms as being relevant to this second type of competitiveness.
purposes of this study, I find it most suitable to operationalize economic convergence in the same as the EU country reports, working papers etc. Over the years, the EU has been evaluating convergence among its member states with the volume index of GDP per capita in purchasing power standards (PPS), expressed in relation to the desired number of EU members states set to equal 100. Therefore, if the index of a country is higher than 100, and the desired number of EU member states is 28, than this country's level of GDP per capita PPS is higher than the EU average.\textsuperscript{19}

This indicator plays an important role in the EU’s evaluation of actual economic convergence among Member States in the context of policy aimed at correcting economic imbalances\textsuperscript{20}. This indicator is specifically intended for cross-country comparisons and since it is expressed in PPS, it eliminates the differences in price levels between countries allowing meaningful volume comparisons of GDP between countries.

\textsuperscript{19} The EU currently has 28 member states.
\textsuperscript{20} Through allocation of Structural and Cohesion Funds to the Member States.
Method:

Case selection:

The objective of this study is to explain lack of full economic convergence of the post-communist Balkan countries with the EU-27 and EU-15 after almost twenty-five years since the beginning of their economic transition. The Balkan countries have much in common in terms of their history, geography, and culture. This research will only focus on the effects of the EU integration process on two post-communist Balkan countries, Slovenia and Bulgaria, because they have been in the EU long enough to draw meaningful insights from their integration experiences. Given this criterion, the case of Romania should also be analyzed; however, the Romanian experience with the EU integration process has been very similar to the Bulgarian. I decided to study fewer cases but with a more detailed analysis. In addition, since one of the main motives of this study is to provide recommendations for Serbia in its EU integration process, I found it more suitable to include Bulgaria and Slovenia in my analysis, given similarities that Serbia has with these two countries in terms of history, common language, culture, state development etc. Finally, the case of Croatia is not examined, because it is still on a lower level of integration with the EU, and, therefore, better lessons for Serbia, as well as for other post-communist Balkan countries involved in the EU integration process can be drawn from the Slovenian and Bulgarian experiences.

Operationalizing integration maturity and economic convergence; data availability:

As explained in the theory section, the independent variable of my theory- integration maturity- will be assessed through the country’s initial conditions (both in economic and political
terms) and policies their respective governments undertake (macroeconomic stabilization policies and structural reforms policies).

Integration maturity:

1. Initial conditions:

   Initial conditions determine the starting position of a country at the beginning of its transition. In economic terms, initial conditions determine the level of a country's economic and market development. In political terms, the initial conditions show the capability of government to implement its stabilization and structural reform policies, at the very onset of the transition period.

   Evaluation of initial conditions will start with a concise description of the economic legacy of these countries under socialism. I will look at the per capita GDP PPS level of Slovenia and Bulgaria (in beginning of their transition) as a percentage level of EU-27 and EU-15 per capita GDP PPS, in order to evaluate the country's initial level of convergence. The data for this analysis is available through the official statistical office of the European Union- the Eurostat.

   In addition, I will reflect upon the transition recession of these countries and discuss how this recession influenced the prospects of economic convergence of these countries with the EU-27 and EU-15. In this case, in addition to the Eurostat, the World Bank calculations of the annual GDP growth rates in these countries will be used as a data source.

   Another assessment tool for the initial conditions of these countries will be their EBRD transition index at the beginning of transition, which will indicate their level of the overall market development, enterprise structure, and development of financial institutions.\textsuperscript{21}

\textsuperscript{21} For a more detailed explanation about the EBRD index, see pages 25 and 26.
Finally, initial conditions in political terms will be assessed by the World Governance Indicators (WGI). The WGI database is a result of collaboration of Kaufman and his colleagues in their intent to make governance measurable and to make the results of these measurements comparable. Focused on the nation-state level, the WGI provide comparable values in six dimensions of governance: voice and accountability, political stability and absence of violence, government effectiveness, rule of law, regulatory quality, and control of corruption. The usefulness of this database stems from the fact that it provides very broad country coverage and can be considered as a summation that averages information from many different data sources. By averaging information, it is able to conveniently demonstrate the substantial elements of governance and is better able to ensure its measurability than any individual data source (Benczes and Rezessy 2014). Also among the unique features of these indicators is that they include the opinions (perceptions) of economic players and households on governance, instead of attempting to just measure specific regulatory systems, particularly criteria considered to be objective and actually observable, such as legislative, organizational and institutional conditions. The data do not provide the input values of governance, but are interpreted as output values, the summation of opinions on governance and its quality.22

For the purposes of this study, I will only reflect upon the country's scores in the dimension of government effectiveness and control of corruption. These two indicators seem to be the most suitable to evaluate the capability of government to implement its stabilization and structural reform policies at the beginning of transition. Unfortunately, the data for this analysis is available only from 1996 onwards and, therefore, does not exactly evaluate a government capability at the beginning of transition. However, I do not find this to be a major obstacle for

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22 Kurtz and Shrank (2007) have provided a summary of the typical criticisms of this methodology. Their rebuttal has been formulated by Kaufmann et al. (2007).
my analysis, because it is unreasonable to expect that after only few years of economic and political transition, governments were able to make significant changes in that respect.

2. Government policies:

Government policies are important because they create an environment that stimulates catch-up growth. Importance of the stabilization policies comes from the initial bursts of economic variables at the start of the transition period. They are also important because they create a credible environment for structural reforms to gain momentum and economic growth to resume. Improvement in structural reforms should result in the improvement of a given country’s competitiveness, a crucial element for sustainable economic growth in the long-run.

2.1 Stabilization policies:

In order to evaluate the success of government's attempts to avoid erratic changes in GDP, inflation, and budget deficits, through stabilization policies, data provided by the Eurostat and the World Bank will be used. I will present the GDP growth, volatility of GDP growth, inflation levels and budget deficits of these countries from 1991-2012, and comment on possible influences of stabilization policies on these variables. A short description of other possible factors contributing to the changes in these factors will also be provided.

2.2 Structural reform policies:

The overall progress in structural reforms achieved by individual countries can best be followed by the EBRD annual transition reports. This institution has designed a rating system that annually assesses how well markets, enterprises, and financial institutions function. It measures progress against a benchmark level of developed industrialized market economies. Since many of these developed industrialized market economies are core EU member states, the EBRD report can be a useful indicator of how far Bulgaria and Slovenia are from these
standards. The EBRD report is a useful indicator of the initial conditions as well as for the progress throughout transition, in terms of maturity of their markets as well as in terms of their capacity to cope with competitive pressure and market forces in the EU single market.

The structural reform aspect of the integration maturity has some similarities with the economic aspect of the Copenhagen Criteria (see page 13). Since the evaluations of fulfillment of the Copenhagen criteria are regularly surveyed by the EU Commission through the Regular/Progress Reports for the period 1997 until the respective country becomes an EU member state, one could use these Reports to assess this aspect of integration maturity. However, the EBRD Report is more comprehensive and follows the countries’ structural development even after they became members of the EU. In addition, there is a notion that the EU reports are politicized and therefore do not objectively assess this aspect of integration maturity (Veebel 2013).

The EBRD Reports are available from 1994 until 2012. However, just as in case of the WGI, I do not see this as a major obstacle, because it is unlikely to expect that, after only a couple of years of economic and political transition, governments were able to make significant changes in this respect. Therefore, it does not seem likely that the level of market and financial institution development, as well as enterprise structure, is much different in 1994 than it was in 1991.

In addition, the EBRD has changed its methodology of evaluating progress and development of transitioning countries in their structural reforms. In order to consolidate these different methodologies, I made my own index of structural reforms that enables a consistent way of following changes in structural reforms from 1994-2012. In particular, from 1994-1996,

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23 Especially in the first couple of years, which are usually followed by the transition recession and the corresponding stabilization policies rather than with the structural reforms.
the EBRD used to evaluate progress in reforms with five different grades, (1, 2, 3, 4, 4*) with 4* being the highest and indicating the level of development of a respective area being equivalent to that of the developed market economies. From 1997 until the most recent in 2012, the EBRD Report used ten grades, eliminating 4*, and adding plusses and minuses on each integer, except 1. In my interpretation of EBRD Reports (Table a, Appendix), these grades are simply labeled as whole integers form 1 to 10, with the same increasing direction. Therefore, what was 4+ in the EBRD Reports 1997-2012 became 10 in my scaling. However, since 1994-1996 EBRD index had only five grades, so, if a certain area of development was graded 4 in 1996 and 4+ in 1997, I denoted it as 9 in 1996 and 10 in 1997, recognizing that progress for two grades in one year was almost never occurring throughout all these years of transition. Similarly, if there was a whole integer change in 1995 and 1996 grading system, I would denote it as one grade change in my report. In addition to consolidating two different grading methodologies, my intent was to denote the EBRD evaluations so they could be averaged, and so a final index of transition development could be expressed annually.

The overall improvement in country’s competitiveness over time will be assessed by looking at its export competitiveness. In particular, I will look at a given country’s export structure in order to see whether, over time, there was a trend of many exports consisting of higher value added products. In the case of Bulgaria, I will also examine the coverage of imports by exports (trade balance), since countries with trade surpluses are generally seen as more competitive than those with trade deficits\(^2\) (Inotai 2013).

\(^2\) Provided that exports do not come from natural resources such as energy, minerals, diamonds etc., but from manufactured goods (Inotai 2013).
Economic convergence:

As explained in the theory section, the economic convergence of Slovenia and Bulgaria with the EU-27 and EU-15 will be assessed by looking at the percentage level of Slovenian and Bulgarian per capita GDP in PPS compared to that of the EU-27 and EU-15.

Even though the EU currently consists of twenty-eight member states, the EU-28 was not chosen as a benchmark, since it includes Croatia, a latecomer in the EU integration process, and therefore irrelevant in terms of efforts of Slovenia and Bulgaria to converge with the most developed EU countries. The EU-15 is chosen as a benchmark since at the time when the transition process began in the CEE, these fifteen EU countries were role models for transitioning countries in terms of high economic development. This study, therefore, provides insight into the amount of convergence with the average per capita GDP in PPS of the EU-15 that transitioning countries achieved over a period of time. The EU-27 is also chosen as a benchmark since it includes eight CEE countries, which have been part of the EU integration process as long as Slovenia and Bulgaria.

The data for the convergence levels of Slovenia and Bulgaria with the EU-15 is available from 1995 until 2012 and with the EU-27 from 1993 until 2012 (excluding 1994), through the Eurostat, the official statistical office of the European Union.

Research design:

The research is organized as a comparative two case study, with both case studies following the below pattern:

1. An assessment of initial conditions by describing a given country’s socialist legacy of the country in question, identifying its level of convergence, describing its experience of transition recession, and looking at its 1994 EBRD index and its 1996 WGI index.
2. A short description of a country’s overall approach to transition

2.1. Description of the type of policies used to stabilize and lower inflation rates as well as to create a balance in public finance, and a country’s actual success in these areas throughout the transition period.

2.2. An assessment of progress in structural reforms that have been made over the years and their influence on the competitiveness of a country in question.

    After conducting two case studies, the following chapter is devoted to the findings from these case studies, reflecting how they help us understand the reasons for the lack of full economic convergence of Slovenia and Bulgaria as well as of the post-communist Balkan countries as a whole. Finally, the last chapter will reflect on the possible implications of my findings, by examining the case of Serbia.
Case study I: Slovenia

Introduction:

In 1989, when the Berlin Wall fell and the transition from central planning to a market democracy began in the CEE, Slovenia was still one of the six constituent republics of the Socialist Federal Republic of Yugoslavia (SFRY). However, due to various structural problems in the Yugoslavian Federation, failure of economic reforms, and different visions of its future, in 1991, Slovenia decided to secede from the Federation, to continue and accelerate its transition process, and to start the EU integration process as a sovereign state (Mrak et al. 2004).

Initial conditions:

The initial conditions in Slovenia in the beginning of its EU integration process were determined by the unique position of Yugoslavia in comparison with other socialist countries, as well as by the specific position of Slovenia within SFR Yugoslavia. As a non-aligned country, Yugoslavia was not a part of the Western Bloc; yet, it was also not considered part of the Eastern bloc. The economic system of Yugoslavia (and therefore of Slovenia) was characterized by social ownership, self-management, and a quasi-market economy, where firms were relatively independent and competing on the market (Lavrac 2006). However, due to serious macroeconomic imbalances and decreasing competitiveness in the foreign markets, starting in the late 1980s, Yugoslavia underwent comprehensive economic reforms, including quite intensive privatization. Slovenia, as one of the smallest Yugoslavian republics, was the most developed, generating “18% of the federation's social product and 20% of its industrial production with only 8% of the population” (Mrak et al. 2004, 116).

However, as a result of the political and economic crisis in Yugoslavia at the end of the 1980s, loss of markets in the former Yugoslav republics and in the countries that were members
of the Council for Mutual Economic Assistance (COMECON)\textsuperscript{25}, regional political instability, and the usual output decline that follows the initial market reforms, Slovenia's GDP went to negative 9\% in 1991 and negative 5.5\% in 1992. After this initial output decline, which affected all transitioning countries, Slovenia's GDP growth picked up in 1993, and since then remained steady at 3-7\% per year until 2008 (Fig. 4).

*Figure 4: GDP Growth Rates of Slovenia (Annual \%), 1991-2012*

![GDP growth rates in Slovenia](https://via.placeholder.com/550x413)


Already in 1993, per capita GDP in PPS of Slovenia was at 70.6\% of the EU-27 level. Compared with other CEE countries, Slovenia together with the Czech Republic was an apparent front runner in terms of economic convergence with the EU-27 and EU-15 at the beginning of transition (Tables b and c, Appendix). In terms of the level of market development, the first EBRD transition report ranks Slovenia very high in certain areas, such as small-scale privatization and exchange policy. In other areas, Slovenia also scored well, with only competition policy being evaluated as still much-undeveloped (Table a, Appendix). Finally, the first WGI from 1996, also evaluates Slovenia very positively. In terms of government effectiveness, already in 1996, Slovenia was on the same level as certain EU member states, such as Italy and Greece (Figure a, Appendix). Further, in terms of control of corruption, Slovenia

\begin{table}
\centering
\begin{tabular}{|c|c|c|}
\hline
Year & Growth Rate & \%
\hline
1991 & -8.9 & \\
1992 & -5.5 & \\
1993 & 2.8 & \\
1994 & 5.3 & \\
1995 & 3.6 & \\
1996 & 3.7 & \\
1997 & 3.5 & \\
1998 & 5.3 & \\
1999 & 4.3 & \\
2000 & 2.9 & \\
2001 & 3.8 & \\
2002 & 4.4 & \\
2003 & 4.0 & \\
2004 & 5.9 & \\
2005 & 6.9 & \\
2006 & 3.6 & \\
2007 & 1.4 & \\
2008 & 0.7 & \\
2009 & -8 & \\
2010 & -5 & \\
2011 & 0 & \\
2012 & 2.5 & \\
\hline
\end{tabular}
\end{table}

\textsuperscript{25}COMECON was an association of Soviet-oriented communist countries, intended to coordinate economic development and facilitate trade. It was disbanded in 1991 when free-market policies were adopted by its members.
scored much higher than these two countries and was on the same level as some of the most
developed EU countries, such as Belgium and France (Figure b, Appendix).

Overall, Slovenia had very favorable initial conditions. The country recovered very
quickly from the initial transition recession, showing a good level of economic convergence with
the EU-27 and EU-15 already in the beginning of transition. In addition, at the beginning of its
transition, Slovenia showed signs of market development (due to the legacy of Yugoslavian style
socialism) and had an effective government setup that was able to implement policies to guide
Slovenia toward even higher levels of convergence with the EU-27 and EU-15.

**Government policies:**

Favorable initial conditions in Slovenia (compared to other transitioning countries) were
one of the reasons why the Slovenian government decided to gradually restructure its economy.
The political elite was afraid that a quick transition approach (so-called *big bang or shock
therapy approach*) could undermine the positive aspects of the previous economic system. In
addition, for the first years of statehood, it was important to maintain economic and political
stability as well as to avoid social unrest, knowing the depth and uncertainty of an economic
transition (Mrak et al. 2004). As a result of the gradual transition approach as well as favorable
initial conditions, Slovenia experienced a relatively stable economic environment throughout its
transition period. It has not only avoided long transition recession, but it also achieved very solid
and the least volatile GDP growth rates among the CEE-8\textsuperscript{26} during the entire transition period
(Table 1).

\textsuperscript{26} CEE-8 are CEE countries that joined the EU in May 2004: Czech Republic, Estonia, Latvia, Lithuania, Slovakia,
Slovenia, Hungary, and Poland.
Table 1: Average rate of GDP growth and volatility of growth, 1993-2007

<table>
<thead>
<tr>
<th>Country</th>
<th>Economic growth 1993-2007</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovenia</td>
<td>4.32</td>
<td>1.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Poland</td>
<td>4.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>3.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Slovakia</td>
<td>5.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>5.3</td>
<td>4.2</td>
</tr>
<tr>
<td>Estonia</td>
<td>5.3</td>
<td>4.3</td>
</tr>
<tr>
<td>Lithuania</td>
<td>3.8</td>
<td>5.7</td>
</tr>
</tbody>
</table>

Source: Eurostat, own calculations

1. Macroeconomic stabilization policies:

Despite its overall gradual approach to transition, the Slovenian government worked very hard to establish macroeconomic stability. Following the declaration of independence in 1991, a new currency was introduced (the tolar), enabling Slovenia to have an independent monetary policy, free from that of Yugoslavia, thus breaking with the hyperinflationary trends of the past. Even though the annual inflation was in double-digits until 1996, the Slovenian government, together with the Central Bank of Slovenia\(^\text{27}\), managed to lower inflation to approximately 6% by 1999 (Fig. 5).

Figure 5: Inflation rate measured by the annual growth rate of the GDP implicit deflator


\(^{27}\)Established in 1991 and independent ever since.
The Slovenian government managed to lower and stabilize inflation under a managed floating exchange rate regime rather than under a more orthodox exchange rate anchor policy (Mrak et al. 2004, 119). This choice of monetary-stabilization policy resulted in braking hyperinflation without causing further output decline. However, from 1999-2004, external inflationary impulses, such as the introduction of the value added tax, increases in indirect taxes, and administered prices\(^{28}\) disturbed the government’s disinflation efforts (Paternalj 2005, 3).

Nevertheless, in accordance with the decision to join the Euro-zone as quickly as possible, the accommodative monetary policy of managed nominal exchange rate depreciation was abandoned in 2005, bringing inflation down and enabling Slovenia to fulfill the Maastricht criteria\(^{29}\).

Even though the initial transition liberalization policies usually lead to real output decline and fiscal crises, Slovenia’s public finance system was able to avoid these tendencies during the initial stages of its transition. As can be seen in Figure 6, the Slovenian government was able to avoid budget deficits until 1996. In 1997, however, the government budget went into deficit by 1.3% of GDP and has since been negative, but this was still minor relative to the budget deficits of other transition economies. According to Mrak et al., Slovenia’s deficit was mainly “the result of reductions in social security contributions, diminished border trade, lower customs duties in accordance with EU and CEFTA agreements, and increases in social transfers, wages, and subsidies” (2004, 127). Even though the size of 1997 fiscal deficit does not seems to be troublesome by itself, it reflected a changing trend in Slovenia’s fiscal position, which has continued until 2007.

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\(^{28}\) I.e. oil, telephone, electricity, and municipal services charges.

\(^{29}\) The Maastricht criteria (also known as the euro convergence criteria) are the criteria which EU member states are required to meet in order to enter the third stage of the Economic and Monetary Union (EMU) and adopt the euro as their currency.
As a response to this negative trend, in December 2001, the Slovenian government began to adopt budgets covering two consecutive years. However, the 2003 budget deficit was much higher than initially planned due to lower than expected growth (Paternalj 2005, 3). In order to avoid the influence of this kind of cyclical deficits on the government budget, the government introduced a novel measure to its 2004 budget. With this measure, the government was essentially given discretionary power to suspend expenditure commitments in the event of insufficient revenue (within certain limits). For example, if the revenue was lower by more than 15 billion tolars (0.25% of GDP) due to unfavorable economic conditions, it was to be offset by a proportional reduction of expenditures in the course of the fiscal year, without the need to pass a supplementary budget (2005, 3). Further, if unfavorable macroeconomic conditions persisted, a higher budget deficit of up to 10 billion tolar (0.17% of GDP) was nevertheless to be accepted at the end of the year. As a result of this novel approach to reject further expenditure to address short revenue, the government managed to keep the deficit within the target limit for 2004. The deficit diminished to below 2% of GDP, while the gross government debt stabilized at roughly
29.5% of GDP (2005, 3). As in the case with monetary policy, and to satisfy the Maastricht criteria necessary to join the Euro-zone, the government worked hard to lower the budget deficit. Thus, public expenditure to GDP ratio declined since 2005, resulting finally in a balanced budget in 2007.

Given this analysis, it seems that in addition to being blessed with very good initial conditions, Slovenia also had very successful stabilization policies. They helped Slovenia set its economy on the right path, create a credible environment for structural reforms, experience stable and quite robust economic growth, further converging with the most developed EU economies.

2. Structural reforms in Slovenia:

Looking at the EBRD transition index of Slovenia from 1993 until 2012 (Table a, Appendix), one can see how gradual Slovenian transition has been. It can easily be noticed that, in the beginning of transition, Slovenia scored very high in certain areas, particularly in the small-scale privatization and exchange policy (confirming its good initial position). The starting year of this table, 1994, seems to be a year with the most improvements for Slovenia in almost every segment of structural reform.

However, one can also see that privatization of large-enterprises started at a slower pace, which continued throughout transition. In 2000, Slovenia scored lower than in 1997 in this respect, remaining stuck at that level until today. Sachs and Pleskovic explain that the proposal by Jeffrey Sachs to launch rapid privatization based on concentrated ownership would have led to “a significant disruption of post-communist nomenclature which favored mass-privatization based on dispersed ownership” (Blanchard et al.1994). A study by Pohl aimed at determining which economic policies were most conducive to enterprise restructuring, overwhelmingly
suggest that “rapid privatization, based on concentrated rather than dispersed ownership, with hard budget constraints and restrained wage increases, is the best facilitator of enterprise restructuring” (Pohl 1997). The Slovenian privatization process was instead based on dispersed ownership, eventually becoming subject of capture by insider-owners. Over the years, this type of privatization resulted in a very slow enterprise restructuring. The EBRD Transition Report (1998) indicates that by 1998 the Slovenian private sector had the lowest share of GDP amongst Central European states. It constituted just 55% of GDP, compared to 80% in Hungary and 75% in Czech Republic and Slovakia (Table 2).

Table 2: Privates sector share of GDP in %, 1998, Central European states

<table>
<thead>
<tr>
<th>Country</th>
<th>Private sector share in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>80</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>75</td>
</tr>
<tr>
<td>Slovakia</td>
<td>75</td>
</tr>
<tr>
<td>Poland</td>
<td>65</td>
</tr>
<tr>
<td>Slovenia</td>
<td>55</td>
</tr>
</tbody>
</table>


Spruk argues that fragile private sector in Slovenia is to be blamed for the rigid business environment and lack of incentives to carry through full enterprise restructuring (2012). As a result, the enterprise restructuring in Slovenia has stalled since the late 1990s (Table a, Appendix).

Overall, it seems that gradualism evolved into a certain inertia, which delays structural reforms, necessary to sustain competitive pressures on the EU internal market and induce even higher economic growth, which eventually would result in the full economic convergence with the EU-27 and EU-15. Further, it seems that continuation of reforms was possible only if there were external shocks, such as accession in the EU in 2004. The accession in the EU was seen as a new challenge that required a breakthrough in economic development. For that matter, the government initiated an ambitious package of structural reforms, which were supposed to be
completed in the next two years. However, the EBRD transition index shows that the only improvement was in price liberalization (Table a, Appendix). The low share of the private sector in the economy remained, there were no significant improvements in enterprise restructuring, market reforms stalled\(^{30}\), and reform of financial institutions (both banking and non-banking) was not completed (Table a, Appendix). The state still controlled almost half of the economy, either directly, through majority ownership of banks, insurance companies, investment funds, utilities etc., or indirectly, holding the largest share of a company and thereby influencing the management.

In order to meet the challenge to become a part of the competitive EU market, the main policy adjustments took place in the macroeconomic area\(^{31}\), rather than in structural reforms. As can be seen in the previous section, in accordance with the decision to join the Euro-zone as soon as possible, there was a lot of work done to satisfy the Maastricht criteria: the public expenditure/GDP ratio was in decline since 2005, resulting in a balanced budget in 2007 (Fig. 6). In addition, the accommodative monetary policy of managed nominal exchange rate depreciation was abandoned in 2005, bringing inflation down and enabling Slovenia to fulfill the Maastricht criteria. Nevertheless, since 2004 (the year Slovenia joined the EU), there was almost no further progress in structural reforms (Table a, Appendix). A decent overall score of Slovenia in structural reforms (7.4) is essentially the result of good initial conditions and the reforms during the first part of the 1990s.

Given such slow structural reforms in Slovenia, it is not surprising that very favorable conditions (such as stable economic growth) on the surface, did not penetrate deeper to improve

\(^{30}\) Especially the competition policy.
\(^{31}\) Such as reduction in growth of wages in the public sector and much stricter control of the regulated prices.
Slovenia’s competitiveness, a crucial element for the long-term economic growth and the capacity to cope with the competitive pressure in the EU single market.

One way to look at a country's competitiveness is its market shares on foreign markets. According to Murn et al., this is “an important indicator of an economy’s export competitiveness, because it reveals whether a growth/decline in exports is a consequence of improved/deteriorated export competitiveness or of rising/declining export markets” (2002, 138). The data from Table 3, reveal that, after maintaining the existing level of market shares in 1995-1998, Slovenia's market shares dropped significantly in 1999-2001. According to Murn et al.’s interpretation, this decline in export markets shows that “a robust growth of Slovenia’s merchandise exports from 1995-2000 (by 46.8%) was, at the aggregate level, the result of the growth of export markets and not of the economy’s improved export competitiveness” (138). More specifically, Slovenia's market share in the EU-732 in 2000 fell even below the 0.439% level of 1995. This did not occur in other CEE countries. For example, Hungary increased its market share in the EU-7 by approximately 1.3 times, Slovakia by 0.9 times, the Czech Republic by approximately 33%, and Poland by 20% in 1995-2000 (138).

Table 3: Slovenia’s total market shares on foreign markets and its market shares in the EU-7, 1995-2001

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<tbody>
<tr>
<td>Total</td>
<td>0.596</td>
<td>0.579</td>
<td>0.578</td>
<td>0.581</td>
<td>0.52</td>
<td>0.489</td>
<td>0.516</td>
</tr>
<tr>
<td>EU-7</td>
<td>0.439</td>
<td>0.432</td>
<td>0.449</td>
<td>0.462</td>
<td>0.429</td>
<td>0.406</td>
<td>0.419</td>
</tr>
</tbody>
</table>

Source: Murn et al. 2002, 139

A shift-share analysis, developed by Havlik and his colleagues, is a good tool for revealing causes of Slovenia's deteriorating export competitiveness and the resulting decline in market shares on foreign markets. In this analysis, the overall manufacturing sector of ten CEE

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32 Seven high developed EU economies: Germany, Italy, France, Austria, United Kingdom, Netherlands, and Belgium.
countries (CEE-10)\textsuperscript{33} is viewed as being comprised of three components, a general demand component, a structural effect component, and a competitive effect component\textsuperscript{34}, in order to analyze structures of manufacturing exports of these ten countries to the EU. Their results show that as much as 66.1% of the total increase in the manufacturing exports of the CEE-10 to the EU in 1995-99 was accounted for by the “competitive effect” component (Havlik et al. 2001, 20-24). Using the authors’ methodology, this means that the CEE-10 increased their market shares in the EU to a large extent by improving their competitiveness against other non-member states exporting to the EU. Estonia, for example, increased its market share by increasing competitiveness by 79.8%, Hungary by 78.6%, Slovakia by 74.6% etc. Slovenia, on the other hand, recorded a negative contribution of the “competitive effect” component of 19.3%, being the only country in this analysis with such a negative trend. This analysis shows that the competitiveness of Slovenian export manufacturing to the EU has deteriorated in comparison with other non-EU member states exporters. Also, since technology driven industries were the largest contributors to overall competitive gains, the deteriorating competitiveness of Slovenian exports seems to be related to the slow pace of restructuring manufacturing industry in the direction of technology driven industries.

Furthermore, a study by Landesmann and Stehrer shows that the restructuring of Slovenia's exports towards high value added products was slower than in some other advanced

\textsuperscript{33} Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

\textsuperscript{34} Havlik et al. define these three components in the following way: “the general demand component indicates how a given country's exports would change if they grew at the same rate as total EU imports; the structural effect component shows to what extent a given country's exports grow because they are centered on goods that are in above-average import demand in the EU; and the competitive effect component shows whether a country increased its exports of certain goods to the EU more than its competitors from outside the EU (Havlik et al. 2001).”
transitioning countries\textsuperscript{35}. Table 4 confirms this by showing the export structure of these countries (including Slovenia) by two taxonomies in comparison with the EU-15.

Table 4: Export structure of Central European transitioning countries relative to EU-15 in export shares of groups of industries- differences in relation to EU-15 in 1995 and 2000\textsuperscript{36}

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<tbody>
<tr>
<td>Czech Rep.</td>
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<td></td>
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<td></td>
<td></td>
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<tr>
<td>Mainstream</td>
<td>7.65</td>
<td>8.95</td>
<td>-0.83</td>
<td>-3.42</td>
<td>-4.37</td>
<td>-0.56</td>
</tr>
<tr>
<td>Labor-intensive</td>
<td>14.37</td>
<td>8.13</td>
<td>11.11</td>
<td>2.07</td>
<td>25.88</td>
<td>19.44</td>
</tr>
<tr>
<td>Capital-intensive</td>
<td>0.36</td>
<td>-4.1</td>
<td>-3.09</td>
<td>-10.15</td>
<td>1.7</td>
<td>-3.35</td>
</tr>
<tr>
<td>Marketing-driven</td>
<td>-6.22</td>
<td>-4.47</td>
<td>-1.07</td>
<td>-4.85</td>
<td>-5.44</td>
<td>-2.73</td>
</tr>
<tr>
<td>Technology-driven</td>
<td>-16.16</td>
<td>-8.51</td>
<td>-6.12</td>
<td>16.35</td>
<td>-17.77</td>
<td>-12.8</td>
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<tbody>
<tr>
<td>Low skill</td>
<td>6.54</td>
<td>-3.32</td>
<td>9.41</td>
<td>-7.79</td>
<td>17.08</td>
<td>4.77</td>
</tr>
<tr>
<td>Medium skill, blue collar</td>
<td>7.33</td>
<td>16.52</td>
<td>3.92</td>
<td>9.36</td>
<td>11.27</td>
<td>11.6</td>
</tr>
<tr>
<td>Medium skill, white collar</td>
<td>-7.11</td>
<td>-8.09</td>
<td>-2.34</td>
<td>0.92</td>
<td>-14.05</td>
<td>-11.91</td>
</tr>
<tr>
<td>High skill</td>
<td>-6.77</td>
<td>-5.11</td>
<td>-10.99</td>
<td>-2.49</td>
<td>-14.3</td>
<td>-13.01</td>
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<tbody>
<tr>
<td>Low skill</td>
<td>12.68</td>
<td>1.42</td>
<td>3.94</td>
<td>-0.08</td>
<td>29.41</td>
<td>26.97</td>
</tr>
<tr>
<td>Medium skill, blue collar</td>
<td>5.8</td>
<td>13.82</td>
<td>12.85</td>
<td>16.61</td>
<td>19.59</td>
<td>20.56</td>
</tr>
<tr>
<td>Medium skill, white collar</td>
<td>-5.43</td>
<td>-7.53</td>
<td>-6.39</td>
<td>-7.2</td>
<td>32</td>
<td>33.62</td>
</tr>
<tr>
<td>High skill</td>
<td>-13.05</td>
<td>-7.71</td>
<td>-10.4</td>
<td>-9.34</td>
<td>19</td>
<td>18.86</td>
</tr>
</tbody>
</table>

Source: Landesmann and Stehrer 2002, 23

\textsuperscript{35}For countries that attempt to converge with the EU level (such as Slovenia), it is very important to foster exports in high value added products. In particular, high-tech and human capital-intensive industries produce higher value added per employee than low-tech and labor intensive industries. Accordingly, a country is more competitive if it exports high value added products.

\textsuperscript{36}The data for the transitioning countries shows the difference in export shares compared to EU-15. The data for the EU-15 shows EU-15 exports shares in percentages.
From this table one can see how Slovenian export was significantly directed toward products of labor-intensive and mainstream industries compared to the exports of the EU-15 countries. Also, Slovenian exports were significantly less directed toward technology-driven industries.

Comparing the Slovenian export structure with that of other advanced transition countries, it seems that Slovenia’s direction of change from 1995-2000 was unfavorable. Hungary, the Czech Republic, and Slovakia considerably reduced their lag behind the EU-15 countries regarding technology-driven industries. At the same time, this lag has widened in the case of Slovenia. Further, by looking at the second taxonomy it seems that the changes in the structure of Slovenia's exports to the EU, in terms of the skill involved, were negligible.

Finally, slow structural reforms began to affect the economic growth performance of Slovenia. As Table 5 shows, Slovenia lost its leading position in economic growth among CEE-8 countries, falling from third place in the 1993–1999 period to second to last place in the 2000–2006 period. Evidently, it appears that Slovenia reached a point where gradualism has more costs than benefits, which supports the claim that more intensive structural reforms are needed for Slovenia to assure its continued convergence with the EU-27 and EU-15.

**Table 5: GDP Growth rates of CEE-8 in two periods: 1993-1999 and 2000-2006**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Poland</td>
<td>5.5</td>
<td>3.7</td>
</tr>
<tr>
<td>Slovakia</td>
<td>5.3</td>
<td>4.9</td>
</tr>
<tr>
<td>Slovenia</td>
<td>4.7</td>
<td>4.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>4.1</td>
<td>8.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>2.9</td>
<td>4.1</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>2.0</td>
<td>4.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>1.7</td>
<td>8.2</td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.6</td>
<td>7.2</td>
</tr>
</tbody>
</table>

Source: Eurostat
Case study II: Bulgaria

Introduction:

A day after the fall of the Berlin Wall, on November 10, 1989, following the trends in other CEE communist countries, the Central Committee of the Bulgarian Communist Party ousted Todor Zhivkov from power as a communist party and the head of his country. Already in December 1990, the Grand National Assembly of Bulgaria “passed a resolution expressing the country’s will to become a member of the European Community” (Noutcheva and Bechev 2008, 118). As a response, the European Community included Bulgaria in all its programs aimed at encouraging the transition to a market democracy that would enable successful integration of Bulgaria with the other CEE countries into the European Community.

Initial conditions:

Just like in other CEE countries, the economy of central planning in Bulgaria, despite certain initial successes, brought vast macroeconomic disequilibria and an unsustainable pattern of economic growth. More so, since Bulgaria followed the Soviet model of economic development very closely, these shortcomings became even more apparent, especially since the beginning of 1960s (Bitzenis and Marangos 2009, 71). As a response to these shortcomings, the communist government of Bulgaria induced a high degree of economic experimentation. However, unlike in Yugoslavia, this experimentation took place within the socialist economic framework and, therefore, Bulgaria did not experience elements of market-based economy. At the same time, the focus of Bulgarian international trade remained oriented towards COMECON countries, with goods and services uncompetitive in world markets. As the COMECON collapsed, following the overall collapse of communism, the Bulgarian economic system experienced a great shock (Background Notes 2014).
Heavy reliance on the COMECON markets, external shocks such as the U.N. embargo on Yugoslavia and the Iraq-Kuwait war,\textsuperscript{37} as well as the overall absence of market elements in the Bulgarian economy, amplified the usual transition recession that follows initial structural reforms and macroeconomic stabilization measures. During this initial transition recession, Bulgaria’s GDP shrunk significantly in the first three years of transition and finally by 1994 and 1995 started to grow moderately again (Fig. 7). In addition to the large declines in GDP, the initial recession brought an influx of unemployment and poverty. Finally, Bulgaria inherited another legacy of communism-large external debt. In 1991, the ratio of external debt to GDP was 157.4, the highest in the region (Transition Report 1994).\textsuperscript{38}

\textit{Figure 7: GDP Growth Rates of Bulgaria (Annual %), 1991-2012}

![GDP growth rates in Bulgaria](http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG)

The deep initial recession resulted in a deterioration of the already low economic convergence of Bulgaria with EU-15 and EU-27 (Tables b and c, Appendix). Also, in terms of

\textsuperscript{37} Yugoslavia and Iraq were Bulgaria’s main trading partners.
\textsuperscript{38} Many reforming, post-communist governments inherited significant external debt from their communist predecessors. In fact, only one country, Romania, started its transition with no significant debt compared to the other transition countries. In 1989, its external debt was less than $2 billion (Transition Report 1994). For some other countries, like Poland, the debt was forgiven when shock therapy was launched. However, this was not the case in Bulgaria, which had to pay back its enormous debt. As a comparison, a country with the next highest external debt/GDP ratio was Hungary, “only” 67.8 (Transition Report 1994).
the level of market development, the first EBRD transition report ranks Bulgaria very low in most areas.

With the exception of the foreign exchange policy, all the other areas ranked between 2 and 4 (Table a, Appendix). Finally, the first WGI from 1996 also ranks Bulgaria poorly. In the area of government effectiveness, Bulgaria took last place among the EU member states, far behind the other transitioning CEE countries (Fig. a, Appendix). In the area of control of corruption, Bulgaria was second to last, which also was far behind the EU average (Fig. b, Appendix).

Overall, Bulgaria had very unfavorable initial conditions. A three year long and heavy recession caused a further lowering of the already poor level of economic convergence with the EU-27 and EU-15 in 1993 and 1995. In addition, at the beginning of its transition, Bulgaria had very low levels of market development (due to the legacy of Soviet-type socialism), inherited a huge external debt, and had an ineffective government setup, saturated with corruption.

**Government policies:**

From 1989 until 1997, the transition approach in Bulgaria could be defined as gradual. Even though there were some signs of the *big-bang approach*, such as an instant price liberalization of more than 70% of commodities in 1989 (Bitzenis 2003, 62), this course of action was abandoned very quickly. For example, the Bulgarian government conducted an enterprise restructuring before privatization leading to increased spending on uncompetitive and unprofitable state-owned enterprises (SOEs)39, a clear characteristic of the gradualist approach. Overall, until 1997, both the Bulgarian society and political parties could not agree upon the reform agenda and speed of reforms. On the one hand, there was an understanding that reforms

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39 Spending on these SOEs led to an increase in already significant debt because of lack of revenues from these SOEs to cover budget deficits (Bitzenis 2003).
are inevitable, but on the other hand, a large share of the population was afraid that they would be adversely affected by certain reforms.

Responding to these concerns, the policy makers avoided painful reforms. However, that was not without cost. The combination of unfavorable initial conditions, macroeconomic imbalances, and insufficient structural reforms, resulted in a severe economic crisis in 1996-97, characterized by both hyperinflation and another deep recession. Nevertheless, perhaps as a blessing in disguise, this crisis made the policy direction clearer. The 1997 elections brought political stability in Bulgaria, since a new government not only had a strong commitment to market-oriented reforms but also enjoyed a clear majority in the Parliament, which enabled pursuing these reforms without a need for concessions and lengthy negotiations with coalition partners. The new government decided upon a reform agenda, which made significant contributions toward achieving robust and sustainable economic growth in the succeeding decade.

1. **Macroeconomic stabilization policies:**

   The first years of the transition period in Bulgaria were characterized by relatively high inflation and fiscal deficits. The Bulgarian Central Bank attempted to stabilize the economy by monetary tightening, but its attempts were generally fruitless. The best achievement in the period from 1991 until 1994 was 51.1% inflation in 1993 (Fig. 8). Even though Bulgaria had an independent central bank, it was under significant political pressure to extend loans to the government and to refinance the banking system (Balyozov 1999). These actions turned into “soft” lending by banks to uncompetitive and loss-making SOEs. As a result, state-owned banks suffered imminent losses thus necessitating government bailouts that resulted in huge fiscal
deficits, high inflation\textsuperscript{40}, and loss of public confidence in the banking system and national currency (Ialnazov and Nenovsky 2002, 33). In fact, the loss of confidence was so immense that it quickly crippled the real sector, bringing the entire economy into recession. After just two years of positive GDP growth, in 1996 and 1997 it turned negative again (Fig. 7). Consequently, the convergence level with the EU-27 and EU-15 decreased as well, from 32\% and 27\% in 1995 to 26\% and 22\% in 1996, respectively (Fig. 2 and 3).

\textit{Figure 8: Inflation rate measured by the annual growth rate of the GDP implicit deflator}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{inflation_rate_graph.png}
\caption{Inflation rate}
\end{figure}


Finally, this economic downturn culminated in a political crisis. A democratic solution was found in early parliamentary elections, with a promise of radical reforms. One of them was a change in the monetary policy from traditional discretionary policy to simple but strict predetermined rules, with the introduction of a currency board as a new monetary authority in Bulgaria, which replaced the central bank. The currency board performed its money supply function under strictly defined rules. For example, the issuance of national currency (lev) was available only upon the request against a backup of foreign currency (anchor currency) with an exchange rate set by law. As a result of this model of money supply, the inflationary expectations

\textsuperscript{40}By the end of 1997, inflation had soared to 987.1\% (Fig. 8).
were reduced, because the issuance of national currency was possible only when there was full coverage by anchor currency. However, this type of policy change could protect the economy from the inflationary pressures from many different factors, such as cyclical volatility of food, energy, and international commodity prices, hikes in excises and government regulated utility prices such as electricity, natural gas, and heating (Kyrkilis 2010, 7). These factors, in addition to growing domestic demand, caused inflation rates to fluctuate after 2001, but these rates were within a range of moderate single digit levels (Fig. 8) and, therefore, significantly lower than before the introduction of the currency board.

The introduction of the currency board and the resulting monetary discipline also translated into decreasing budget deficits and public debt. In addition, tax reforms consisting of lowering the corporate tax rate, reducing marginal income tax rates, increasing the untaxed income threshold, and applying higher excise taxes on alcohol and tobacco, offset the foregone tax revenues arising from the new monetary policies (Kyrkilis 2010, 7). These changes contributed to stabilizing Bulgaria’s public finances and restoring investors’ confidence in the Bulgarian economy (Fig. 9).

*Figure 9: Government Fiscal Balance (% of GDP), 1992-2012*

![Graph showing government fiscal balance from 1992 to 2012](http://data.worldbank.org/indicator/GC.BAL.CASH.GD.ZS)

After four years of monetary and fiscal stability, in 2002, Bulgaria started EU accession negotiations, which required the country’s fiscal balances to meet the Maastricht criteria. This was a serious challenge for the Bulgarian government, because the government was facing a serious dilemma about the type of fiscal policy it should adopt for after its economy stabilized. The government was aware that the social welfare of its people had been substantially reduced during the entire transition period, but it also feared a type of fiscal policy that would require debt financing in times of crisis. After the bitter experience of the fiscal crisis of 1996-1997, the government decided to pursue a counter-cyclical fiscal policy, which required the formation of a budget surplus during the economic boom and which could be injected into the economy in times of crisis. Being very consistent in pursing this type of fiscal policy, the government managed to build fiscal buffers by accumulating surpluses between 2004 and 2008, and reduce public debt from over 70% of GDP in 2000 to 18.5% in 2012, the second lowest debt level in the EU (Bulgaria 2014).

It seems that, in addition to having very poor initial conditions, in the beginning of its transition, Bulgaria also had a type of stabilization policy that prolonged and deepened the recession. However, after a resolute U-turn in the monetary regime and introduction of a currency board, the government managed to lower and stabilize inflation and regulate public finances, creating favorable conditions for structural reforms and robust and sustainable economic growth.

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41 There are two Maastricht criteria regarding the fiscal policy: a national budget deficit at or below 3% of GDP and national public debt not to exceed 60% of GDP. For more information about the Maastricht criteria see page 34.
2. **Structural reforms:**

The first EBRD transition report in 1994 ranks development in the basic elements of market economy in Bulgaria with a very low overall index of 3.5 (Table a, Appendix). In this report, Bulgaria received very poor rankings in every segment of development of market economy except in the area of a foreign exchange policy. Since then, structural reforms in Bulgaria have been conducted at a fairly good pace overall, but the areas in which reforms were most needed, such as privatization, did not improve quickly enough.

In particular, given the lack of competitiveness and amount of losses induced by the Bulgarian SOEs, the Bulgarian economy needed a shock therapy approach to privatization, similar to what occurred in Russia and the Czech Republic. The mass privatization program, consistent with the shock therapy approach, started in Bulgaria in December 1995, after a three-year long debate on its structure. As a comparison, this type of privatization started in Russia already in 1992, only a year after the beginning of its transition. Even when the mass privatization started in Bulgaria in late 1995, there was not much progress. By 1997, only 20% of the state property was privatized, while the SOEs continued to be unprofitable in the vast majority of cases (Transition Report 1998).

Hesitancy in more rapid privatization was mostly justified with concerns over the resulting social losses, such as even higher levels of already exorbitant unemployment and poverty. However, continued government tax spending on the SOEs did not bring much relief to the Bulgarian people either, besides possibly keeping the unemployment rate from further increase in the short run. In fact, increased spending on the loss-making SOEs became an intolerable pressure on the government budget and monetary policy, creating budget deficits, increasing debt, and very high levels of inflation. As explained in the section above, in 1996,
confidence in the banking system reached such low levels that it rapidly took the economy into a deep recession.

Following this political change in 1997, the Bulgarian economy underwent comprehensive structural reforms, particularly in the areas of privatization and trade liberalization, key areas for boosting the country's competitiveness. In 1998 only, the government completed 654 privatizations, which is almost as many as the number of privatizations completed in the prior five years from 1993 through 1997 (Valev 2004, 413). In addition, subsidies to enterprises were cut; the government closed 110 out of 140 unprofitable state firms, and many banks were privatized (Brixi, Shatalov, and Zlaoui 2000). As a result of these reforms, the private sector share of Bulgaria’s GDP increased from 45% in 1996 to 70% in 2000, bringing Bulgaria substantially closer to the ratio of private sector shares in more advanced transition economies (Transition Report 2000, 14).

Despite the fact that since the political change in 1997, all the subsequent governments remained committed to continue progress in reforms, the EU "stick and carrot" policy also contributed to the acceleration of reforms and avoidance of "inertia" in transition. In particular, since Bulgaria was a laggard in transition and consequently was not able to become an EU member in 2004 with eight other CEE countries, the EU used this tool every time there was doubt that the Bulgarian government would slow down its reforms. Consequently, a very good overall score (7.9) in structural reforms was an especially favorable and commendable development, particularly given Bulgaria’s unfavorable initial conditions and the length and depth of its transition recession (Table a, Appendix).

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42 The EU stick and carrot policy is a policy of conditionality, which (with respect to EU enlargements) conditions improvement in the level of integration with the EU, financial assistance etc. on further progress in reforms.
A strong commitment of all the Bulgarian governments since 1997 to establish and then maintain macroeconomic stability and accelerate structural reforms resulted in the improved competitiveness and the level of convergence of Bulgaria with the EU-27 and EU-15 in the last decade. However, despite a strong commitment to reforms, a legacy of unfavorable initial conditions strengthened by the inconsistent and ineffective policies from the first years of transition (1991-1997) has been a significant obstacle for even bigger improvements.

From 1991-1997, in addition to substantial imbalances on the macroeconomic side, Bulgaria’s capital stock depleted, since assets and profits of the SOEs and banks “were being stripped by vested interest groups and widespread corruption practices” (World Bank 2005, 29). Therefore, by the time the Bulgarian government started its accelerated privatization program in 1998, revenue from privatization of many SOEs and banks had been substantially reduced relative to 1991 levels. Similarly, the prolonged period of poor economic performance and the resulting high levels of long-term unemployment, contributed to the loss of skills in Bulgaria’s human capital (29).

Nevertheless, thanks to the deep structural reforms since 1997, Bulgarian economic growth resumed (Fig. 7). The World Bank growth accounting analysis shows that Bulgaria’s growth was driven by the increase in total factor productivity (TFP). For example, for the period 1998-2003, their analysis shows that TFP contributed 3.8% of the GDP growth of 4.5% per year, with the capital accumulation contributing 0.6%, and the labor force contributing -0.3% (61). These data imply that, on average, GDP growth in 1998-2003 was mostly driven by the elimination of inefficiencies, while the upgrading of capital stock was at an early stage and the labor force was acting as a drag on growth.
Upgrading of capital stock can be seen through increased total investment in the economy. After experiencing an average investment rate to GDP in 1991-2004 of about 17 %\textsuperscript{43}, this rate has been recovering relatively rapidly, reaching 23.5 percentage of GDP in 2004 (49). Also, as a result of the structural reforms and the resulting improved investment climate, it was the private sector that carried out most of the investment, with a share of about 73% of total investment (49). Foreign direct investment (FDI) also played a big role in rebuilding Bulgaria’s capital stock. From negligible levels of around 1% of GDP during 1989-1997, it increased to about 7% of GDP during 2000-04 (49).

As a result of adopting liberal trade policies, the overall trade of goods and services expanded from comprising 95% to comprising 127% of GDP between 1998 and 2004 (69). However, since 1998, Bulgaria entered a period of constant trade deficits (Fig. 10), indicating its insufficient export competitiveness.

**Figure 10: Trade deficits of Bulgaria as a percentage of GDP, 1991-2012**

The reason for insufficient improvement in Bulgaria’s export competitiveness, despite a substantial increase in investment, is that investment has mostly been directed towards the domestic market rather than foreign markets. According to the World Bank, from 1998-2003,

\textsuperscript{43} Compared to an average of 25 in CEE-8.
investment in sectors oriented towards the domestic market increased by about 9% of GDP, reaching a level of 21% of GDP in 2003, whereas, investment in sectors oriented towards foreign markets grew only 1% of the GDP during the same period, reaching a level of 4% of the GDP in 2003 (69). In addition, investment in sectors oriented towards foreign markets has been directed much more towards resource-intensive activities than towards medium to high-tech\textsuperscript{44} activities, indicating that Bulgaria’s export is saturated with exports of low value added.

Since Bulgaria’s monetary policy is run by the currency board\textsuperscript{45} and since Bulgaria is committed to switching its currency (the lev) to the euro, it means that Bulgaria cannot count on gaining competitiveness by devaluing its currency. This is problematic for Bulgaria, because many of its competitors in these sectors (mainly non-European) do not face this obstacle. Given Bulgaria’s goal to grow faster and to consequently converge with the EU-27 and EU-15, there seems to be no other way for Bulgaria to gain competitiveness than by making further progress in structural reforms, which would create much more favorable business environment. This environment would in turn attract investments, which would upgrade Bulgaria’s capital and bring Bulgaria on a higher stage of the global production chain.

\textsuperscript{44} Over 1998-2003, investment in resource intensive tradables increased by about 1.5% of GDP, reaching a level of about 3.1% of GDP in 2003. In contrast, during the same period of time, expansion of investment in medium to high-tech-intensive tradables showed much smaller increase, only 0.2%, reaching a level of just under 1% in 2003 (World Bank 2005, 69).

\textsuperscript{45} Since 1997.
Research findings:

Given the two case studies in chapters 7 and 8, the following findings are most relevant to an understanding of the reasons for the lack of full economic convergence of Slovenia and Bulgaria with the EU-27 and EU-15 and for the different levels of convergence of these two countries:

• Slovenia had very favorable initial conditions. These included the legacy of Yugoslavian style socialism, so by the time the transition process began in the CEE, Slovenia already had elements of market economy and a very good level of economic convergence. Further, Slovenia experienced a quick recovery from the transition recession and very positive WGI scores, being on the same level as certain EU member states.

• Slovenia also had very successful stabilization policies. By 1997, single digit inflation was achieved under a managed floating exchange regime, which did not affect the GDP of Slovenia negatively. Similarly, Slovenia’s public finances avoided fiscal crisis and budget deficits that usually follow initial transition liberalization policies.

• With regards to its structural reforms, Slovenia’s achievement is less impressive. Even though the gradual approach to reforms helped avoid unnecessary losses of GDP and secured a stable GDP growth rate from 1993 until 2008, Slovenia reached a point where it generated more negative than positive results. In particular, by the late 1990s, the gradualist approach to reforms turned into inertia, with resulting further delays in reforms and constrains on Slovenia’s development capacity. A change in such inert system became possible only with an exogenous shock, but even then, the changes were incremental. For example, from 2001 until 2012, in terms of the reforms, Slovenia progressed only 0.5 points, with 0.38-point progress (Table a, Appendix) being made as a result of the exogenous shock - the accession to the EU in 2004.
• Such slow improvement in structural reforms was not without costs. It weakened Slovenia’s competitiveness, hampering future economic development, by reducing Slovenia’s capacity to cope with the competitive pressures in the EU single market. The empirical analysis by Murn et al. identifies this negative trend, focusing on the gradual worsening of the level of export competitiveness of Slovenia. Havlik et al. attribute this negative trend to the slow pace of restructuring manufacturing industry in the direction of technology driven industries; whereas, Landesmann and Stehrer show that the overall pace of export restructuring in Slovenia towards high value added products was slower than in other advanced transitioning economies.

• Overall, given Slovenia’s favorable initial conditions, and recognizing Slovenia’s successes in stabilization policies and relative successes in structural reforms, it does not surprise that Slovenia went on a path towards the full convergence with the EU-15 and EU-27. Over more than two decades of transition, Slovenia progressed 14 points towards the full convergence with the EU-27 level (from 70 to 84) and 13 points in the case of the EU-15 (from 64 to 77) (Fig.2 and 3). In 2008, the level of convergence was even better, (91 and 82) but it has deteriorated since then, due to the negative effects of the world financial crisis on Slovenia. Nevertheless, had Slovenia progressed more in its structural reforms, the convergence level with the EU-27 and EU-15 would have been even better, since Slovenia would have been even more prepared to cope with the competitiveness in the EU and consequently would have been better able to exploit the benefits of integration.

• Finally, the case of Slovenia shows that having favorable initial conditions is not sufficient for achieving full convergence with the most developed EU countries. This is because the effect of initial conditions eventually dies away and other factors, such as structural reforms,
become increasingly important. In order to fully converge, Slovenia would need to make significant progress in structural reforms, in order to make its economy more competitive.

- The case of Bulgaria shows that unfavorable initial conditions can be overcome if there is a strong and lasting commitment to pursuing sound stabilization policies and deep structural reforms. In particular, fifteen years after the beginning of deep reforms in 1997, Bulgaria improved 21 point towards the full convergence with the EU-27 and EU-15 (Fig. 2 and 3), having an average GDP growth rate of 5.4 percent, from 1998 until 2008, higher than that of the EU member states.

- Unfortunately for the Bulgarian people, this is not how the transition started. First several years of transition (until 1997) were manifested by a hesitancy to reform, which when combined with very unfavorable initial conditions, resulted in a financial and banking crisis. The effect was to worsen the already poor initial conditions through major deteriorations on the macro-financial side and a significant loss of value of the capital stock. Bulgaria also lost a lot of its human capital because a large share of its labor force became long-term unemployed. This crisis clearly proved that there is no long-term benefit in delaying structural reform and that the longer the delay is, the deeper the crisis hits.

- Starting in 1997, Bulgaria had a completely different approach to transition, which resulted in a stable macroeconomic environment, significant improvement in structural reforms, and stable and robust economic growth. As a result of the introduction of the currency board, inflation was lowered and stabilized, and public finances were regulated. Regarding structural reforms, the liberalization of trade was completed and privatization (both large-scale and small-scale privatization) was very close to being fully completed. Bulgaria’s overall score in structural reforms of 7.9 is especially admirable given the length and depth of its transition recessions. As
a result of these improvements, the competitiveness of Bulgaria improved, which can be seen in the World Bank analysis according to which the growth in Bulgaria was mostly driven by the increase in TFP. Similarly, as a consequence of a more credible business environment, foreign direct investment in Bulgaria has been significantly higher.

- Nevertheless, as a consequence of the poor initial conditions, worsened by the crisis in 1996 - 1997, as well as a consequence of the increased investments being almost entirely directed towards the domestic market, Bulgaria’s export competitiveness did not significantly improve. This can be seen with the constant trade deficits as well as the saturation of exports with products of low value added. In order to expand its development capacity and grow faster, Bulgaria’s economy has to build up its export capacity beyond unskilled labor-intensive products. In order to accomplish this, Bulgaria cannot rely on devaluing its currency, because its monetary policy is run by the currency board and because Bulgaria is committed to switching its currency to the euro. Therefore, in order to build up its export capacity, Bulgaria needs to further improve in structural reforms, which should attract investment by creating a better business environment. These investments would upgrade Bulgaria’s capital stock and bring Bulgaria on a higher stage of production chain.
Conclusions and implications:

Relying on the findings from the two case studies, the hypotheses proposed in chapter 4, appear to hold true for the following reasons:

• Neither Slovenia nor Bulgaria have a sufficient level of integration maturity that would enable full convergence with the GDP per capita levels of EU-15 and EU-27. This is primarily due to their inadequate export competitiveness, and as a result, they are not capable of coping with the competitive pressure of the EU single market and, therefore, are not capable of exploiting the maximum benefits of the given form of integration. This does not necessarily mean their economies will not be able to grow, but rather that due to the insufficient maturity, the costs of integration will be higher than it needed and will hinder the maximum growth potential. Therefore, even though their economies might grow, such growth will not necessarily be sufficient for the full convergence of economic development to occur. The inadequate export competitiveness is linked to unfinished structural reforms.

• In the case of Slovenia, structural reforms significantly slowed down since the beginning of the new millennium, which had its cost in the form of deteriorating economic competitiveness and lower rates of economic growth relative to its Central European competitor countries. The inertia in structural reforms may be the main reason for Slovenia’s poor economic performance since the onset of the world financial crisis. The loss of competitiveness indicates that Slovenia can no longer rely on its very favorable initial conditions, because even though important, their influence on growth is declining over time.

• In the case of Bulgaria, even though there was a significant improvement in structural reforms, it was not large enough to offset the damages done in the beginning of transition. Macroeconomic stabilization policies were essential for recovery and growth since 1997, during
which period the impact of structural reforms was strong and robust, but even better progress in structural reforms is required in order to overcome very unfavorable initial conditions, such as what Bulgaria experienced during the period 1991-1997.

- This explanation for the observed lack of the full economic convergence of Slovenia and Bulgaria with the EU-27 and EU-15 can be broadened to include all the other post-communist Balkan countries that are currently in the process of integration in the EU. They have much in common in terms of their economic history, geography, and culture. Also, all of these countries (besides Romania) had a more hectic approach to transition and EU integration during the 1990s than did Slovenia and Bulgaria, characterized by their greater focus on nation building. Nevertheless, by being such laggards in these processes, they now have an opportunity to learn from the mistakes made by countries such as Slovenia and Bulgaria.

- Despite hesitancy in structural reforms, Slovenia still seems to be more mature for integration than Bulgaria. A combination of very good initial conditions, successful stabilization policies in the beginning of transition, and relative success in structural reforms still seem to outplay the more limited achievements of Bulgaria. Nevertheless, a resiliency of Bulgaria economy during the ongoing crisis in the EU witnesses that unless radical changes occur in Slovenia regarding the structural reforms, the difference in the level of convergence with the EU between these two countries may be significantly reduced.

- The explanations for the observed different level of convergence of Slovenia and Bulgaria can also be broaden to include all the other post-communist Balkan countries. Despite having much in common in terms of their history, geography, and a hectic approach in the 1990s, they are also different in many aspects. For example, even though the majority of these countries were part of Yugoslavia and, therefore, share a legacy of Yugoslavian style socialism, some, like
Albania and Romania, were not part of Yugoslavia and share more of a Soviet legacy. Also, even within former Yugoslavian countries, there are substantial differences in development. Finally, some countries are now fully committed to integrate in the EU; whereas, some like Bosnia and Herzegovina are still ambivalent.

The main focus of my study was to explain the observed inconsistency between the expected and actual effects of the EU integration process for the post-communist Balkan countries. The study found that the reason for this inconsistency is insufficient maturity of the post-communist Balkan countries for the given form of integration. The study also explores those factors that constitute integration maturity, thereby allowing for a relatively more successful and effective integration that meets the goal of catching-up with the economic development in the EU countries.

As mentioned in chapter 6, one of the main motives of this study is to provide recommendations for Serbia in its EU integration process. I found it most suitable to analyze the cases of Bulgaria and Slovenia because of their similarities with Serbia in terms of history, common language, culture, state development, etc.

In particular, Serbia, like Slovenia, inherited a legacy of Yugoslavian type socialism, which as described earlier, was significantly more market oriented and better performing than the Soviet type. Nevertheless, Serbia unlike Slovenia, did not take advantage of being ahead of other transitioning countries. Rather than stabilization policies and structural reforms, the Serbian government insisted on political objectives, which led Serbia to multiple military conflicts, international isolation, and economic backwardness with an increasing development gap instead of catching-up. In this sense, Serbia, like Bulgaria, lost its comparative advantage relative to many other countries embarking on transition just after the fall of the Berlin Wall. Similarly, like
Bulgaria in 1997, Serbia, after the political turn in 2000, sought to catch-up quickly for missed opportunities by adopting economic policies similar to those in Bulgaria that enabled it to become a member of the EU. The result of reforms in Serbia was a stable macroeconomic environment and robust economic growth. Nevertheless, many of the reforms were not fully completed due to their potential political consequences (i.e., loss of elections), leaving Serbia on a lower level of competitiveness than the EU. Despite this, the significant part of the Serbian political public tends to argue that continued EU integration and eventual accession to the EU will by itself bring benefits and long-term prosperity, which would enable the Serbian people to enjoy the economic development and living standards prevailing in the most developed EU countries.

The findings from this study cannot confirm the argument that the continued integration will by itself result in the economic convergence. The study, however, does show that convergence is contingent upon the level of integration maturity. The good news for Serbian people is that, despite the lost opportunities in the 1990s, there is still a path forward to catch-up with the economic development and the living standards of the EU-27 and EU-15. Nevertheless, it will require great effort to pursue structural reforms, which (as explained) can bring a great deal of economic pain and social dislocation in the short-run.

The examination of factors and conditions for successful integration is particularly timely today, not only for Serbia, but for all the other Western Balkan countries, as well as for the EU. Considering the huge differences in the respective development and the number of these Western Balkan countries, the enlargement of the EU will have far-reaching consequences for the development of the whole union. On the other hand, preparation for membership and integration overall, the state of preparedness and analysis of the effects of continued integration, can provide
important information for policy makers and can influence public opinion. After all, broad based public support is essential to integration success, which will require a very well-informed citizenry that can understand the effects of integration, and be able to take into consideration long-run societal interests at both the micro and macro levels.
Appendix:

**Table a: EBRD transition index, 1994-2012**

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Source: Eurostat
**Table c: Convergence level in volume indices of GDP per capita in PPS (EU15=100)**

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<td>65</td>
<td>68</td>
<td>67</td>
<td>69</td>
<td>70</td>
<td>70</td>
</tr>
</tbody>
</table>

Source: Eurostat

**Figure a: WGI for the Government Effectiveness, 1996-2012**

![Graph of Government Effectiveness](image1)


**Figure b: WGI for the Control of Corruption, 1996-2012**

![Graph of Control of Corruption](image2)


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