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The political economy of Baltic States' accession into the EU: The impact on the role of the state

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The political economy of Baltic States' accession into the EU: The impact on the role of the state[φ]

Introduction

After a decade and a half of transition reforms, many analysts agree that the transition in the Baltic States like in other Central and Eastern European countries (CEECs) is coming to its completion with the sustainable democratic institutions and conditions for a market economy in place and membership in the European Union (EU). Of course, there are areas in most CEECs such as railways or energy, agriculture, pension system, health and education, or governance structures – which are still in the process of structural reforms (as in some of the incumbent EU members like Germany). Moreover, transition in those countries "from plan to market" has gradually turned into a permanent transition reflecting shifts in global markets and changing modes of governance in most countries of the world[1]. However, by now it is already possible to analyze the main outcomes of transition reforms and changing role of the state (or the size and scope of government), even though it should be acknowledged that changes in informal structures – values and patterns of social behavior – will take much longer than formal systemic reforms.

The process of integration into the EU has been the major factor which has increasingly impacted on the transition reforms and their outcomes in Central and Eastern Europe. The impact of the EU on reforms in CEECs has been first acknowledged by the analysts of transition, mainly by focusing on the aid and trade policies of the Union[2]. The role of the EU as a model to be imitated, as a supplier of a framework for external economic policies, and, later, of templates for domestic policies, has been increasingly recognized by the analysts of European integration and some scholars of transition reforms[3].

[φ] The paper was presented at the conference on European Union enlargement, Miami, April 22, 2005. Its earlier versions have been discussed at the NOPSA conference of 2002 and the seminar at the Maxwell School of Syracuse university.

[1] For an example of broader discussion of changing role of the state see World Development Report, The State in a Changing World, Washington, D. C., The World Bank, 1997.

[2] See Lavigne, M. The Economics of Transition. From Socialist to Market Economy, New York: St. Martin's Press, 1999.

[3] See for example, Grabbe, H. How Does Europeanisation Affect CEE Governance? Conditionality, Diffusion and Diversity, in Journal of European Public Policy, vol. 8, issue 4, p. 1013-1031 (December 2001); Vachudova, M. A. The Leverage of International Institutions on Democratizing States: Eastern Europe and European Union, Manuscript under Review at International Organizations, 2002; Orlowski, W., Mayhew, A. The impact of EU accession on enterprise adaptation and institutional development in the countries of Central and Eastern Europe*,* Sussex: Sussex European Institute, SEI Working paper No. 44, p. 1-76; Orenstein, M. A. Out of the Red. Building Capitalism and Democracy in Postcommunist Europe, Michigan: The University of Michigan Press, 2001; also a collection of papers from the ECPR Joint sessions of workshops in Turin, 22-27 March, 2002; some contributions to the Special

However, most of the studies focusing on the impact of the EU on political structures, policy content and outcomes in the CEECs remain fragmented and policy or issue specific focusing on the impact of the EU on concrete policy areas or institutional structures[4]. As one of the relatively recent and most significant contributions to the analysis of the most recent EU enlargement suggested, "there is little cross-fertilization between theoretical studies of the impact of international organizations, the Europeanization literature, the more theoretical literature on the transformations in the CEECs and the mainly descriptive literature on the effect of the EU on the candidates which is often limited to single countries and single policy areas."[5] This description of the state of academic affairs in the field is still accurate a couple of years ago.

This paper *aims at providing a broad analysis of the EU's impact on the CEECs which is not sector or policy specific by focusing on the changing role of the state in these countries as a result of direct and indirect impact of the EU*. It draws on the concepts developed by the Europeanization studies, debates on the regulation in EU and in particular studies of transition reforms. The studies of the two processes of transition and EU accession, in particular the character and outcomes of their interaction, have for a long time been fragmented and divided into two separate fields. Some analysts go as far as to claim that, "the two not only pass each other as ships in the night, but rarely even sail in the same sea."[6] This paper starts with the premise that integrating the results of studies from the transition reforms and EU accession policies can provide new insights about the changing role of the state, boundaries between private and public, and potential implications for the success of public policies in the CEECs and growth of their economies.

In addition, the paper also critically examines the prevailing arguments concerning the character of EU's impact on CEECs and provides a different perspective on the issue. Although the literature on the impact of the EU on the redrawing of boundaries between market and the state so far has been rather limited, there have been several arguments which are made explicitly by the authors or are tacitly accepted as the conventional wisdom in policy specific analysis.

The first argument, which is particularly clearly expressed in the literature using neo-Marxist approaches to the study of EU policies towards CEECs, is that the impact of

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Issue on the Enlarged European Union of West European Politics, vol. 25, no. 2, April 2002, edited by Mair, P., Zielonka, J.; and some contributions to the Journal of European Public Policy, vol. 9, No. 4, August 2002.

[4] Rare exceptions include Grabbe, H. European Integration and Corporate Governance in Central Europe: Trajectories of Institutional Change, in Federowicz, M, Vitols, S. (eds.) Corporate Governance in a Changing Economic and Political Environment: Trajectories of Institutional Change on the European Continent, Berlin: Sigma/Wisseschaftszentrum Berlin, 2002; Maniokas, K. EU Enlargement and Europeanization: When a patchwork becomes a blueprint, Draft PhD dissertation, June 2002.

[5] Schimmelfenning, F., Sedelmeier, U. Theorizing EU enlargement: research focus, hypotheses, and the state of research, in Journal of European Public Policy, 9:4, August 2002, p. 507.

[6] Dimitrova, A. L. (2002) Enlargement Governance and Institution Building in Central and astern Europe: The case of the European Union's administrative capacity requirement, Draft paper, p. 4.

the EU on the CEECs could be best described as an exercise of neo-liberal restructuring.[7] In other words, the influence of the EU has contributed to the shrinking of the state in CEECs, or is sometimes even characterized as an "export of a market radical variant of neo-liberalism."[8]

The other increasingly accepted argument in the literature on EU accession is about the strengthening of the regulatory role of the state in CEECs.[9] This is not surprising taking into account that one of the main criteria for joining the EU is the adoption of its *acquis communautaire* – about 80000 pages of legislation which governs (and extends beyond) the cross-border transactions of EU's internal market. However, most analysts do not address the implications of expanding the regulatory functions of the state in CEECs, neither examine this trend in relation with changes in other functions of the state or place the debate in the context of more general debates on deregulation and re-regulation that have been taking place in the EU or OECD countries.[10]

In addition to filling some of the existing analytical voids, this paper argues that the description of the EU's impact on CEECs as a "neo-liberal restructuring" is incomplete and misleading. While the focus on trajectories of expanding the regulatory functions of the state and importing "regulatory state" from the EU provides a more accurate description of the process, it still remains incomplete. *This paper introduces a number of qualifications to these arguments showing that the influence of the EU has been causing divergent and sometimes contradictory outcomes*.

In terms of its impact on the role of state it has been (1) encouraging the shrinking of certain functions (in particular by direct and indirect influence of liberalizing external transactions, privatization, de-monopolization and, to some extent, restriction of room for stabilization policies) while (2) contributing to the expansion of others (in particular, regulatory function and public investments), (3) with the unintended consequences,

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[7] See Bieler, A. The struggle over EU enlargement: a historical materialist analysis of European integration, in Journal of European Public Policy, 9:4, August 2002, p. 575-597; Bohle, D. The ties that bind the new Europe: neoliberal restructuring and transnational actors in the deepening and widening of the European Union, Draft paper presented at Workshop 4 "Enlargement and European Governance", ECPR Joint Session Workshops, Turin, 22-27 March 2002.

[8] Bohle, D. p. 35.

[9] See for example, Grabbe, H. 2002; Maniokas, K. 2002; Mayhew, A. Preparing for accession: problems for the associated countries, in Mayhew, A. Recreating Europe, Cambridge: Cambridge University Press, 1998, p. 200-235. For a detailed analysis of the impact of adopting EU regulations on the economy of a candidate country see Vilpišauskas, R. The Regulatory Alignment in the Context of EU Accession and its Impact on the Functioning of Lithuanian Economy, in Revenga, A. (ed.) Lithuania: Country Economic Memorandum: Volume II: Technical Papers, Washington D.C.: World Bank, 2002, p. 205-246.

[10] The most well known examples of writings on the regulatory reform in Western Europe and USA include the works of G. Majone (for example, Majone, G. (ed.) Regulating Europe, London: Routledge, 1996), also Vogel, S. Freer markets, more rules: regulatory reform in advanced industrial countries, Ithaca: Cornell University Press, 1996; Midttun, A. Svindland, E. (eds.) Approaches and Dilemmas in Economic Regulation, New York: Palgrave, 2001.

mostly because of the lack of EU competence in these areas and therefore shortage of attention and resources, of relatively neglecting others (the enforcement of property rights, internal order and security, reforms of welfare functions - health, social security and education). Therefore, the term "*weaker guardianship, less direct participation in the economy, status quo in welfare promotion and more regulation*" rather than the promotion of straightforward "neo-liberal" policies describes better the impact of the EU.[11]

The paper is structured by discussing first the roles of the state in general and in transition countries, the sources and instruments of EU influence on the role of state in the new EU member states from Central and Eastern Europe and presenting a number of tentative conclusions about the EU's impact. Most empirical evidence is based on the observations drawn from the Baltic States. This choice is based on several motives. First, at the outset of transition reforms the Baltic States faced the need to create institutional structures which have been lacking due to their incorporation into the Soviet Union. Therefore, the impact of the EU could arguably be more evident in the case of the Baltic States as compared to the Visegrad countries which at least formally had their own institutions during the Soviet period. Second, although being similar in size, recent historical record, policy objectives and *similar policy of the EU towards them*, the three Baltic countries have chosen somewhat different paths of transition reforms. Third, the research on policy reforms in the Baltic States is still scarce in comparison to the Visegrad countries, which are most often chosen as case studies addressing the impact of the EU on transition countries and its new members[12].

The dependent variable in this paper is the role of the state while the independent variable is the influence of the EU mediated by domestic factors such as state-society relations and institutional structures in the context of rapid change and uncertainty which come into play both at the stage of policy decisions and their implementation. Often the impact of the EU is difficult to differentiate from the general influence of globalization (exogenous) or the role of domestic (endogenous) factors. However, a number of observations could be made with a satisfactory degree of certainty to draw a broad picture of the patterns of EU influence on the role of state in candidate CEECs and point to further venues for research.

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[11] Though the extent of convergence toward these roles in each transition country has been dependent on domestic political economy factors and previous decisions made at the outset of transition reforms.

[12] Among the recent studies of Central European EU members see Vachudova. M. Europe Undivided. Democracy, Leverage, and Integration after Communism, Oxford: Oxford University Press, 2005.

The contested role of the state

The proper role of the state has been probably one of the most debated issues in the political economy literature for a number of centuries. The problem of demarcation concerning the proper size of the public vis-à-vis private is an issue of contention not only between supporters of two types of organization of economic activities - market and planning economy, but also between proponents of different roles of the state in the market economy.[13] The distinction between public and private has many aspects including free exchange and authority, competition and hierarchy, laissez-faire and planning, etc. while different typologies of roles usually imply both positive and prescriptive conclusions concerning functions of the state.[14] Some of them used in public finance theory refer to technical and economic properties of goods (usually dealing with issues of information and incentives), some are based on the argument of popular preferences. These debates tend to reflect different values, political economy factors and different dominant paradigms which change in time and constantly redraw the boundaries between public and private in each society.

It is not in the scope of this paper to discuss the arguments used to justify smaller or larger role of the state. The concept of the role of the state is important in providing an instrument that could be used to trace the trajectories of EU influence on transition reforms and their outcomes and to evaluate their potential implications. In other words, the purpose is to present a positive analysis with some tentative normative conclusions. The paper uses the metaphors of state which reflect different functions assigned to it (or rather different emphasis):

(1) The guardian (minimal) state which represents a metaphor for the functions of law and order enforcement (or protection of property rights and enforcement of contracts);
(2) The stabilizer state which stands for a metaphor of monetary and fiscal measures aimed at reducing unemployment and inflation;
(3) The welfare state which represents the redistributive and paternalistic functions, most often based on the arguments of social justice and merit;
(4) The regulatory state which influences the private actors by enforcing compulsory rules based on the perceived need to correct "market failures" (monopoly power, information asymmetries, and negative externalities).

These categories are not exclusive (some of them overlap in their effects, for example, regulations have redistributive effects as well, or their conceptual basis), nor they are exhaustive.[15] They do not imply that equally balanced assignment of all of these

[13] See Lane, J.-E. The Public Sector. Concepts. Models and Approaches, London: Sage, 2000.

[14] As the World Bank Report maintains, the unique aspects of the state are its powers to tax, to prohibit, to punish, and to require participation. The World Bank, World Development Report 1997, The State in a changing world, Washington, D. C., World Bank, 1997, p. 25.

functions is an objective desirable in itself, though it could be hypothesized that the successful enforcement of protection of property rights and contracts is the necessary prerequisite for the functioning of markets and growth of welfare.[16] Rather, they represent a collection of paradigms each of which dominated or coexisted at some point of history. Moreover, often public and private spheres coexist in fulfilling similar functions, or the expansion of private sphere is paralleled by the strengthening of government's role through different means. For example, different regulatory measures are implemented by self-regulation in addition to rules set by the national or supranational government. The privatization of enterprises is often followed by a more intense regulation of their activities. Removal of regulatory differences between the member states in the Single Market is paralleled by the re-regulation, i.e. setting EU wide common standards.

These categories are further used to analyze the influence of the EU on transition reforms. Importantly, the constraints and opportunities set by the EU for the implementation of any of these functions is likely to have significant political and economic implications for the new members.

Changing role of the state in the Baltic countries

The understanding of the role of the state at the outset of the reforms was rather straightforward – transition from statist, control and planning based economies to market economies meant reducing radically the scope and size of government activities. The political economy dilemmas facing reformers in transition countries was the downsizing of their own apparatus thereby limiting their power (tying their own hands) and by conducting reforms to create enough winners as to ensure the continuity of newly introduced arrangement and not to create political obstacles for further reforms. While the political support for reforms has been relatively high at the end of 1980s and the start of 1990s in the Baltic states where transition reforms have been identified with the reestablishment of independence, later the popular support went down. The accession into the EU has played a role of additional legitimizing factor (although this role should not be overemphasized).

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[15] Some authors suggest slightly different categorizations. For example, one of still widely used classification of state functions of influencing allocation of goods, redistribution and stabilization has been suggested several decades ago by Musgrave. Others maintain that governments carry out three categories of economic activities - regulation to create and amend property rights, price setting directly or through taxes and subsidies, and production of different (public) goods like education, defense or health care (see Connolly, S. Munro, A. Economics of the Public Sector, London, Prentice Hall, 1999). Still other categorization is suggested by the World Bank defining the roles of the state along two axes of addressing market failures and improving equity on one, and fulfilling minimal, intermediate and activist functions on the other (see the World Bank Report 1997).

[16] The actual exercise of a certain functional measure of the state might simply be a result of a political decision not based on any coherent criteria (for example, a reward of a narrow interest group by redistributive means), or might result from a misinformed decision (for example, attempting to correct a "market failure" by unintentionally creating a larger "government failure").

The debates at the start of economic reforms have concerned mainly the speed and sequence of reforms.[17] Later, with the "normalization" of politics they moved to the familiar debates about the proper role of the state in a market economy (for example, by bringing into the debate the currently fashionable emphasis on the role of properly designed institutions to support functioning of the markets – so called Post-Washington consensus).[18] The influence of the EU has also been transforming from generally supportive of the reduction of the role of the state to changing the functional nature and scope of state activities, and in some cases even reversing the trajectories of transition reforms (by increasing the state interventions into the economy or setting the limits to its further reduction). The latter changes differed in every of the Baltic states (and between them and other transition countries) depending on the previous transition policy decisions.

The role of state has been reduced significantly during the transition reforms, mostly during the period of 1990-1995. In particular, its role in price setting and direct ownership of factors of production has been restricted through the liberalization of external transactions, reduction of price controls, reduction of subsidies, other obstacles to competition, privatization of enterprises and restitution (though not so much enforcement) of property rights.

The stabilization function, which played a particularly important role at the outset of reforms, was subsequently implemented by restrictive monetary and fiscal policies. This is especially evident in the Baltic states with Estonia and Lithuania establishing currency boards and in the second half of 1990s (in particular after the financial crisis in Russia in August 1998) pursuing restricted budgetary policies. This had a positive impact on stabilization of macroeconomic environment and resulting fastest in Europe economic growth and contributed significantly to these two countries meeting all convergence (Maastricht) criteria in 2004. Both Estonia and Lithuania were among the first three new members of the EU to join the Exchange rate mechanism II in mid-2004, followed in Spring 2005 by Latvia.

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[17] See, for example, the World Development Report, From Plan to Market, Washington, D. C., The World Bank, 1996.

[18] See Kolodko, G. W. Ten Years of Postsocialist Transition: the Lessons for Policy Reforms, Washington D. C., World Bank Development Research Group, Research paper, 1998; Ahrens J., Meurers, "Institutions, Governance, and Economic Performance in Post-Socialist Countries: A conceptual and Empirical Approach", 2000, http://www.sigov.si/zmar/conference2000/pdf/meurers.pdf.

Table 1. The Baltic states and Poland with respect to meeting Maastricht criteria

	Criteria	Lithuania	Latvia	Estonia	Poland
Inflation, 2004 (yearly average)	**2,2%***	1,1	**6,2**	**3,0**	**3,6**
Public sector balance, 2004 (% of GDP)	**<= 3%**	-2,5	-0,8	1,8	**-4,8**
State debt, 2004 (% of GDP)	**<= 60%**	19,7	14,4	4,9	43,6
Long-term interest rates, March 2004-February 2005	**6,2%***	4,34	4,71	4,34	**6,75**
Stability of national currency with respect to euro, Februaty 2003-January 2005	**15% limit**	Fixed	Fixed with 1 % margin for fluctuation	fixed	12,2

Source: SEB Vilniaus bankas

The reform of the state apparatus – public administration and suppliers of public services – has proceeded slower than economic restructuring, thereby constantly producing coordination problems during the implementation of reforms and slowing down further development of the markets in the fields such as education and health care. The regulatory functions remained rather extensive, and it is in this area as well as public administration where the past legacies ("path dependencies") have been most noticeably felt. The actual tendencies in regulatory framework represented an incremental muddling through the regulatory structures inherited from the previous system and adding new ones rather than consistent deregulation of the transition economies.[19]

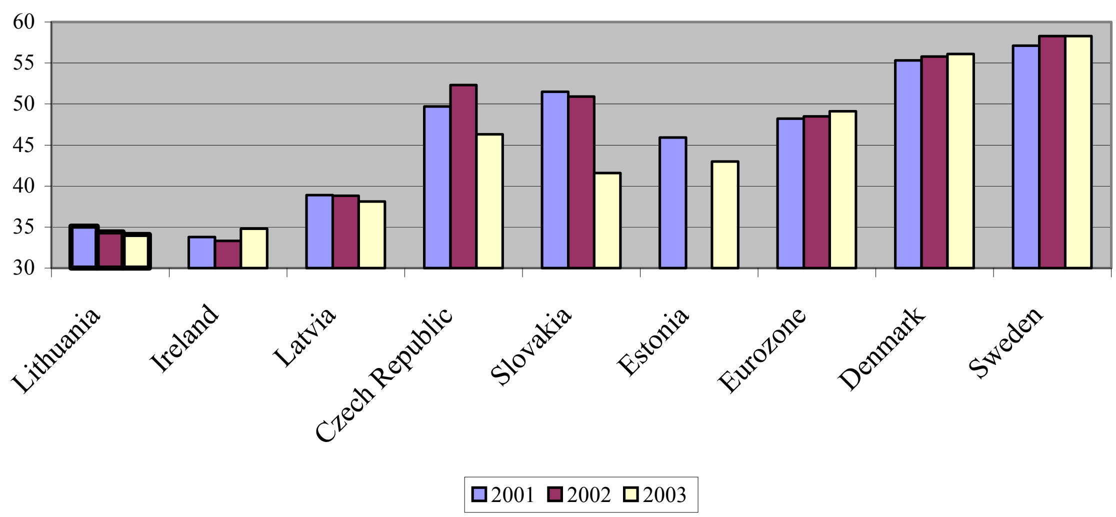
It should be noted, though, that even when agreement concerning the reform objectives to be achieved existed, the actual implementation of these policy measures has been uneven and often inconsistent due to political economy factors such as uncertainty concerning the instruments, lack of experience, coordination problems, interest group pressure and financial constraints. The influence of the EU extended not only to setting limits or creating new roles for the state, but also in structuring the process of actual policy implementation (effectiveness of governance) by creating new incentives and constraints (for example, creating mechanisms of control to monitor the use of EU funds).

[19] The over-regulation of the economy, in particular in the areas of access to land and labor, tax administration and movement of goods, which complicate set up and functioning of small and medium enterprises in Lithuania has been noted by different observers. See for example, FIAS, Lithuania. Administrative Barriers, FIAS, IFC and World Bank, July 1999.

The progress in reforms and shifting boundaries between public and private spheres can be illustrated by indexes of transition and economic freedom which are compiled regularly by institutions such as the EBRD, the Heritage Foundation and Wall Street Journal, the Freedom House and the Fraser Institute.

These evaluations illustrate that by now a major share of GDP is produced in the private sector. Small business privatization and trade and foreign exchange liberalization are typical of the advanced industrial economies. It should be noted that the current degree of liberalization in the Baltic States had been achieved about eight years ago. Less progress is made in governance reforms, functioning of non banking institutions, reforms of infrastructure, including regulation of utilities prices. Also, it should be noted that before the accession into the EU, the share of resources redistributed through the budget has been relatively low in the Baltic states comparable only to Ireland's.

Figure 1. Overall fiscal expenditures as % of GDP



Source: Eurostat, cited in the World Bank (2004)

Several observations can be made from these evaluations. First, the Baltic States progressed most in liberalization of foreign trade which exceeds comparable indicators of most advanced economies. Second, the fiscal burden of government equals respective indicators of EU member states, often being lower if calculated as a share of GDP. Third, the least progress is reported in protecting property rights and regulatory environment. It could be noted, that although all three countries fall into the category of "mostly free countries" in most rankings of transition indexes Estonia is evaluated slightly more favorably than Latvia and Lithuania which tends to correlate with economic indicators such as GDP growth and per capita incomes. Estonia was also the only Baltic State to join the Luxembourg group of accession countries that started negotiations with the EU in 1998, with Latvia and Lithuania joining in the second wave in 2000 (though political factors also played a role in this process of selection). By the date of accession into the EU and a year from then all three Baltic States have shown similar economic performance, though diverging on some indicators.

The sources and instruments of EU impact

The importance of the EU and its potential to influence transition reforms in the Baltic States originated from several factors.

First, it was the willingness of these countries' governments to open up to the EU influence which was related to both a broad desire "to return to Europe" and a concrete foreign policy objective to join the EU. The desire to become members of the EU which was particularly strengthened by the Copenhagen EU Summit decisions, in 1993, resulted in the adoption of increasingly concrete policy measures, shaping the role of the state in the candidate countries.

Second, the potential of the EU to exert influence on candidate countries resulted from the asymmetrical nature of EU-accession country relationship. The governments in the latter expected to reap significant benefits from the accession, while policy makers in the EU were relatively cautious about the enlargement due to relatively less significant potential economic impact on the current members as compared with the candidate countries. The chosen method of enlargement when the candidates have to adjust to all existing EU norms (not only extensive *acquis communautaire*, but also additional membership criteria introduced by the Copenhagen Summit and detailed later by the Commission) also increased the potential influence of the EU, represented by the European Commission.[20]

Third, the uncertainty about the conduct of reforms due to their complexity and the lack of expertise significantly strengthened the willingness of policy makers in the Baltic countries to recreate policy models of the Western countries and adopt the explicit prescriptions of external advisors (usually linked with financial assistance). This has resulted in unilateral, or so called "anticipatory adaptation" of regimes governing economic relations of industrialized democratic countries which was at the basis of transition to market economy and democratic governance.[21] It formed a part of the learning and imitation process of the policy makers in transition countries. This process of adaptation to a large extent has been taking place irrespective of external demands.[22]

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[20] On this point see Grabbe, H. How Does Europeanisation Affect CEE Governance? Conditionality, Diffusion and Diversity, in Journal of European Public Policy, vol. 8, issue 4, p. 1013-1031 (December 2001).

[21] Nicolaidis, K. East European Trade in the Aftermath of 1989: Did International Institutions Matter? in Keohane, R. O., Nye, J. S., Hoffman, S. (eds.) After the Cold War. International Institutions and State Strategies in Europe, 1989-1991, Cambridge: Harvard University Press, 1993.

[22] It has often resulted in a mixture of "positive reference models" both from the external environment and from the past. For example, inter-war cooperative experiences have often been referred to in the discussion on the models of trilateral Baltic cooperation.

Assistance measures and trade agreements. From the start of transition reforms, the most important initial policy measures of the EU towards CEECs consisted of financial assistance program Phare as well as coordination of other international assistance measures, and first (Trade, commercial and economic cooperation) and second generation (Europe or association) agreements. The Phare program throughout the first half of the 1990s targeted economic restructuring (privatization, infrastructure, financial sector, agriculture, etc.) and other reform measures (for example, later introduced measures of support for democratic institutions). However, more significant economic impact has been made by trade liberalization measures which reduced substantially for trade between the EU and CEECs.

The EC recognized the independence of the three Baltic States in August 27, 1991, and already EC representatives suggested including the three states into the Phare program, thereby differentiating them from the other former Soviet Union republics.[23] The preparation to sign trade and cooperation agreements similar to those concluded with CEECs were also started. The agreements were signed in May 1992 and came into force in the first months of 1993.

Table 2. The main bilateral economic agreements between the Baltic States and the EU

Agreement	Signed	In force	Main provisions
Trade and Cooperation Agreements	11.05.92	01.02.93 (for Latvia, Lithuania) 01.03.93 (for Estonia)	Most favorite nation status, non-discrimination; extension of EU generalized system of preferences; economic cooperation in some areas
Agreements on Free Trade and Trade related matters	18.07.94	01.01.95	Liberalization of trade based on GATT principles; free trade in industrial goods (CN 25-97); 4 years transition period of gradual liberalization given to Latvia, 6 years transition period of gradual liberalization given to Lithuania; standard protection clauses; Joint committees to oversee the implementation of the agreements
Association (Europe) Agreements	12.06.95	01.02.98	Objectives of Estonia, Latvia and Lithuania to become EU members acknowledged; the provisions of free trade agreement incorporated; political dialogue; economic cooperation in areas such as competition policy (EU rules), movement of services, capital and labor, establishment, protection of intellectual property rights, consumer protection, approximation of laws, cooperation in other areas such as industrial policy, science and technology, energy, environment, etc.; Association Council to supervise the implementation of the agreement and Association Committee

Source: respective bilateral agreements

Signing of the Free trade agreements between the EU and the Baltic States in 1994 contributed significantly to the removal of barriers to trade between those countries

[23] For example, during the period of 1995-1999, the Phare allocations to the Baltic states totaled 143 million Ecu for Estonia, 186 million Ecu for Latvia and 232 million Ecu for Lithuania.

and the EU and restructuring of economic activities in these countries. The increasing flows of trade with the EU currently accounting for around 50-70 percent of these countries' foreign trade turnover have resulted to a significant degree from trade liberalization measures. The agreements have also been important in several other respects. By "locking in" the level of liberalization achieved they were prevented from returning to more protectionist policies after the "normalization" of domestic politics and resurgence of interest groups activities.[24]

Moreover, there is ample evidence to argue that these agreements, together with the incentives of perspective EU membership and co-ordinatory role of the EU, proved to be the major factor behind other free trade agreements concluded by the Baltic States.[25] These include several free trade agreements liberalizing completely trade between the three as well as free trade agreements liberalizing trade in industrial products between the Baltic States and members of Central European Free Trade Association (CEFTA) which itself was a product of joint integrative measures of CEFTA countries into the EU. The fact that around 70-80 percent of trade of the Baltic States is now conducted with the other EU members and countries with which EU has free trade agreements is a result of EU policies.

However, the actual influence of the EU on liberalization of external transactions in the Baltic States should not be overestimated. First, in the case of Estonia the free trade agreement with the EU did not result in any changes of country's external trade policy since after the trade regime reforms in 1992-1993 all trade restrictions have been removed unilaterally. Second, trade liberalization with Latvia and Lithuania has been gradual reflecting the influence of domestic interest groups. Third, the EU itself did not liberalize trade completely, leaving in place tariff barriers to trade in agricultural products and possibilities to use commercial protection instruments which have later been used in the form of antidumping duties and will be removed completely only after the accession. These measures added legitimacy to the use of similar protection instruments by the candidate countries (except Estonia due to its particularly liberal trade policy).

Membership criteria, pre-accession process and adoption of acquis communautaire. The influence of the EU on the transition reforms in the Baltic States has been strengthened after the EU recognized their candidate country status and included them into the pre-accession strategy consisting of Phare, Europe agreements (though in the case of the Baltic states they came into force only several years later) and the White paper on integration into the internal market presented by the Commission in 1995. In other words, the Baltic States were provided with the opportunity to further integrate their markets into the EU, participate in the Council meetings together with other CEECs, and

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[24] For the evidence of this argument in the case of CEFTA countries see Kaminski, B. The EU Factor in Trade Policies of Central European Countries, Washington, D.C.: The World Bank, November 1999.

[25] For a detailed analysis of links between EU policies towards the Baltic states and the economic cooperation measures between those three states see Vilpišauskas, R. Regional integration in Europe: analyzing intra-Baltic economic co-operation", Florence, European University Institute, Robert Schuman Centre, Working paper No. 41, 2000.

to focus on adopting EU's legal rules governing the internal market. In the latter case, the Commission has suggested that each country should draw up its own timetable of legal approximation. This move strengthened the influence of the EU on reforms and public policies in the Baltic States and provided instruments to structure their efforts aimed at preparations for the accession.

The pre-accession strategy followed from the well known Copenhagen criteria of EU membership declared in 1993 representing an innovative measure in comparison to the previous EU enlargements. These membership criteria included (1) stable institutions (guarantee of democracy, rule of law, human rights, minority rights), (2) functioning market economy, (3) capacity to cope with competitive pressures inside the EU, and (4) ability to adopt the *acquis* and accept the aims of political, economic and monetary union. Later more conditions were added, for example, the requirement for administrative capacity added in Madrid Council of 1995, conditions concerning specific issues such as nuclear safety have been set, and those same Copenhagen criteria have been gradually made more concrete. As it has been noted, the conditions set by the Copenhagen Summit, namely the first political and economic criteria, go beyond those for any previous applicant which provides an opportunity for the EU to involve itself in domestic policy making of the candidate CEECs to a degree unprecedented in the current member states.[26] It was the adoption of policy measures aimed at meeting the economic criteria of "a functioning market economy" and transposition of the *acquis* which contributed most to the changing role of the state in the Baltic countries.

Although the general phrasing of membership criteria initially caused uncertainty and speculations, they have been gradually given more concrete expression by the European Commission. The efforts of candidate CEECs aimed at meeting the membership obligations criteria have been since 1995 directed by the White book setting regulatory norms governing EU internal market to be adopted. The *acquis* was presented on the basis of 23 sections and included areas such as free movement of goods, services, capital and people, competition, telecommunications, audiovisual services, transport, customs, social, environmental and other measures. The White book detailed the EU legal norms to be implemented and regulatory structures to be set up by the candidate countries and represented an unprecedented exercise of re-regulation on the part of transition countries. The extent of this exercise has been discussed elsewhere, though it should be noted that the main factors which complicated the regulatory efforts of the transition countries included more extensive than during previous enlargements *acquis* of the EU and lower starting positions of the transition countries in terms of economic development and administrative capacity.[27]

[26] Grabbe, H. Europeanisation Goes East: Power and Uncertainty in the EU Accesison Process, chapter to appear in Featherstone, K. Radaelli, C. (eds.) The Politics of Europeanisation, Oxford, Oxford University Press, Second Draft, 2002, p. 5.

[27] See Vilpišauskas, R. The Regulatory Alignment in the Context of EU Accession and its Impact on the Functioning of Lithuanian Economy, in Lithuania: Country Economic Memorandum: Volume II: Technical Papers, Revenga, A. (ed.) Washington D.C.: World Bank, 2002, p. 205-246.

Accession negotiations and monitoring of progress in meeting membership criteria. The political and economic criteria have been made more concrete first in the Agenda 2000 produced by the Commission in 1997.[28] Many conditions detailed under these criteria had a direct connection with the role of the state in the candidate countries. For example, the need to liberalize trade was emphasized once again. The importance of macroeconomic stability and protection of property rights and contracts was underlined. Later these conditions have been regularly reviewed by the Commission in the context of preparations for accession. The first Accession Partnerships were decided in March 1998 for each candidate CEECs and later revised twice in 1999 and 2001 on the basis of Progress Reports and consultation with national authorities.

The Accession Partnerships represent the most advanced form of policy advice provided by the EU to the candidate countries by distinguishing the categories of measures in terms of their urgency and by directly linking the financial means and progress in negotiations with the progress of the implementation of suggested measures. The recommendations of the Commission, set in the Accession Partnerships on the basis of the issues identified by the Progress Reports, have been mirrored in the National Programs for the Adoption of *Acquis* of each candidate country. The NAPPs have become the main instrument of managing the complex process of regulatory alignment in the candidate countries by setting the timetable of legislative approximation measures, setting up administrative structures and financing those measures. The accession negotiations conducted on the basis of 31 chapters covering all EU *acquis* also illustrate the complexity of the adjustment process which took place in the Baltics.

It has been noted that "the EU's most powerful conditionality tool is access to different stages in the accession process, particularly achieving candidate status and starting negotiations."[29] The gate keeping role of the Commission has been especially evident since the start of accession negotiations through the linkages of closing negotiation chapters with concrete policy measures to be undertaken by candidate countries (for example, in the case of Lithuania the chapter of Telecommunications and IT has been closed only after the independent regulatory agency was established, the Energy chapter was closed after the commitment on decommission the second reactor of Ignalina Nuclear power Plan by 2010 was received from the government).

Finally, the influence of the EU has been also increasing due to a wider use of different policy advice measures, extending beyond the competence of the EU in its older member states. The benchmarking and policy advice on the issues such as employment strategies, administrative capacities or pressure on the issues grouped under the criteria of "the functioning market economy" such as pension reforms and land reform allowed exerting additional influence on public policies and transition reforms in candidate countries. It seems very likely that the experienced accumulated during the enlargement

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[28] European Commission, Agenda 2000. For a Stronger and Wider Union, Bulletin of the European Union, Supplement 5/97, 1997.

[29] Grabbe, H. How Does Europeanisation Affect CEE Governance? Conditionality, Diffusion and Diversity, in Journal of European Public Policy, vol. 8, issue 4, p. 1013-1031 (December 2001), p. 6.

process in using "soft coordination" measures toward the candidate countries has been used in developing the Lisbon agenda and later in transforming it. It will be this indirect impact of the EU through policy learning and creation of incentives and also policy competition (as in the case of direct taxation) that will increasingly influence further development of the state in the new EU members.

Moreover, there were powerful incentives for policy makers in the former candidate countries to attach the EU more significance than it actually had in order to legitimize their own policies, or due to a poor level of information on the differences between EU wide and member states' policy models. Likewise, different prescriptions of the EU received divergent attention and varied in terms of the success of actual implementation in the candidate countries. The gap between rhetoric and actual policy decisions is also important in understanding and explaining the trajectories of EU influence on the changing role of the state in the candidate countries and new members of the EU. The following section presents a number of propositions concerning the influence of the EU on transition reforms in the Baltic States.

Integration and transition: the multifaceted influence of the EU

First, as it could be expected the influence of the EU on shrinking the role of the state is most evident in liberalization of external transactions of the Baltic States. The main instruments in this field included the agreements on liberalization of trade as well as the membership criteria. However, the extent and speed of liberalization has been also dependent on the lobbying of domestic interest groups and this trend was actually reversed exactly due to the impact of EU membership, i.e. in the case of Estonia (to a lower degree in Latvia and Lithuania) the external restrictions to trade actually increased after adopting the common external tariffs of the EU.

Second, the EU contributed to the reduced direct participation of the state in the economy by encouraging the privatization of state owned enterprises, reduction of price regulation and reduction of subsidies. These policy prescriptions followed from the regular criticisms included into the Progress Reports produced by the Commission. However, the influence of the EU should not be overestimated. The different methods of privatization chosen (for example, voucher privatization in Lithuania with no foreign participation and privatization open to outsiders in Estonia), divergent speed and shares of private (and foreign) capital illustrate the limits of EU influence as regards the form of ownership. The EU's influence increased only during the final stages of large scale privatization, but even in this area its influence depended on domestic political economy factors (changes in governments, the resistance of interest groups and financial constraints). For example, despite the emphasis on privatization of the state owned banks in Lithuania which was made explicit by the Commission in it Progress Reports and Accession Partnerships (and linked with Phare support), there have been substantial delays of several years in completing the process of bank privatization.

Third, despite the inclusion of the establishment and protection of property rights into the membership criteria and Accession Partnerships, the actual implementation process in the Baltic countries has been conducted with substantial delays.[30] For example, there has been an explicit linkage with a date of 2000 set by the Commission for the completion of the restitution of property rights to the land in Lithuania. However, this target date has not been met due to the lack of recourses, political changes in the government and failures of institutional coordination. Therefore, it could be stated that in the cases where the EU *acquis* has been missing and the policy prescriptions have been based on the general economic membership criteria ("the functioning market economy"), the actual influence of the EU of policy reforms and role of the state has been divergent and dependent on domestic factors.

Moreover, the need for scarce resources to be given to the implementation of the *acquis* and meeting other internally (for example, restitution of savings in Lithuania) and externally set priorities (for example, allocating the share of national budget equaling 2 percent of GDP from to national defense in order to be ready for NATO membership) has actually reduced the capacity of the state to fulfill properly its "guardian" functions. The restitution of property rights has been especially impaired due to the shortage of resources. The maintenance of internal order and protection of property has also been overshadowed by other issues with direct relevance to the accession into the EU and presence of well organized interest groups (for example, agricultural policy and absorption of EU structural funds). Despite the fact that Justice and Home Affairs chapter covered some of these issues, like in most other cases, the focus was on cross-border aspects and containment of potential negative spillovers rather than overall enforcement of order and property rights (which remains the competence of member states).

Fourth, the EU has increasingly set restrictions on the active role of the state in the field of macroeconomic management, although the constraints are becoming more evident after accession into the EU and during the preparations to join the EMU. Since mid-1990s all three Baltic states have implemented restrictive monetary policies, and increasingly restrictive fiscal policies, in particular after the economic crisis in Russia in August 1998. The Commission has consistently encouraged the conduct of balanced fiscal policies in its regular reports and other documents such as the join assessments of medium-term economic policy priorities signed with each Baltic state, although its role has been somewhat less direct than, for example, IMF. Importantly, the EU in the form of Maastricht criteria (which were not directly applicable for the accession into the EU) limited only budgetary deficits and the state debt, but did not say anything about the overall size of government expenditures. Likewise, it does not provide strict constraints on taxation policy with the exceptions of indirect taxes and recommendation on avoiding the "harmful tax competition". It should be noted, that as a result of aligning VAT and excise taxes, the level of indirect taxation has been increasing in the Baltic states. There have also been discussions on whether the abolishing of profit tax in Estonia does not

[30] It should be noted, that due to the existence of *acquis* a particular group of property rights – copyrights, industrial property rights – are given much more attention than the rights to the productive property. Similarly qu te a lot of attention in the process of legal harmonization is given to other post-modern issues such as animal welfare which reflect the preferences of rich Western societies.

contradict the code of conduct of the EU, although finally it was approved by the Commission. Overall, the level of direct taxation in the Baltic states (in particular, company taxation) has been among the lowest in the EU-25. It seems quite likely that the need to catch-up and the competition in the Single market will preserve the trend towards lower taxation.

Table 3. The level of direct taxation in the EU-25 member states and candidates

	Income tax	Profit tax	Social insurance payment, %		
			The share of employee	The share of employer	Overall level
Austria	50	25	17.2	25	42.1
Belgium	50	34	13.1	17.9	31
Bulgaria	*29*	19.5	25	17.7	42.7
Croatia	45	20	n.d	n.d	n.d
Czech Rep.	32	28	12	35	47
Cyprus	30	15	n.d	n.d	n.d
Denmark	26.5	30	n.d	n.d	n.d
Estonia	**24**	**24; 0 (if reinvested)**	**2**	**33**	**35**
Finland	35.5	29	6.1	25.4	31.5
France	49.6	34.3	15.5	33.9	49.3
Germany	47	26.4	20	21.3	41.3
Hungary	38	16	13	33.5	46.5
Ireland	42	12.5	8	10.8	18.8
Italy	45.6	34	8.9	30.9	39.8
Latvia	**25**	**15**	**9**	**26.1**	**35.1**
Lithuania	**33**	**15**	**3**	**31**	**34**
Luxembourg	38.95	22.9	16.4	13.6	30
Malta	35	35	n.d	n.d	n.d
Netherlands	52	34.5	39.5	17.2	56.7
Poland	40	19	27	19.7	46.6
Portugal	40	30	11	23.8	34.8
Rumania	16	16	n.d	n.d	n.d
Slovakia	19	19	12.8	38	50.8
Slovenia	50	25	22.1	15.9	38
Spain	45	40	4.7	23.6	28.3
Sweden	60	28	7	25.9	32.9

Turkey	40	30	n.d	n.d	n.d
Great Britain	40	30	11	12.8	23.8
Greece	40	35	11.6	24.1	35.7
Minimum tariff	19	12.5			
Maximum tariff	60	40			
ES 25 average (mat.)	39.53	26.26			
ES 15 average	44.14	29.71			
ES 10 average	32.6	21.1			

Source: www.euractive.com, http://www.ssa.gov/policy/docs/progdesc/ssptw/2002-2003europe/guide.html, KPMG, Ernst Young (2003/2004 data)

The stabilization policies initiated in the Baltic States during the first half of 1990s proved successful in bringing down inflation to a level lower than in the EU and therefore the political pressure to counteract inflation has been practically absent from in the end of 1990s and beginning of 2000s. The public debates about possible surge of price increases resumed with the accession into the EU and in particular with the anticipation of joining the monetary union. However, it should not prevent the Baltic states from joining the eurozone in 2007-2008. It is quite likely that the current monetary regimes of the Baltic states will be maintained until accession into the EMU which will imply minimal changes. The employment policies have received more attention of policy makers in the Baltic States due to the popular salience of this issue and increasing levels of unemployment in the second half of 1990s. Interestingly, the Commission has played an active role in encouraging to sign the Joint assessment of employment policies with the candidate countries in 2002. However, after the accession the levels of unemployment started decreasing partly due to a very strong economic growth in all three Baltic countries, partly due to the opportunities to work on Ireland, Great Britain and Sweden which opened up their labor markets after the enlargement.

Fifth, the accession into the EU has been changing the expenditure patterns in the Baltic States. The need to prepare for the use of the EU funds and the actual co-financing of them changes the priorities of public investment programs. For example, after the accession into the EU the absorption of the structural funds resulted in the increasing state investments into the private productive sector. The absorption of the EU funds in 2005 has become the major factor accounting for the growth of public investments and subsidies by 17 percent. The public investments into the transport and rural development increased in particular.

This poses several questions, namely, the contradictory emphasis on the restrictions of state aid stressed during the negotiations on competition policy and a current increase in public support to various producer groups in the newly acceded countries as a result of use of the EU funds. Moreover, the need for co-financing in combination with the investments required to meet EU norms, tax competition in the Single market, setting up regulatory infrastructure and lack of reforms in the public sectors currently absorbing most budgetary resources (i.e. education, health, social security) is creating a stress on fiscal policies and complicating the preservation of fiscal balance. In general, these factors are likely to exert an upward pressure on the budgets in the Baltic States which could be dealt with by improving tax collection and reforming social policies. Interestingly, recent discussions in Lithuania tend to illustrate that the need to preserve relatively low fiscal deficits can be used to justify the introduction of new taxes.

Sixth, the influence of the EU on the welfare role of the state has been indirect and rather contradictory. Although the Commission has stressed the importance of pension reform, the EU has little direct influence in this area. This has been one of the reasons for the lack of progress in reforming the overall system of social support and such policies as health care which have been dominated by well established domestic interest groups. Therefore, despite a formal support for the reforms, the need to invest attention and financial resources into the fields directly linked with the *acquis* and focus on structural funds had an unintended side effect of neglecting the reforms of social policies. Probably the only exception is the agricultural support which has a strong social support dimension in the EU and receives enough attention due to its political importance (in particular in Latvia and Lithuania). However, the influence of the EU on agricultural policies in the Baltics illustrates well the main contradictions between the prescriptions of the EU and its own common policy. The policy makers of the candidate countries were caught between the need (and encouragements from the Commission) to create conditions for restructuring of the agriculture and the generous and highly redistributive model of the Common agricultural policy that encourages the freezing of the current farming structures. The prospect of gradually but significantly increasing support measures given to farmers will later also make the reform of the CAP more difficult (unless the accession of Turkey will psuh for more radical reform).

Seventh, the most significant influence of the EU on the role of the state has consisted in widening the scope of regulatory activities in the Baltic States. The adoption of the *acquis* governing the internal market and other common policies (in particular, environment, labor relations, agriculture, transport and energy) represents a massive re-regulatory exercise in these countries. This is likely to have several important implications for these countries. First, the analyses of the effects of regulatory alignment on the economies of candidate countries shows that the main beneficiaries from regulatory alignment are the export oriented large companies which trade with the EU.[31]

[31] See Vilpišauskas, R. The Regulatory Alignment in the Context of EU Accession and its Impact on the Functioning of Lithuanian Economy, in Lithuania: Country Economic Memorandum: Volume II: Technical Papers, Revenga, A. (ed.) Washington D.C.: World Bank, 2002, p. 205-246.

The main burden of adjustment is likely to fall on small and medium sized enterprises operating domestically, in particular in most regulated fields such as agriculture. This is likely to create calls for the public measures to soften the adjustment pressure created by EU accession, with resulting state activism.

The fast adoption of EU norms is also likely to create potential for over-regulation (which has been observed in the Baltic states) with its negative effects on economic growth and overload of political agenda with its negative effects on the quality of legislation, its implementation and monitoring (though interestingly, according to the European Commission scoreboard, after the enlargement Lithuania has joined the best performing member states in the EU-25 in terms of implementing Single market acquis with Estonia and Latvia lagging quite far behind). The potential for overregulation and regulatory capture is higher due to the past legacies, lack of attention to the actual effects of regulation and low level of expertise. There have been cases, when domestic interest groups have attempted to use newly introduced EU norms to restrict the activities of their competitors (the case of pharmaceutical companies and concrete producers in Lithuania).

This illustrates that in some cases the regulatory standards inherited from the past have been actually higher (i.e. some health and safety at work norms), or that in some cases the regulatory alignment policy has not followed the optimal strategy of extending transition periods where the adjustment impact is significant and focusing more resources during the immediate perspective to create the regulatory environment necessary to take advantage of the internal market, for example, early adoption of the protocol on European conformity assessment and mutual recognition of product standards.

In general, the re-regulatory exercise of adopting the EU *acquis* resembles in some respects the process of correcting "market failures" with very limited possibilities for the markets to appear. This could be evidenced by the process of de-monopolization of the energy sector in Lithuania, where regulation of the future market relations exceeds the minimum set by the EU and is likely to prevent the actual competition (in addition to the technical limits set by the limited sources of supply). Similar tendencies could be observed in the field of telecommunications where the Commission has been pressing to introduce the old regulatory framework before replacing it with a new one approved before the enlargement in the EU.

Conclusions

This paper described the main trajectories of the changing role of the state in the Baltic States as a result of their accession into the EU. The analysis of the EU's impact provides enough basis to make two concluding observations (one positive, and one normative): (1) the process of accession into the EU of the candidate CEECs has resulted in what could be described as "weaker guardianship, less direct participation in the economy, status quo in welfare promotion and more regulation"; (2) the diffusion of state activities together with the past legacies, interest group activities and relatively inefficient public administration results in a "widely present and weak" state slowing down the achievement of the main objectives of economic growth and welfare, despite the impressive catching-up taking place in the Baltic States since year 2000.