



Economic Regimes for Export

Extending the EU's Norms of Economic Governance into the Neighbourhood

Gergana Noutcheva and Michael Emerson

Abstract

With its new European Neighbourhood Policy (ENP), the European Union has begun to develop a further ring in a widening set of economic policy regimes that gravitate around it. There are now no less than six rings to this system. We observe that the EU economic regime has extended its outreach to all categories of countries but the degree of acceptance of EU economic norms and the speed of adoption of EU economic rules is diminishing in the areas further away from the EU core. In the immediate vicinity, the EFTA ring, a high level of economic standards existed prior to the countries' full inclusion in the single market and the mechanisms of *acquis* enforcement have been modelled on the EU's internal rules and procedures. In the outer rings of lower economic standards, the EU has been more successful in encouraging convergence on its economic norms in countries to which it has extended the membership perspective. The promise of full integration in the EU has legitimized the EU's external governance through conditionality to steer the course of economic transition in the candidates and potential candidates. In the ENP ring, the EU has excluded the mega-incentive of accession as member state and this has decreased the possibilities for exerting strong leverage over the ENP partners. The evolving EU economic relationship with the southern and eastern neighbours is less hierarchical in nature and more based on mutual agreement and cooperation. In the outmost ring occupied by Russia, we see the EU reaching the geographical limits of its economic influence. Generally, the EU gravitational pull is getting weaker in the more distant periphery and the EU instruments are shifting from more traditional methods of hierarchical governance to softer modes of horizontal cooperation.

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ECONOMIC REGIMES FOR EXPORT

EXTENDING THE EU'S NORMS OF ECONOMIC GOVERNANCE INTO THE NEIGHBOURHOOD

GERGANA NOUTCHEVA & MICHAEL EMERSON

1. Introduction

With its new European Neighbourhood Policy (ENP) the European Union has begun to develop a further ring in a widening set of economic policy regimes that gravitate around it. There are now no less than six rings to this system. The first ring is the 'old EU', which first defined in the 1980s and then applied in the 1990s the rules of the internal market and economic and monetary union. This stock of laws, norms and rules became known as the '*acquis communautaire*', i.e. meaning effectively the 'acquired jurisdiction of the European Community'.

In a second ring the EU's internal market was extended to the EFTA states, to form the European Economic Area (EEA) in 1994, with adoption of virtually the whole of the internal market *acquis*. This was a case of extension of the system to states with the most advanced governance standards.

The third ring saw extension of the *acquis* to the new member states acceding in 2004. In this case the new member states from central and eastern Europe were at the same time completing their regime change out of communism.

The fourth ring consists of the Western Balkan states, which are not yet accession candidates, and for whom the Stabilisation and Association process (SAA) was devised. This involves a substantial but less complete or rapid adoption of the *acquis*, but the political incentive of accession to the EU in the long term is still present. These are also cases of post-communist regime change, but with the addition of severe post-conflict and state building agendas.

The European Neighbourhood Policy (ENP), initiated in 2003, thus represents the fifth and largest ring, embracing six former Soviet Union states of eastern Europe (excluding Russia) and the ten south Mediterranean states of the Barcelona Process. This also involves the post-communist transition for the post-Soviet states, but the same policy is addressing the culturally different challenges of modernisation of the Arab world. Both groups of states have serious weaknesses of political and economic governance to resolve, and the EU *acquis* is only selectively being introduced, depending on the will and aptitudes of each state individually. Most of the European neighbouring states look for a long-term perspective of EU accession, but this is not encouraged by the EU itself.

Last but not least, Russia occupies alone the sixth ring, with a set of 'common space' agreements signed with the EU in 2005. These are more limited still than the ENP in commitment to convergence on EU norms, and there is no demand by Russia for EU membership perspectives, but there is a more ambitious geo-strategic content.

This paper focuses mainly on the emerging ENP, but places it in the perspective of the other rings in the EU's spectrum of arrangements for exporting its norms and rules of economic governance. The comparison between these several regimes, all belonging to the same family, allows us to examine both the extent and limits of this complex and growing process. Looking across the rings, we observe that the EU economic regime has extended its outreach to all categories of countries but the degree of acceptance of EU economic norms and the speed of adoption of EU economic rules is diminishing in the areas further away from the EU core. In the immediate vicinity, the EFTA ring, a high level of economic standards existed prior to the

countries' full inclusion in the single market and the mechanism of *acquis* enforcement have been modelled on the EU's internal rules and procedures. In the outer rings of lower economic standards, the EU has been more successful in encouraging convergence on its economic norms in countries to which it has extended the membership perspective. The promise of full integration in the EU has legitimized the EU's external governance through conditionality to steer the course of economic transition in the candidates and potential candidates. In the ENP ring, the EU has excluded the mega-incentive of accession as member state and this has decreased the possibilities for exerting strong leverage over the ENP partners. The evolving EU economic relationship with the southern and eastern neighbours is less hierarchical in nature and more based on mutual agreement and cooperation. In the outmost ring occupied by Russia, we see the EU reaching the geographical limits of its economic influence. Generally, the EU gravitational pull is getting weaker in the more distant periphery and the EU instruments are shifting from more traditional methods of hierarchical governance to softer modes of horizontal cooperation.

A further part of the system of external influences bearing upon these states comes with the projection of norms and rules of economic governance by the International Financial Institutions or IFIs (principally in the present context the IMF, IBRD, WTO and EBRD). In general terms the mix of influence of the EU and the IFIs varies as a function of the strength of the EU integration factor, with the IFIs fading in significance for EU member states, but remaining as important actors in other parts of the European neighbourhood. How best to blend the EU's *acquis* and the *Washington consensus* in the European neighbourhood becomes a major issue for the policy makers.

2. Shaping the rules of economic governance in the old EU

The EU's own internal system of economic governance has been analysed in both the economic literature focusing on the substance and economic rationale of EU policies¹ and the political economy literature concentrating on the modes of economic policy-making.² A great deal of the economic decisions of EU governments have come to be constrained by the economic competences transferred to the EU level, in particular in trade, competition, monetary and several sectoral policy areas, and commitments made to coordinate other aspects of their economic policies. Yet, regardless of the EU layer of governance, there is substantial discretion left to the national governments to preserve their national economic features that continue to co-exist with the common economic policies. Member states have, for instance, opted for a wide range of policies with respect to the extent of state involvement in the economy compatible with EU competition policy, on the speed and extent of privatisation, on the level of social protection and taxation, and the degree of rigidity or flexibility of labour market regulation.

The evolution of the EU economic system has since the 1970s alternated between advances in the macro and micro-economic domains, with the pursuit of monetary union and completion of the single internal market. The 1970s saw first attempts to move fast towards monetary union

¹ See for instance Daniel Gros (ed.). *Fiscal and Monetary Policy for a Low-Speed Europe* (Brussels, Centre for European Policy Studies: 2002). Daniel Gros, Thomas Mayer and Angel Ubide, *The Nine Lives of the Stability Pact* (Brussels, Centre for European Policy Studies: 2004). Daniel Gros, Thomas Mayer and Angel Ubide, *EMU at Risk* (Brussels, Centre for European Policy Studies: 2005).

² See for instance Ingo Linsenmann and Wolfgang Wessels, "Modes of Economic Governance in the EU," paper presented at the conference "Economic coordination in EMU," College of Europe, Brugge, 28-29 June, 2002. Stefan Collignon, 2003. "Is Europe Going Far Enough? Reflections on the Stability and Growth Pact, the Lisbon Strategy and the EU's Economic Governance," *European Political Economy Review* (1, No. 2): 222-247.

with the Werner Plan, but these foundered on the monetary instability provoked by the first oil shock of 1973. This failure led to criticism of an excessively monetarist approach, and neglect for the public finance redistribution function in all advanced Western economies, be they federal or unitary states. This led to the influential MacDougall report, which provided analytical underpinnings for subsequent demands that monetary integration be accompanied by an EU redistribution function.³ The late 1970s saw a re-launch of monetary integration ideas by Commission President Roy Jenkins, which led to the birth of the European Monetary System under the leadership of Chancellor Schmidt and President Giscard d'Estaing. However at the beginning of the decade long presidency of the Commission by Jacques Delors in 1984 the priority switched to completing the single market, with the target date of 1992.⁴ Only after this project was assured did EU leaders return to the monetary union question in earnest, embracing the logic that 'one market' needed 'one money'.⁵ The norms and structure of the emerging system was sketched in a report by a group of experts commissioned by President Delors and headed by Tommaso Padoa Schioppa.⁶ The literature traces the increasing relevance of the EU layer of governance in economic policy formulation in the member states since the Single European Act of 1987, the Maastricht Treaty of 1992, and the establishment of the European Monetary Union (EMU) in 1999, particularly in the eurozone member states.⁷

The first feature of the EU's approach to economic governance is encoded in the internal market regime, with regulatory norms and methods adopted in a comprehensive range of EU common policies, such as for technical product standards, indirect taxation, competition policy, transport, environment, energy, etc. The programme to complete the internal market by 1992 required no less than 300 legal acts, which became the heart of the '*acquis*', defining the basic rules and standards in the specific sectors. They are tightly linked to the liberal economic logic underpinning the internal market and the 'four freedoms' constituting its core – the free movement of goods, services, capital and labour. The progressive empowerment of the EU institutional structures, considered by many analysts a key factor for the progress in market integration, has been at the heart of conceptualisations of the EU economic governance as a supranational system.⁸

A second distinct feature of the EU governance practice is agreement on a limited redistribution function, aiming at strengthening the economic and social cohesion across borders. There is an explicit commitment to "reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions, including rural areas"⁹ among the

³ D. MacDougall et al., "*The Role of Public Finance in European Economic Integration*," (Brussels, European Commission: 1977).

⁴ Michael Emerson et al., *The Economics of 1992: The E.C. Commission's Assessment of the Economic Effects of Completing the Internal Market* (Oxford, Oxford University Press: 1988.)

⁵ Michael Emerson, Daniel Gros et al., *One Market, One Money* (Oxford, Oxford University Press: 1992).

⁶ T. Padoa Schioppa et al., *Efficiency, Stability and Equity – a Strategy for the System of the European Community* (Oxford, Oxford University Press: 1987).

⁷ See Stefan Collignon, 2003. "Is Europe Going Far Enough? Reflections on the Stability and Growth Pact, the Lisbon Strategy and the EU's Economic Governance," *European Political Economy Review* (1, No. 2): 222-247.

⁸ See for instance Simon Bulmer, 1997. "New Institutionalism, the Single Market and EU Governance," *ARENA Working Papers*, WP 97/25.

⁹ Art. 130a, Treaty Establishing the European Community.

member states. The agreement on substantial regional and structural funds in the common budget is the concrete instrument for promoting cohesion.¹⁰

This emerging blend of economic liberalism and social cohesion is a basic reflection of the EU's preferred range of socio-economic models, which while quite wide, can still be contrasted with the more liberal model observed in the United States. The concrete emergence of the EU's blend of market liberalism and social cohesion policies can be attributed historically and personally to the Cockfield-Delors tandem. Thus on the one hand the ultra-liberal Lord Cockfield, sent to Brussels by Margaret Thatcher, saw to the liberal fundamentals of the 1992 programme. On the other hand, the socialist Jacques Delors was convinced that neither the single market nor the single currency could be politically viable for the EU without a substantial set of social cohesion policies, which in practice translated into a massive development of the EU's regional and structural fund instruments.¹¹

With the launch of the EMU, the European Central Bank was empowered to maintain price stability within the Eurozone economy. The rules governing decision-making in monetary policy exhibit features of 'traditional' governance with a firm treaty base and institutionalisation at EU level.¹² The common currency and the single monetary framework are the third feature of the EU economic governance system. The criteria set to ensure the convergence of macroeconomic policies of governments prior to membership in the EMU, known also as the Maastricht criteria, constitute the consensus among the member states on the basic principles of macroeconomic governance such as low inflation, sustainable public finances and external accounts, a transparent and predictable environment for economic agents.

Box 1. The Maastricht Criteria

Inflation - no more than 1.5% above the average inflation rate of the lowest 3 inflation countries

Interest rates - the long-term rate should be no more than 2% above the average of the three countries with the lowest inflation rates

Budget deficit - no more than 3% of GDP

National debt - no more than 60% of GDP

Exchange rates - currency within the normal ERM bands with no re-alignments for at least 2 years

These elements of supranational governance in the economic domain, however, co-exist with softer mechanisms of policy coordination.¹³ These rely less on hierarchical methods and formal rules and sanctioning procedures, and more on horizontal coordination through common benchmarking, target setting and voluntary implementation.

The main elements of real supranational governance, as in the single market *acquis* and the euro currency controlled by the independent European Central Bank, are thus flanked by a complex set of economic policy coordination methods, of varying hardness or softness, and of varying

¹⁰ See Pascal Lamy, 2004. "Europe and the Future of Economic Governance," *Journal of Common Market Studies* 42 (1): 5-21.

¹¹ T. Padoa Schioppa et al., "Efficiency, Stability and Equity – a Strategy for the System of the European Community" (Oxford, Oxford University Press: 1987).

¹² See H. Wallace and W. Wallace (eds.). *Policy-making in the European Union*. 4th edn. (Oxford: Oxford University Press, 2000).

¹³ See Adrienne Heritier, "New Modes of Governance in Europe: Policy-making without legislating?" In A. Heritier (ed.), *Common Goods: Reinventing European and International Governance* (Boulder, CO: Rowman & Littlefield, 2002).

effectiveness too. At the macroeconomic level, the Stability and Growth Pact is an attempted example of ‘hard’ coordination in the area of fiscal policy.¹⁴ It is a framework for regulating the fiscal behaviour of member states by putting limits to government spending and debt levels.¹⁵ It includes a budgetary surveillance mechanism with a legal procedure for penalising governments in breach of the common rules, based on treaty provisions.¹⁶ In contrast, the annual Broad Economic Policy Guidelines (BEPG) and the employment policy present models of ‘soft’ coordination.¹⁷ They are not legally binding frameworks and work on the basis of policy monitoring and policy recommendation without formal sanctions in the case of non-compliance.

The ‘hardest’ part of the Stability and Growth Pact – its budget deficit constraints – came to the hard test of a reality check in 2003-2004 when several member states were into breach of their budget deficit commitments. France and Germany in particular reacted by defying compliance, complaining of the excessive rigidity and restrictiveness of the rules. Instead they demanded revision of the rules, to render them more flexible and accommodating with respect to circumstances permitting overshooting budget deficit limits. The Council (ECOFIN), legally authorised to impose financial sanctions, fell short of penalising its two largest member states at the end of 2004¹⁸ and the rules of the Stability and Growth Pact were subsequently softened in June 2005.¹⁹

At the micro-economic level, the so-called ‘Lisbon Strategy’, launched in 2000, set the target of 2010 for the EU to become “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”.²⁰ The Lisbon Strategy is based on a highly detailed benchmarking of performance indicators, subject to annual review at summit level. It is as an example of the ‘open method of coordination’, seeks to achieve results through lessons learning and sharing of best practices, and raising the domestic political costs of poor performance, rather than through applying detailed norms at EU level.²¹

The Lisbon Strategy was initiated because of the disappointing growth performance at the heart of the EU, principally of the founding member states. The combination of ‘one market’ and ‘one money’ had been expected to translate into a significant boost to growth. The conclusion drawn from the failure for this to emerge was not so much that the EU-level economic regime was defective, but rather that the founding member states were failing in their domestic policies to

¹⁴ Ingo Linsenmann and Wolfgang Wessels, “Modes of Economic Governance in the EU,” paper presented at the conference “Economic coordination in EMU,” College of Europe, Brugge, 28-29 June, 2002.

¹⁵ See Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997, OJ C 236, 02/08/1997.

¹⁶ See Council Regulation No 1467/97 of July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 209, 02/08/1997.

¹⁷ Ingo Linsenmann and Wolfgang Wessels, “Modes of Economic Governance in the EU,” paper presented at the conference “Economic coordination in EMU,” College of Europe, Brugge, 28-29 June, 2002.

¹⁸ See Daniel Gros, “*The Stability Pact is dead! Long Live the Treaty?*” CEPS Commentary, January 2005, available at www.ceps.be.

¹⁹ See Council Regulation No 1056/2005 of 27 June 2005 amending Regulation No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 174/5, 7.7.2005.

²⁰ See Lisbon European Council, Presidency Conclusions, 23-24 March 2000.

²¹ See Burkard Eberlein and Dieter Kerwer, 2004. “New Governance in the European Union: A Theoretical Perspective,” *Journal of Common Market Studies* 42 (1): 121-42.

face up to the challenges of globalisation, compared to the US, Asia and the smaller and newer member states of the EU (from Ireland and the Nordics to Central and Eastern Europe).

Assessments of the effectiveness of all these coordination mechanisms to bring about policy convergence and good economic outcomes are mixed to say the least. The Growth and Stability Pact was challenged in 2004 by both France and Germany, and as remarked above the rules were promptly changed to become more accommodating.²² The Broad Economic Policy Guidelines are a set of policy recommendations, without teeth. The Lisbon agenda is recognised to have been over-ambitious in its objectives, over-complex in its specific targeting, and short on real political action by the member states. Nonetheless the EU economic governance system has been experimenting in the design of new coordination schemes on an unprecedented scale. The EU economic governance system, therefore, is a mix of modes of governance. The EMU, the Single Market regulatory norms, including the social dimension to support the less developed areas, and the ‘hard’, ‘soft’ and ‘open’ coordination mechanisms in other economic areas all form part of the EU economic governance framework. It is a patchwork system of national and supranational elements, of macro-economic and micro-economic policy components, yet a system with a constantly evolving European dimension that has affected governance structures at national level. Together it forms a certain culture of European economic governance that shapes the discourse and expectations of the EU representatives when dealing with the European integration aspirations of neighbouring non-member states.

3. Exporting the rules of the internal market to the EFTA states

The EU’s first important act of export of its economic regime was initiated by Jacques Delors, when the internal market programme was becoming credible, and the EFTA states with their very deep level of trade integration with the EU feared that they could become relatively disadvantaged. Delors for his part wanted to avoid a cascade of new membership applications from these small states, and so offered them a formula for guaranteeing full access to the internal market. The conditions for this were wholesale adoption, with implementation through their domestic legislation, of all the 300 legal acts of the EU to complete the opening of the market. The EU and EFTA states were thus to become joint members of the European Economic Area (EEA). It was also agreed that the EEA would be a dynamic jurisdiction, in that the EFTA states accepted an open-ended obligation to adopt further domestic laws to implement subsequent developments of EU internal market, which have turned out to be of large importance especially in the service sectors.

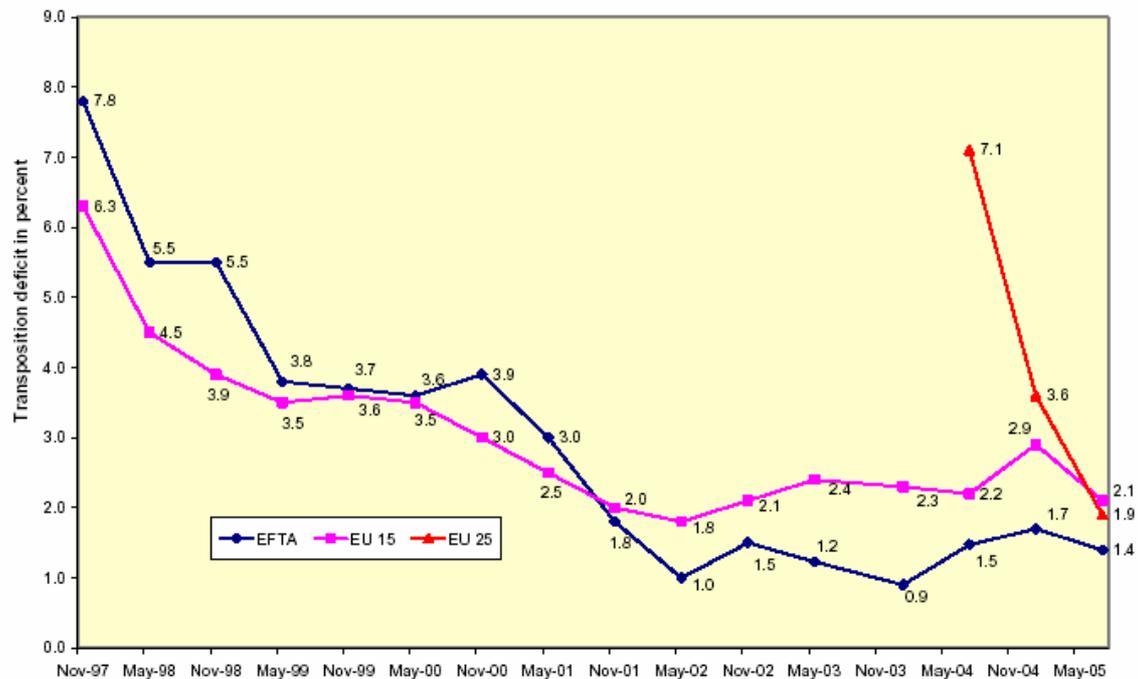
From a political standpoint the EEA involved the highly democratic EFTA states accepting the legally binding specification of their internal economic policies by the EU on a grand scale, without any power to join in the policy shaping process at all.²³ This extreme experiment with ‘democratic deficit politics’ had several results. First attempts were made to give some dignified institutional means for the EFTA state to participate in policy shaping and legal implementation. Committee structures were set up for consultations over new EU legislation. An EFTA Court was set up in Luxembourg, alongside the European Court of Justice, to rule over legal disputes. This interesting innovation involves judges from EFTA states making binding rulings on the implementation of EU law in their states, a system that could only conceivably work where the officials of the partner states enjoyed the highest trust for their competence and loyalty to the intentions of the EEA. In addition, an EFTA Surveillance Authority watches over the legal

²² Daniel Gros, Thomas Mayer and Angel Ubide, *EMU at Risk* (Brussels, Centre for European Policy Studies: 2005).

²³ Michael Emerson et al., 2002. *Navigating by the Stars: Norway, the European Economic Area and the European Union*. Brussels: Centre for European Policy Studies.

transposition of EU directives and publishes twice yearly the Internal Market Scoreboard measuring the success of the EFTA countries in implementing the Internal Market legislation. The latest results show that the EFTA countries have closed down their transposition deficit and have even achieved a better implementation rate compared to the EU member states (see graph below).

Figure 1. Transposition deficit for EFTA States, EU 15 and EU 25 as of 30 April 2005



Source: EFTA Surveillance Authority (2005) *Internal Market Scoreboard – EFTA States*.

Second, notwithstanding these noteworthy efforts, the democracy deficit in the system was too much for the Swiss, who voted against ratification of the EEA Treaty by referendum. As a result Switzerland fell back to a position of negotiating a selective but increasingly extensive set of agreements with the EU on various sectors of the internal market, and other policies such as recently the Schengen system for free movement of persons. The EU however for its part was not willing to see Switzerland establish an important ‘cherry-picking’ precedent for ‘importers’ of its economic system, and insisted upon a guillotine clause, whereby if Switzerland failed by referendum to implement one of the agreements all of them would be rendered null and void. Also Switzerland ended up with a weaker position institutionally than the EEA states.

Third, Finland, Sweden and Norway, soon after ratifying the EEA, decided that the democracy deficit was too uncomfortable for them too, and that the better option was to request full membership. As is well known, of the three Norway failed to ratify accession by referendum, and so fell back into the original EEA with only Iceland and Liechtenstein.

The EEA experience, while governing only small populations, is nonetheless rich as an extreme experiment in the export and import of economic regimes. It is also an important reference for any analysis of more limited attempts for neighbourhood states to gain ‘a stake in the internal market’, and for the implications of the import of economic regimes for democratic legitimacy.

4. Economic governance and the enlargement into Central and Eastern Europe

The EU enlargement policy towards central and eastern Europe has often been cited as a successful example of EU ‘external governance by conditionality’.²⁴ The EU conditionality model of offering incentives for EU rule adoption, and disincentives for failure to align with the EU norms, has been credited with the pace of political and economic transformation in the candidate countries in the period preceding their membership in the EU.²⁵ Given the asymmetry of the EU relationship with future members, and the top-down transfer of EU rules, the candidate states had no choice but to take all elements of the EU governance system described above.²⁶

The central and east European countries were relatively open to new ideas about governance methods and practices from the EU because they were in active search of a credible model to replace the collapsed communist system. In the early 1990s, the economies in the region suffered devastating shocks after the breakdown of the centrally planned economic structures. The economic objective of EU enlargement policy was to make sure that the candidate countries had achieved a level of economic stability and acceptance of market principles as the basis for economic management prior to their full exposure to competition within the internal market.

In terms of the mechanisms for bringing about the desired economic change in the candidate countries, the process of rule transfer is clear-cut. The aspiring candidates had no say on the EU Internal Market laws, and the EU was only willing to grant temporary derogations to full alignment with the *acquis* on exceptional basis. Furthermore, the process of legal approximation is by definition technocratic in nature, driven by officials in Brussels and national capitals and with limited participation of civil society. With regard to the adoption of specific EU directives and regulations, the EU institutional machinery is in a hierarchical relationship above national governments.

Concerning the economic criteria for accession, however, the EU’s impact on the governance structures of the candidate countries is not so explicit beyond compliance with EU law. The EU did not and could not prescribe a particular economic model to the transition economies in Central and Eastern Europe. Instead, it formulated two broad economic criteria known as the Copenhagen economic criteria – a functioning marketing economy and capacity to cope with competitive pressures within the single market (see box 2) - and monitored progress towards their fulfilment while giving freedom to the governments to devise their specific reform programmes and adjustment measures.

The two economic criteria formulated by the EU are linked and reforms intended to improve the functioning of a market economy contribute to its competitiveness, and vice-versa. For evaluation purposes, however, the Commission kept the assessment of the two sub-criteria separately. And although the Commission required compliance with both of them, in practice the ‘functioning market economy’ requirement was key to getting positive marks and

²⁴ See Frank Schimmelfennig and Ulrich Sedelmeier, 2004. “Governance by Conditionality: EU Rule Transfer to the Candidate Countries of Central and Eastern Europe,” *Journal of European Public Policy* 11 (4): 661-679.

²⁵ See Heather Grabbe, 1999. “A Partnership for Accession? The Implications of EU Conditionality for the Central and Eastern European Applicants,” *EUI Working Paper*, RCS N 12/99, Florence: European University Institute; Judith Kelly, 2004. “International Actors on the Domestic Scene: Membership Conditionality and Socialization by International Institutions,” *International Organization* 58, (3): 425-457.

²⁶ Schimmelfennig and Sedelmeier 2004: 675.

favourable treatment from Brussels in the pre-accession process.²⁷ It is also the criterion that is “backward-looking”, taking stock retrospectively of reforms already undertaken and of goals already reached. The competitiveness condition is “forward-looking”, and is expected to be fulfilled only upon accession.²⁸ Indeed, the capacity to cope with the competitive pressures of the single market presupposes a functioning marketing economy, and comes only after a longer-term period of sustained effort at restructuring the inefficiencies of the centrally planned economies.

Box 2. The Copenhagen Economic Criteria and Sub-criteria

“Membership requires the existence of a *functioning market economy*, as well as the *capacity to cope with competitive pressure* and market forces within the Union.”

To measure the closeness of a country to being a *functioning market economy*, the European Commission applied the following sub-criteria:

- consensus about economic policy;
- macroeconomic stability, including price stability, sustainable public finances and external accounts;
- price and trade liberalization;
- free market entry (creation of new firms) and exit (bankruptcy legislation);
- adequate legal system, including enforcement of property rights;
- sufficiently developed financial sector.

To determine the capacity of a country to cope with competitive pressures within the single market, the European Commission employed the following sub-criteria:

- existence of a functioning market economy;
- sufficient human and physical capital, including quality of education and infrastructure;
- public and private stock capital, including FDI levels;
- progress in enterprise restructuring;
- sectoral structure of the economy, including sectoral shifts between share of agriculture, industry and services;
- small and medium enterprise development;
- limited state interference in the economy;
- sufficient trade and investment integration with the EU market.

Source: Headings from Regular Reports on Progress towards Accession of candidate countries. Brussels: European Commission.

The Commission did not specify threshold levels that would clearly indicate whether a country has fulfilled a certain sub-criterion or not. The open-ended conditions allow for broad interpretation of what constitutes Copenhagen-compliant economic performance. In the absence of clear benchmarks, the Commission looked at the general progress in the transition process, focusing more on the big picture rather than details. What was sufficient in order to receive a good score from Brussels was a positive record of the main economic indicators over a period of time and a proven record of structural reforms to demonstrate their sustainability and irreversibility of the general economic trend.²⁹

²⁷ Conversations with European Commission officials.

²⁸ Ibid.

²⁹ Ibid.

The choices of the candidate countries concerning the precise content of macroeconomic and sectoral policies, however, were constrained by other external sources such as the International Financial Institutions (IFIs), which were keen on providing policy advice and financial resources on condition of their endorsement of the ‘Washington consensus’ as a platform for economic governance. In essence, there was no contradiction between the European Commission and the IFIs on the broad framework of economic reform. The IMF and the World Bank supported the EU orientation of the countries from central and eastern Europe and worked towards their EU membership, and they set the reform priorities in their area of specialization – macroeconomic policy and structural reform, respectively. The European Commission, in turn, accepted the leadership of the IFIs in their specific fields and complemented their programs, but put special emphasis on issues that are of particular importance to the EU and are related to the country’s relationship with it.

The European Commission directly endorsed the IMF’s liberal approach to economic stabilization and growth and even co-financed it through its macro-financial assistance (MFA) scheme. The major precondition for the provision of such assistance is an agreement between the government of the country and the IMF on a macro-economic program, which means that IMF conditionality is built into the EU’s macro-financial package. The candidate countries received MFA from the EU mostly in the early days of transition of the 1990s, and strict MFA conditionality was absent from the late stages of substantive accession preparations. There was nonetheless an implicit agreement between the EU and the IMF that the Fund would take the lead on macro-economic policy, given its expertise in the area and its involvement in the transition economies.

The World Bank in turn added its resources to the incentive of EU membership in order to stimulate structural reform in the transition economies. It anchored its own programmes in the general EU framework, providing additional inducements linked to specific reform conditions in various sectors. Thus, while helping the candidates reach ‘EU standards,’ the World Bank has exercised its own leverage over the reform agenda of the countries. In principle, the World Bank conditionality complemented the EU conditionality. In practice, the World Bank’s method of setting concrete and often quantifiable targets went down to a level of detail in the specific policy areas beyond that which the EU reached with its grand approach to accession conditionality.

The EU’s own Maastricht criteria, which touch upon issues of macroeconomic governance, played an indirect but important role in making the candidates aware of what the macroeconomic rules of the game were in the Eurozone. Although the EU policy is that candidate countries should not join the EMU immediately upon accession to the EU, and the Maastricht criteria have therefore not been applied in the pre-accession period, the macroeconomic rules of the Eurozone were already built into the expectations of the governments of the acceding states, most of whom favoured early joining of EMU.³⁰

5. State-building and governance in the Western Balkans

The EU’s economic policy in the Western Balkans, i.e. states of the former Yugoslavia not yet accepted as member states plus Albania, is subordinated to the primary goal of state-building and strengthening the institutional base of the fragile state structures across the region. This is pursued within the political and legal framework of the *Stabilisation and Association Process (SAP)*, which represents a preliminary stage to the process of negotiating accession that should

³⁰ See Daniel Gros et al. *The Euro at 25: a Special Report on Enlargement* (Brussels, Centre for European Policy Studies: 2002).

follow when the priority political and governance criteria are met. Economic transition is very much on the agenda, but after the outstanding constitutional questions have been settled, notably in the cases of Bosnia and Serbia and Montenegro, where clear lines of responsibility for economic policy-making remained to be defined between sub-state entities. Post-war reconstruction, state- and institution-building come first. What is similar to the EU approach to central and eastern Europe is the conditional offer of membership, which is the strongest incentive the EU can put on the table, even if this may be dulled by the unspecified and distant time horizon. This has set the stage for a strong conditionality policy with concrete demands and rewards for reforms.

Two examples, Bosnia-Herzegovina (BiH) and Serbia-Montenegro (SCG), illustrate these tendencies. The EU has demanded a high level of economic harmonisation between the constituent entities, parts of the two common states. Prior to the EU intervention through the SAP, the two entities in BiH in one case, and Serbia and Montenegro in the other, were seeking maximum independence from each other. Bosnia-Herzegovina's progress towards a Stabilisation and Association Agreement (SAA) with the EU was made conditional, among other things, on a reform of the indirect tax system. This has involved the ceding of competences to the state level by the entity governments – most notably, the competence to collect taxes - and has resulted in a more integrated decision-making system for economic policy within the common state. In the case of Serbia and Montenegro, in order to qualify for a SAA, Serbia and Montenegro were requested to harmonize their customs tariffs, to coordinate their customs services and to create the conditions for free movement of people, goods, services and capital between the two republics. However, the EU had to relax its requirement of a common external trade regime after meeting firm resistance of the governments in Belgrade and Podgorica. This has not meant a change in the major thrust of the EU conditionality policy in BiH and SCG, which has been to advance the political goal of building institutionally stronger common states.

Two entities in this region, Montenegro and Kosovo, have adopted the Euro as their currency, renouncing both continued membership in the former Yugoslav and now Serbian dinar area, and creation of their own independent currencies. In addition, Bosnia has adopted a currency board monetary regime, with a fixed exchange rate in relation to the DM initially, and subsequently the Euro. The EU has in general discouraged neighbouring non-member states from unilateral adoption of the Euro, or 'Euroisation'. The official economic reasoning of the EU has been that these states should not aspire to joining the Eurozone before being more convergent and integrated with the EU economy, since only then would it be safe to renounce the option to make exchange rate adjustments. The political reasoning was that the Euro is only for full member states. These arguments are not universally shared by economists, who point also to the advantages for weak states in borrowing the credibility of the world's leading monetary regimes, either by Dollarisation or Euroisation, notably through eliminating the exchange risk premium in interest rates. Such arrangements are a very strong example of regime export, improving weaknesses in the domestic governance of the state concerned. In the two cases of Euroisation, Montenegro decided to go ahead unilaterally in spite of discouragement from the EU, while for Kosovo the UNMIK protectorate authorities agreed only because of the political impossibility of the dinar alternative. For Bosnia the currency board regime was decided by the Dayton powers.

The Western Balkan countries, therefore, see a special category of external influence over their governance structures through both conditionality and direct imposition by protectorate powers. While the EU's incentive is equivalent to that offered to the candidate countries from Central and Eastern Europe – full membership – the initial state of affairs in the Western Balkans has required a more targeted approach to setting country-specific conditions, penetrating deep into the domestic governance structures of the potential candidates.

6. The two Neighbourhoods: East and South

While the economic objectives of the ENP are comparable to those of the enlargement policy, the initial conditions in the southern and eastern neighbourhoods are quite different.

The countries from the former communist bloc, either from central Europe or the former Soviet Union, have a similar domestic environment as transition economies coming out of communist regimes, and seeking to modernise and adapt to the market principles governing the capitalist economies. They were all insulated for a long time from international competitive forces due to the restriction of their commercial exchanges within the communist bloc market. Their integration into the international economic system is a major challenge for both the local economic agents driving the process and the public authorities supporting it through creating a favourable regulatory environment. The CIS countries in question - Ukraine, Moldova, Belarus, Georgia, Armenia and Azerbaijan - have a very short history of independence and state consolidation, and their institutional apparatus is still far from fit to manage the enforcement of a regulatory framework necessary for a modern economy. The EU model of economic governance, which has been successful in delivering prosperity to its member states, has a degree of attraction and legitimacy in the eyes of the post-Soviet elites and societies. Yet, there is a wide variation in the openness to and acceptance of EU-inspired economic norms and regulatory rules among the countries from this regional group. Nevertheless, Ukraine, Moldova, Georgia and Armenia all openly express their long-term aspirations for full EU membership, even while this is discouraged by the EU itself, especially after the referendum crisis over the Constitution.

In the southern neighbourhood, however, the EU is confronted with a drastically different institutional and cultural setting. The Arab states are distant from the European core, geographically, politically, culturally and economically. The southern neighbours are consolidated states, mostly with authoritarian regimes, yet with mainly market economies exposed to at least some international competition. Most of the Mediterranean countries have experienced a degree of authoritarian stability in their domestic affairs in the last decades, with little interest in radical change on the scale of the post-communist regime changes. The southern Arab regimes are increasingly under pressure from Islamist political and religious movements. Resistance to EU-promoted ideas and governance methods can be expected to be greater than for the European neighbours, albeit with some countries of the region such as Morocco being more receptive than others to European-style values of political and economic liberalism. Israel is the exception in the region, with a population more interested in re-integration with Europe than with its Arab neighbours.

A comparison of the level of development of the southern and eastern neighbours reveals data that many would consider surprising. The southern Arab neighbours on average enjoy higher income levels than the east European neighbours - see Table 1. For example Algeria and Tunisia have significantly higher GDP per capita than the South Caucasus states. Israel stands out in this ranking because its economic prosperity is on par with that of the EU. These comparisons are confirmed by data on the proportion of population living below the poverty line, with \$2 per day taken to be the standard measure. Thus while Ukraine has a poverty ratio of 46% of the population and Moldova even 64%, Egypt records 44%, Morocco 14% and Tunisia 7%.

An interesting outlier is Belarus, with the highest income level among the Eastern neighbours, and the lowest poverty ratio of 2%, meaning practically no poverty at all. These relatively positive indicators for Belarus are confirmed in a detailed report recently published by the World Bank.³¹ The story is made all the more intriguing when taken together with the data

³¹ World Bank, 2005. "Belarus: Window of Opportunity to Enhance Competitiveness and Sustain Economic Growth, Washington D.C.: World Bank, June.

displayed in the two figures below on the quality of economic regulatory policy and the rule of law, which are usually fundamental indicators of the quality of economic governance. On these measures Belarus scores outright bottom place among all neighbourhood states, as it does also in measures of democracy, since its regime is the only remaining first-class dictatorship left in Europe. The explanation for the relatively positive economic data for Belarus is that this country has avoided the typical post-communist economic collapse brought about by sudden regime change, and its state-run economy has continued in particular to supply basic industrial and consumer goods to the Russian market. The World Bank does warn that this relatively positive experience of recent years may be difficult to sustain, as Belarus does not modernise its product lines, and will find international competition increasingly severe, including in the Russian market.³²

Table 1. Level of Development and Poverty Rates

	Country	GNI Per Capita (USD) 2004 Atlas Method ¹	GNI Per Capita (USD) 2004 Purchasing Power Parity (PPP) ¹	Population 2003 (million) ²	Poverty headcount ratio at \$2 a day (PPP) (% of population) ³
Eastern Neighbourhood Countries	Armenia	1120	4270	3.06	49 (1998)
	Azerbaijan	950	3830	8.37	9 (2001)
	Belarus	2120	6900	9.90	2 (2000)
	Georgia	1040	2930	5.13	16 (2001)
	Moldova	710	1930	4.27	64 (2001)
	Ukraine	1260	6250	48.52	46 (1999)
Southern Neighbourhood Countries	Algeria	2280	6280	31.80	15 (1995)
	Egypt	1310	4120	71.93	44 (1999)
	Israel	17380	23510	6.43	NA
	Jordan	2140	4640	5.47	7 (1997)
	Lebanon	4980	5380	3.65	NA
	Libya	4450	NA	5.55	NA
	Morocco	1520	4100	30.57	14 (1999)
	Syria	1190	3550	17.80	NA
	Tunisia	2630	7310	9.83	7 (2000)
	WB and Gaza	1120	NA	3.56	NA

¹ World Development Indicators, World Bank, 2005.

² International Financial Statistics, International Monetary Fund, April 2005.

³ World Development Indicators, World Bank, 2005.

An estimate of the human capital stock in the two neighbourhoods is provided by data on educational attainment – see Tables 2 and 3. The inter-regional differences are striking with the eastern neighbours scoring much higher than the southern ones on all indicators. The comparison is all the more intriguing when put in the broader context of the EU-15 and the several rings of countries around it. The transition countries from Central and Eastern Europe, many of which are already EU member states, have comparable levels of educational attainment

³² Ibid.

with the top achievers from the old EU and surpass with a comfortable margin the less advanced “old” EU members Greece and Portugal. The average achievement in North Africa and Middle East is much below the average for the transition bloc, including the CIS countries from the former Soviet Union. Recent studies suggest a correlation between the degree of educational attainment and the availability of skilled and productive labour force which, in turn, is considered an important driver of economic and social progress.³³ The data clearly show that the eastern neighbours on average have better human capital stock from which to pursue their development goals than southern neighbours. It should be noted, however, that the data on educational performance in Table 3 is based on achievement in mathematics and the physical sciences, where the former communist countries are particularly strong, as opposed to the social sciences where their stock of knowledge in Marxist-Leninist political economy has of course become totally obsolete.

Table 2. Educational Indicators

Regions	Average Years of Schooling ¹	% of Population Completing Higher Education
Advanced countries	9.8	13.0
Transition countries	9.7	9.9
North Africa, Middle East	5.4	3.4

¹ Total population aged 25 and Over. Indicator takes into account typical duration of each level of schooling within countries. Source: Barro, R. and Lee, J-W. (2000) “International Data on Educational Attainment: Updates and Implications,” *CID Working Paper* 42. Harvard University: Centre for International Development.

Table 3. Educational Performance

Groups of countries	Index of Performance ²
EU – average of France, Germany, Italy, Spain and UK	511
EU – average of Greece and Portugal	450
EU new member states – average of Czech R, Hungary, Latvia, Lithuania, Slovakia, Slovenia	530
Russia	539
North Africa – average of Morocco, Tunisia, Jordan	415

² Third International Mathematics and Science Study (TIMSS) conducted in 1995 by the International Association for the Evaluation of the Educational Achievement and the TIMSS-Repeat study conducted in 1999. Mean performance: TIMSS-95/TIMSS-Repeat Study, re-scaled, weighted by sampling probabilities. Source: Schuetz, G., Ursprung, H. and Woessmann, L. (2005) “Educational Policy and Equality of Opportunity,” *CESifo Working Paper* 1515. Munich, Germany: Centre for Economic Studies & Ifo Institute for Economic Research.

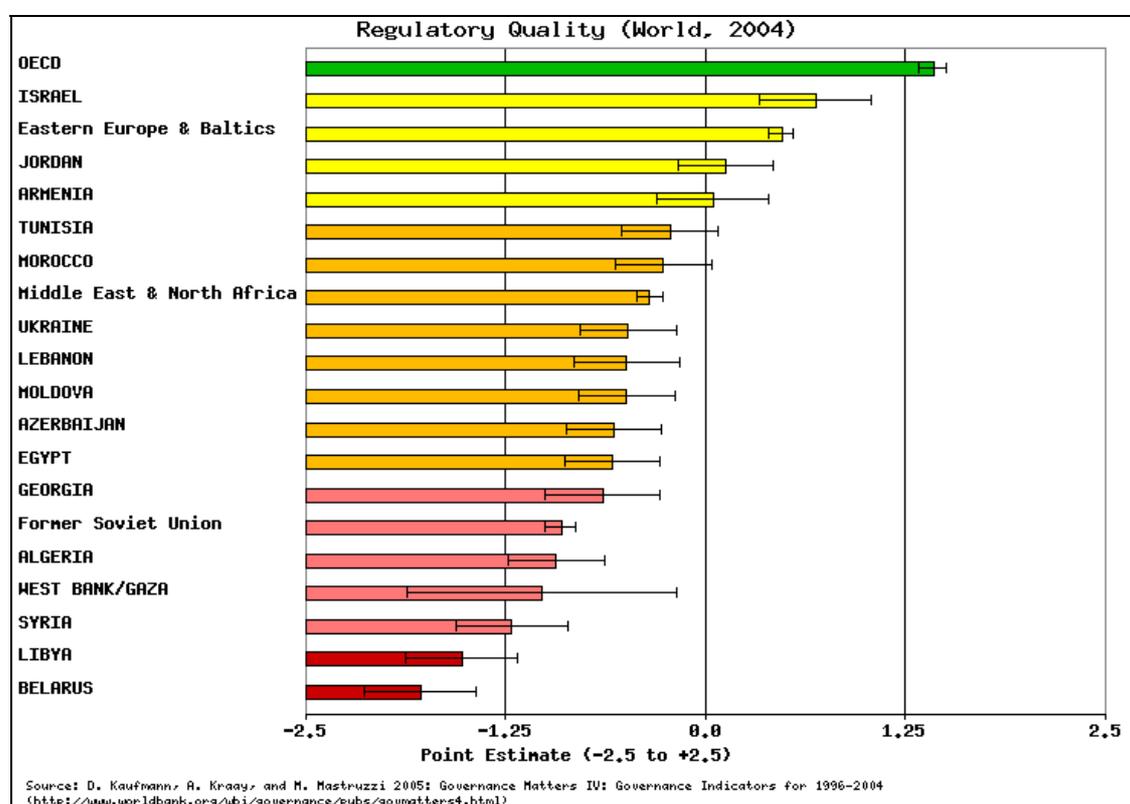
The economic objective of the ENP is to help the southern and eastern neighbours develop and modernise by anchoring their economies on the EU model of economic governance. Two measurements from the World Bank’s six governance indicators are particularly suited for assessing where the neighbouring countries stand in terms of their capacity to implement effectively the rules governing economic policy-making – the regulatory quality indicator and the rule of law indicator. The former gives an indication of the quality of policies and regulation, whereas the latter measures the respect of existing rules in policy implementation.³⁴

³³ See Barro, R. and Lee, J-W. (2000) “International Data on Educational Attainment: Updates and Implications,” *CID Working Paper* 42. Harvard University: Centre for International Development.

³⁴ Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, 2004. “*Governance Matters III: Governance Indicators for 1996-2002*,” Washington D.C.: World Bank.

These indicators do not assess convergence on EU regulatory norms and governance practices, but they do give an idea about the difference in the regulatory standards between the developed world and the transition and less developed countries, and their regional groups. A comparison of data for 2004 shows that the southern Mediterranean neighbours have more advanced regulatory frameworks and institutions on average than the east European neighbour states. Yet the average level of the south Mediterranean countries is well below the average for the new EU member states, and further below the standards of OECD countries. The institutional weakness in the former Soviet Union countries is particularly striking as most of them score lower than the Mediterranean states on the rule of law. The most authoritarian regimes in both the southern and eastern neighbourhoods – Libya and Belarus – have been disqualified from inclusion in the ENP policy framework on political criteria, and this is illustrated in their bottom rankings in the governance assessments of figure 2.

Figure 2. Regulatory Quality in the EU Neighbourhood, 2004



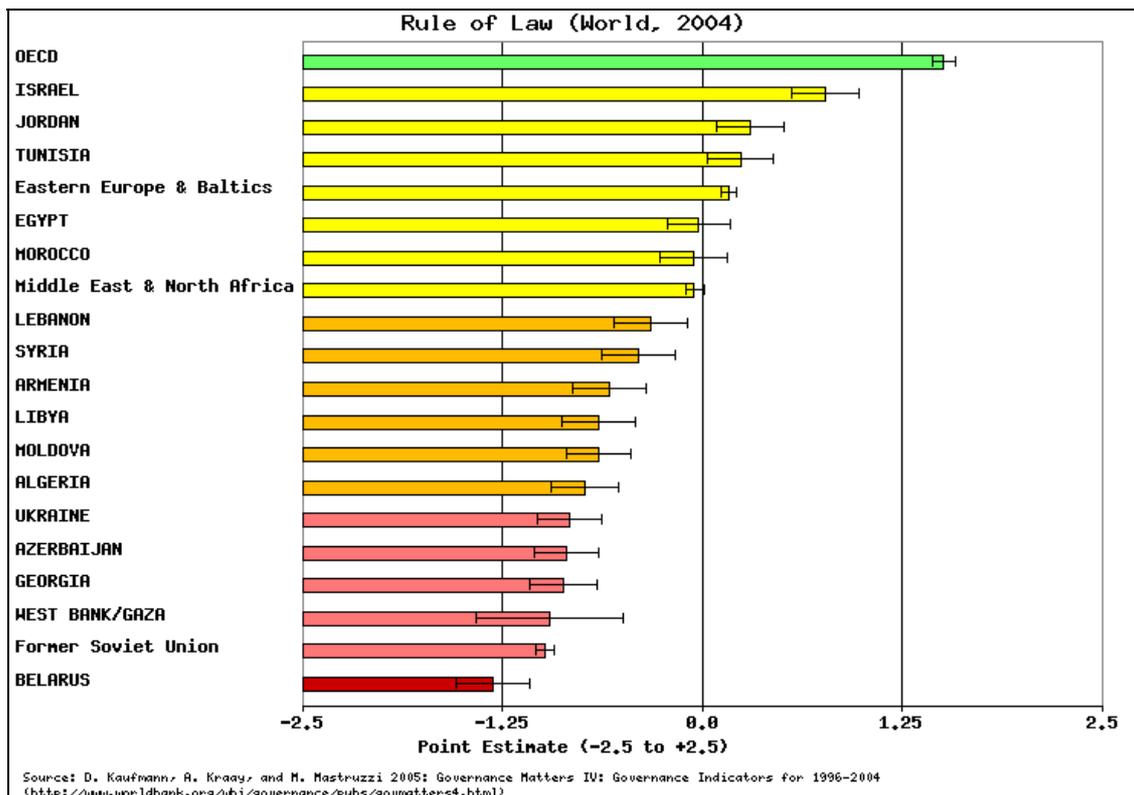
Has there been any improvement of the governance structures and practices in the neighbourhood in recent years? While the ENP is a new instrument, the EU has maintained relations with the southern and eastern neighbours for about a decade now, in the framework of the Barcelona Process with the Mediterranean countries and in the context of the Partnership and Cooperation Agreements with the CIS countries. According to World Bank data a comparison of the 1996 and 2004 governance scores of the neighbours shows that most of them have regressed rather than progressed on both regulatory quality and rule of law.³⁵ The three Southern Caucasus countries and Ukraine have improved their regulatory frameworks, although starting from a very low level whereas the regulatory regimes in most Mediterranean countries

³⁵ See World Bank Governance Indicators, 1996-2004.

have deteriorated. With regard to the rule of law, the situation is largely unchanged in both the southern and eastern neighbourhoods, but with a lot of room for improvement considering the low ratings of all the neighbours in comparison with the average of the advanced industrial economies.

These assessments based on World Bank data are largely confirmed by the European Commission's own evaluation of the economic achievements of ten years of Barcelona process in the Mediterranean. Using various economic and social indicators to measure the reform progress in the southern neighbourhood since 1995, the Commission concluded in a report issued in April 2005 that "...overall economic performance was rather unsatisfactory."³⁶ The general feeling in the year of the 10th anniversary of the Barcelona process is that it has failed to deliver economic development and prosperity to the southern neighbours. The economic and financial chapter is one of the key pillars of the Euro-Mediterranean partnership aiming at creating an area of shared prosperity through a gradual establishment of a free-trade area and a substantial increase in the EU's financial assistance to its partners.³⁷ While the EU cannot be blamed for the economic failures of its neighbours, its engagement in the Mediterranean has not produced the desired positive effect on their economic performance to date.

Figure 3. Rule of Law in the EU Neighbourhood, 2004



For the eastern European neighbours, the comparison with the central European and Baltic states joining the EU in 2004 and the South East European countries preparing for accession is

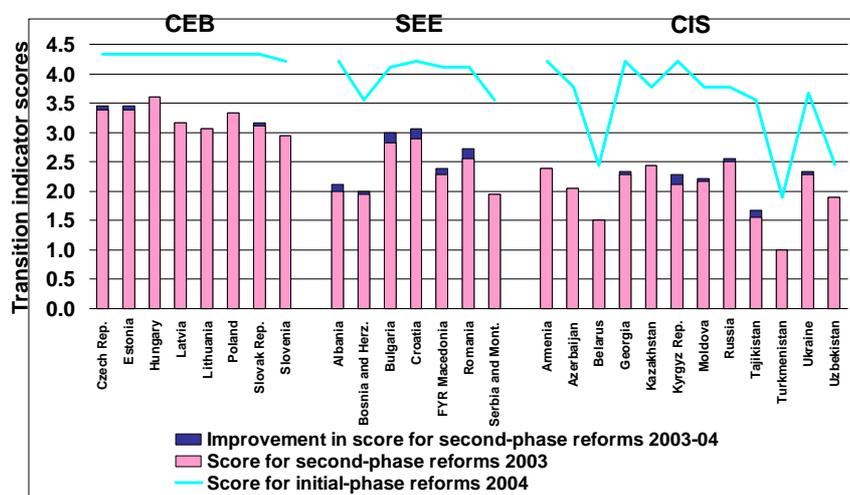
³⁶ European Commission (2005), "10 Years of Barcelona Process: Taking Stock of Economic Progress in EU Mediterranean Partners", Occasional Papers N 17, Brussels: DG for Economic and Financial Affairs, European Commission, p.19.

³⁷ See the Barcelona Declaration adopted at the Euro-Mediterranean Conference, 27-28 November 1995.

particularly informative, since all of them share a common economic legacy linked to the communist centrally planned system. The EBRD has developed a specific set of indicators for measuring progress in transition of former communist economies. In its 2004 Transition Report, the EBRD found uneven governance improvement and mixed commitment to economic reform across the former communist bloc 15 years after the start of the transition process.³⁸ Comparing the performance of the CIS region with the results achieved by the Central European and Baltic states and the South East European countries, EBRD expresses the concern that “...some CIS countries may become locked into a trap of weak governance, low productivity and high vulnerability – typical of low and middle-income countries...”³⁹

Figure 4. Progress in Transition, 2004

Transition indicators 2004: the New Member States and the Candidate Countries



Source: EBRD Transition Report, 2004. Scores range from 1 to 4+, where 1 represents little or no change from a rigidly planned economy and 4+ represents the standard of an industrialised market economy.

Legend: **Initial phase reforms** include price liberalisation, foreign exchange and trade liberalisation and small-scale privatisation. **Second phase reforms** include large-scale privatisation, governance and enterprise restructuring, competition policy, infrastructure reforms, banking and interest rate liberalisation and security markets and non-bank financial institutions.

The Report also notes that the EU membership perspective has proven the most powerful incentive for economic reform for accession candidate states. In the course of 2004, the transition economies that made the most progress are the EU candidate countries from South East Europe, with Bulgaria and Romania making a final push to fulfil the EU accession requirements, and Croatia seeking the opening of negotiations. The potential candidates from South East Europe (Albania, Macedonia, Bosnia-Herzegovina and Serbia-Montenegro) with somewhat longer-term membership prospects did advance their economic reform agendas too although with less results. The new EU member states from Central Europe and the Baltic

³⁸ See “Progress in Transition and Macroeconomic Performance,” EBRD Transition Report, 2004, pp. 3-15.

³⁹ Ibid., p. 15.

region have achieved a level of market reforms that put them on par with the advanced industrialised economies prior to their accession, but once the reward of membership was assured, the drive for reform has substantially weakened in 2004 compared to previous years (see Figure 4).

The two EU neighbourhoods thus reveal important differences in their past economic trajectories and governance standards at the time when the ENP is launched. Intra-regional heterogeneity in terms of level of development and standards of economic governance is present in both regional groups.⁴⁰ It is realistic to foresee an uneven pattern of progress given the initial conditions in the individual partner states.

7. Economic Governance and the European Neighbourhood Policy

While the ENP is not about preparing for membership of the EU, it is closely linked to the enlargement process. As in the case of the EEA, the ENP is a direct response to the concerns of the neighbours over important developments in the EU itself. Just as the EEA was intended to compensate the EFTA states for their exclusion from the benefits of membership in relation to the internal market programme, so the ENP is intended to compensate the ‘new neighbours’ to the east and south for perceived disadvantages from the EU’s expansion in both central Europe and the Mediterranean (with Cyprus and Malta). The impetus for the ENP originated from the concern of some northern member states to help Ukraine, Moldova and Belarus. As soon as this initiative began to gather momentum in 2003 the southern member states for their part insisted that the new northern neighbours should not receive a relative advantage compared to the southern Mediterranean states. As a result by 2004 the EU’s policy documents, originally using the term ‘Wider Europe’, came to embrace east and south with the ‘neighbourhood’ appellation,⁴¹ and the first Action Plans were drafted for a selection of eastern neighbours (Moldova, Ukraine) and southern ones (Jordan, Morocco, Tunisia, Israel and Palestine). The relationship with the enlargement process was furthered with the decision to entrust the drafting of the first policy papers to the Commission’s Directorate-General for Enlargement. The officials responsible constructed a derivative of what they had professional experience of, namely managing the agenda of negotiations with accession candidates, which is based on securing compliance with the *acquis*. In particular the draft Action Plans copied the structure of policy headings used in the accession negotiations and regular monitoring reports of the candidate states’ efforts. The content of the Action Plans thus have a huge number of about 300 bulleted action points, as if compliance with all the *acquis* were the ultimate objective.

Yet the specificity of the actions is very sketchy, with only selective explicit references to the *acquis*, since the neighbourhood states could not be treated as accession candidates, either as a matter of political choice of the EU, or the capacities of the partner states. These features are underlining the essential ambiguity of the ENP. It looks as if it is about the partner states converging on EU norms, but without the incentive of membership on the table, and with initial conditions very far away from the ultimate objective. As the policy advanced it has remained a question whether it can be regarded as an operationally viable strategy on the part of the EU, or just a placebo.⁴²

⁴⁰ For analysis of the differences among the CIS countries see Susanne Milcher and Ben Slay, 2005. “The economics of the ‘European Neighbourhood Policy’: An Initial Assessment.” Warsaw: Centre for Social and Economic Research.

⁴¹ See European Commission, 2004. “European Neighbourhood Policy: Strategy Paper.” COM(2004) 373. Brussels: European Commission, May

⁴² See Michael Emerson, 2004. “European Neighbourhood Policy: Strategy or Placebo?” *CEPS Working Document N 215*. Brussels: Centre for European Policy Studies, November.

The primary difference compared to the accession process is the expected degree of regulatory convergence, the choice of regulatory norms to adopt, and the pace to implement the regulatory reforms. While for the candidate countries, it is a ‘take-it-or-leave-it’ proposal, where governments have no choice but to harmonise the national legislation with the whole body of EU law, for the ENP partners, full legal harmonisation with the EU *acquis* is not foreseen. The expectation is for partial and progressive alignment with EU legal norms in areas where it makes economic sense, suits the development level and serves the development goals of the neighbours. Moreover, since the Action Plans are the product of joint negotiations between the European Commission and the partner state, there is a further degree of freedom in the choice of reforms that are targeted.

Another difference is in the much greater emphasis in the ENP Action Plans on development objectives. For its future members the EU did not specify a required GDP or wealth level, as long as the right economic policy mix, largely defined by reference to EU norms, was put in place. The development objective, however, is much more explicit, with references to the country’s Poverty Reduction Strategy Paper (PRSP) developed under the auspices of the World Bank. In poorer countries, such as Moldova, welfare improvement is singled out as a target, and the government is asked to take concrete measures to reduce poverty through improving the effectiveness of social assistance and the social safety net in general, including the social protection of children.⁴³

The economic sections of the first wave of Action Plans for Jordan, Israel, Palestine, Morocco, Tunisia, Moldova and Ukraine echo in their structure of headings the economic reform agenda from the accession process. The standard agenda has been adapted to an extent in the consultations processes with the partner state, to take on board national priorities and government preferences. The reform priorities fall under the headings of four thematic areas:

- Macroeconomic policies;
- Structural reforms;
- Social and employment policy, including poverty reduction where appropriate;
- Regional development and sustainable development.

Compared to the provisions of the existing Association Agreements with the Mediterranean countries and the Partnership and Cooperation Agreements with the CIS countries, the Action Plans have a higher degree of specificity and go a step further in thematically enriching the economic dialogue with the neighbours. However, the economic reform priorities jointly identified with the national authorities give only broad guidelines about desirable improvements in various domains. They are not of a prescriptive nature nor do they set threshold levels for measuring achievement.

A further difference between the eastern and southern neighbours lies in the balance between the political and economic content of the Action Plans. To the extent that the notion of ‘Europe’ has a magnetic power of attraction in east European societies, the appeal of the EU’s norms of democracy and human rights is especially vivid, as the Georgian and Ukrainian Rose and Orange revolutions showed. In the east, political elites can lean on the European project to legitimise their domestic agenda and thus build a political identity based on *rapprochement* with the Western European democracies. Correspondingly the content of the east European Action Plans is strong on democracy and human rights.

This is in contrast with the southern Arab Mediterranean neighbourhood, which resist the idea of political conditionality and are hardly impressed by the EU’s talk about common political values. Instead, for the Arab Mediterranean states the economic benefits of regulatory

⁴³ See Proposed EU/Moldova Action Plan, 9 December 2004, Brussels: European Commission.

convergence with the EU has to be the prime factor to persuade ruling elites to anchor their economic policies in the EU framework. Moreover in the south the EU itself has been hesitant to pursue democratisation policies forcefully, and has emphasised economic reform, counting on a positive spill-over effect from the economic to the political domain.⁴⁴ Even if this anticipated spillover from the economic to the political has proved illusory, the Action Plans for the southern neighbourhood reveal a continuation of this trend, with recommended political reforms limited by what is acceptable to the ruling elites. The southern governments could be more responsive to economic arguments and pledges for market access openings where the ENP has the potential to deliver.

A recent World Bank/European Commission study provides the economic rationale that could win the political support of southern governments for regulatory convergence with the internal market, notably in the service sector.⁴⁵ The study examined the effects of bringing the Mediterranean partner states closer to the EU services market and argues that the potential benefits offered by free trade in goods, which is already programmed in free trade agreements, are rather modest by comparison with what could be achieved by policy reforms and competitive private-sector development in the area of ‘backbone services’, such as transport, logistics, financial services, telecommunications and electricity, as well as other service sectors that can profit from proximity to the EU market, such as tourism, IT services, business and professional services, and distribution.⁴⁶ The potential liberalisation of trade in services can constitute a serious offer to southern neighbours by promising to improve the competitiveness of their economies and by giving them a chance to profit from their potential comparative advantage, owing to proximity and cheap labour, in relation to the EU market. The Commission’s most recent policy paper, containing recommendations for reinvigorating the Barcelona Process to be discussed at summit level in connection with its 10th anniversary in November 2005, seeks to advance along these lines.⁴⁷ For example it is recommending the negotiation of comprehensive free-trade-in-services agreements between the EU and the Mediterranean partner states, which would boost substantially the existing free-trade-in-goods projects.

The economic incentives for encouraging such a process are potentially powerful, but need to be worked out on an operational level. The case for doing that in partnership with other external actors, in particular the World Bank, the IMF, the European Investment Bank and the EBRD, is compelling, especially given the successful cooperation between the EU and the IFIs in steering the transition economies from Central and Eastern Europe and the Balkans.⁴⁸ By pooling their financial resources and coordinating their policy advice on macroeconomics and structural reform, the European Commission and the IFIs can build on their existing experience and collectively provide the external anchor for the reform process in both the eastern and the southern neighbourhoods.

⁴⁴ See Richard Youngs, 2002. “The European Union and Democracy Promotion in the Arab-Muslim World.” *Middle East & Euro-Med Working Paper N 2*, Brussels: Centre for European Policy Studies.

⁴⁵ See D. Mueller-Jentsch, 2004. *Deeper Integration and Trade in Services in the Euro-Mediterranean Region –Southern Dimensions of the European Neighbourhood Policy*, Washington D.C.: World Bank.

⁴⁶ *Ibid.*

⁴⁷ European Commission, 2005. “Tenth Anniversary of the Euro-Mediterranean Partnership: A Work Programme to Meet the Challenges of the Next Five Years,” Communication from the Commission to the Council and the European Parliament. Brussels: European Commission, April.

⁴⁸ See Michael Emerson, 2005. “The Black Sea as Epicentre of the After-Shocks of the EU’s Earthquake,” *CEPS Policy Brief N 79*, Brussels: Centre for European Policy Studies, July.

Two features of the Action Plan process suggest a less hierarchical mode of EU involvement in the governance structures of the neighbours: 1) the *joint* setting of priorities for action; and 2) the *joint* monitoring of reform performance. Partners are free to determine their own ‘level of ambition’ in how much they want to reform and how far they want to integrate with the European economy. Furthermore, the Action Plans are not legally binding documents and the ENP governments are not obliged to fulfil what they have agreed to. The Action Plans are an expression of the collective will of the EU and the respective government but deviations from the commitments undertaken are not subject to any formal sanctioning procedures. And because the EU has not specified clear incentives for reform, the potential disincentives for non-reform are not credible either. While the incentive-based logic of the conditionality model is not fully endorsed in the ENP, greater emphasis is put on the socialisation of partners who are treated as equals and invited to take on board certain EU norms and practices if those are considered appropriate. Partners are not in a position to determine the EU regulatory rules but they have more freedom to negotiate the import of a sub-set of those rules only. In this sense they are better placed than the accession candidates to define the limits of external influence on their domestic governance structures.

Finally, the process of negotiating the Action Plans and of performance monitoring is predominantly an intergovernmental matter, which gives the central role to national administrations of the partner states. Yet, the involvement of civil society actors in the monitoring phase is not precluded – indeed it is explicitly encouraged in the Ukraine Action Plan. In the enlargement context, civil society actors themselves have been keen on making their opinions known to the European Commission as an instrument for putting additional pressure on their governments. Civil society activists from the new democracies in the eastern neighbourhood have also seen an opportunity to influence the reforms in their countries by voicing their concerns and independent views with EU representatives. Some have even been pushing for an official monitoring role of civil society groups in the review procedure of the Actions Plans.⁴⁹ It remains to be seen how the ENP monitoring process will be conducted but the possibility for innovation and unconventional approaches is there suggesting a governance mode different from the traditional state-centred command and control method.

8. A common economic space with Russia?

The EU and Russia agreed in May 2005 documents on four so-called ‘common spaces’, one of which is entitled a “Common European Economic Space” (CEES), the others dealing with education and security questions.

This is in principle the outermost ring of the EU’s set of economic relationships with its neighbours, but what does it amount to? The concrete trade interdependence is of huge importance, with primary commodities from Russia, especially oil and gas, being exchanged for goods and services on a large scale. But these trade volumes are not informative about the economic policy regimes that govern the EU-Russia relations. On the policy regimes some analogy can be made between the Swiss case in relation to the EEA on the one hand, and the Russian case in relation to the ENP on the other. In both cases one state of a group opts out of a comprehensive integration package, and negotiates a set of ad hoc agreements with certain notable exclusions. In the Russian case the most egregious exclusion from the set of common spaces is the democracy, human rights and the rule of law basket, which may be attributed to President Putin’s increasingly authoritarian power structure.

⁴⁹ Conversations with NGO activists from the Open Society network in the former Soviet republics of the eastern neighbourhood.

However, even leaving aside this fundamental exclusion, the four agreements that were signed in 2005 have been criticised by independent observers on both EU and Russia sides for their fuzzy content, and for being the product of bureaucratic processes with little operational and strategic content. The grandiose names reflect their initiation and agreement at summit level by the Presidents of Russia and the EU Commission and Council Presidency.⁵⁰

The exercise in producing the common CEES document with over two years of work by officials reveals that the outer limits of the EU's economic regime export process has indeed been reached. The CEES document is all about convergence and harmonisation of economic norms, but Russia has insisted in marking its difference. It does not like the ENP either for itself or the eastern neighbours. For itself Russia has insisted on the equal partner principle, rather than accepting an asymmetric and dominant EU role in norm setting, and is therefore formally excluded from the ENP. For the EU's eastern neighbours that are also Russia's 'near abroad', the ENP threatens to undermine Russia's own ambitions to re-consolidate the post-Soviet space through initiatives that not coincidentally echo those of the EU. In 2000 Russia created a sub-group of the CIS called the EurAsian Economic Community including Russia, Belarus and three Central Asia republics. After encountering difficulty in giving substance to ambitious programming documents for harmonising and integrating the economic regimes of these states, Russia switched its priority to creating its own "Single Economic Space" (SES) with a more compact core group, consisting of Russia, Belarus, Ukraine and Kazakhstan, and aiming at deep regulatory convergence and ultimately a customs union. From the beginning Ukraine was wary of accepting more than free trade commitments, recognising that the customs union proposition would be incompatible with free trade or, a fortiori, deeper integration with the EU. Recent years have thus seen implicit competition between two regional hegemon, the EU and Russia, over their overlapping neighbourhoods. In the critical case of Ukraine as the most important piece in the competition, following the Orange Revolution in Kiev at the end of 2004, the Yushchenko regime has more categorically asserted its EU integration ambitions, and distanced itself from the SES initiative for anything going beyond free trade.

Returning to the EU-Russian relations, Russia's insistence on the principle of equal partnership has made the CEES document hugely ambiguous as to how the aims of convergence and harmonisation of products and markets will actually take place. Who will converge on whom? It is inconceivable that the EU will converge on Russian standards, and so the real question is whether the lack of explicit reference to Russian convergence on EU standards is merely a diplomatic discretion masking a process of real convergence, or whether the declared ambition is an empty political paper.

The CEES seems destined to remain mainly in the category superficial summitry. Russia's own huge windfall gains from the high price of oil and gas make the strategic outlook for the Russian economy more and more likely to resemble a giant case of the old Dutch disease, where other export-oriented industries are crowded out of world markets by the need for the natural resource economy to import. This will make protectionist pressures from industrial interests in Russia all the more persistent, and convergence on EU norms correspondingly slow and grudging.

9. Conclusions

The European Neighbourhood Policy stands for the time uneasily located somewhere in the middle ground between political fact and fiction. The export of the EU's economic regime to the

⁵⁰ See Michael Emerson, 2005. "EU-Russia – Four Common Spaces and the Proliferation of the Fuzzy." CEPS Policy Brief N 71. Brussels: Centre for European Policy Studies, May; Sergey Karaganov et al., 2005. "Russia-EU Relations: The Present Situation and Prospects." *CEPS Working Document N 225*. Brussels: Centre for European Policy Studies, July.

EEA, the new member states and accession candidates and those in the Western Balkans that have acknowledged accession perspectives all belong to the world of political, legal and economic facts. The common economic space with Russia, on the other hand, is more of a fiction in policy terms, notwithstanding the importance of the commodity trade between the EU and Russia.

The question whether the ENP can set in motion a process leading to better governance and improved economic performance in the neighbourhood therefore remains open. The outcome will depend on both the initial conditions in partner states and on the implementation of the ENP. A domestic transformation process equivalent to the economic change that took place in Central and Eastern European countries prior to their accession to the EU is hardly achievable in the ENP states in a similar time frame and without the mega-incentive of full EU membership. Yet there is a set of potential incentives that the EU can put on the table, most of which are in the economic field, and which could form the core of a finely tailored conditionality policy. The EU is not in a position to lead in setting the specific economic conditions in all areas, but it is well placed to coordinate its policies and pool its resources with other key international players such as the IMF, the World Bank, the European Investment Bank, and EBRD. Given the positive experience from Central and Eastern Europe and drawing on the collaborative formulas worked out in the enlargement context, the conditionality component of the ENP could play a central role in stimulating economic change in the neighbourhood.

Yet there is still uncertainty in the ENP with regard to the links between conditions and rewards, or the rules determining the set of conditions to activate a certain set of incentives. The EU prefers to keep the ambiguity on this question, opting for “a broad balance ... between the extent of a partner’s real progress in acting on the basis of ‘common values’ and the ambitiousness of the EU offer,” in the words of one of the architects of the ENP.⁵¹ This sets the stage for differentiation among partners which will undoubtedly surface at a later phase of the implementation of the Action Plans. The delivery of rewards to best performing partners can create competitive peer pressure on underperformers and can stimulate them to raise the level of ambition of their commitments in order to receive a similar access to benefits.

Whether the EU will be successful in triggering such competitive inter-ENP partner dynamics will also depend on the method of monitoring and measuring compliance with the reform priorities identified in the Action Plans. In the enlargement context, this was an entirely EU affair and the Commission in particular felt at ease giving recommendations to the candidate countries and criticising failures to reform. The ENP monitoring will be bi-annual and jointly executed with the partner state governments, which weakens the possibility for public pressure. In the absence of clear benchmarks, the EU will look at the general progress in the reform process focusing more on the big picture rather than on the concrete details. If partner governments demonstrate an incremental improvement of the economic situation of their countries, the positive evaluations will follow suit. There remain doubts, however, as to how critical and prescriptive the EU will be with underperforming partners.

In general, the economic dimension of the ENP can be seen as an attempt to export the EU norms of economic governance to the neighbourhood. The EU is proposing to partners to learn from the EU’s economic experience and to align their rules with the EU’s regulatory framework. The EU certainly does not have a recipe for all economic problems of partner states nor can it maintain that it has a model of economic governance that solves all of its own internal problems. It nevertheless offers to partners the opportunity to emulate the path of EU member

⁵¹ See Michael Leigh, “The EU’s Neighbourhood Policy.” In E. Brimmer and S. Fröhlich (eds.), *The Strategic Implications of the European Union Enlargement* (Washington: Center for Transatlantic Relations, 2005).

states and create joint prosperity through economic integration. In essence, this is an extension of the internal economic logic of the EU to its external relations. In line with its internal practice, the EU's external governance methods combine 'hard' and 'soft' mechanisms of promoting convergence towards common economic rules. In the neighbourhood compared to the enlargement context, the EU counts more on partner state initiative for putting in place a regime of governance reflecting the features of the EU's system and taking into consideration the national specificities of individual partner states.

Finally there are three strategic reasons in the current political context why the EU should be motivated to give forceful effect to the potential of the ENP. The first is that, resulting from the referendum crisis in mid- 2005 over the draft Constitution, the EU's perspectives for ongoing enlargement to include all European states that want it are now seen to be more remote. The EU needs therefore to find ways of enhancing the credibility of the ENP in order to lessen discouragement of reform-oriented policies among the fragile and poorly governed states of the neighbourhood. Second, and specifically for the eastern neighbours, there are the new openings for democratic political reform in states such as Georgia and Ukraine that need to be consolidated. Third, and specifically for the southern Arab neighbouring states, there is a big question mark as to whether these states can progress on the path of political and economic modernisation, and so also relegate the politics of radical Islam to the sidelines. As the summer and autumn of 2005 have shown, the tensions and violence emanating from the minority Muslim communities within the EU itself has been escalating, be it the radical Islamic terrorism of the London bombings or the delinquent riots of the French suburbs. The distinction between the internal and external is being eroded in society, and this ineluctably pushes the EU to try to extend the reach of its political values and economic norms.

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