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**Determinants of Competitiveness and Economic Governance: Some
Evidence from the new EU member states and Croatia**

Nevenka Cuckovic

Institute for International Relations (IMO), Zagreb, Croatia

Phone: ++ 385-1-4877-475; Fax: ++ 385-1-4828-361

nevena@irmo.hr

Kresimir Jurlin

Institute for International Relations (IMO), Zagreb, Croatia

Phone: ++ 385-1-4877-479; Fax: ++ 385-1-4828-361

kreso@irmo.hr

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Abstract

The issues of competitiveness and economic governance are very much interrelated notions as they reflect well the general level of efficiency of an economy as a whole and especially of an enterprise sector. In the EU context, two levels of economic governance do affect the level of country competitiveness: domestic economic governance mechanisms (policies and institutions) and the EU economic governance mechanisms for both member states and acceding countries such as Croatia. Apart from that, at the country level, macroeconomic and microeconomic governance mechanisms have a direct impact on both domestic and international economic competitiveness. Coordination and economic policy mix coherence as well as institutions (rules and regulations) would be also examined including aspects of open mechanisms of coordination at the EU, when analyzing the level of competitiveness of selected countries.

The paper will focus on examining and analyzing evidence on how domestic and EU economic governance rules affect the level of competitiveness in Croatia at both country and enterprise sector levels. It will also make some comparisons with new EU member states from Central and Eastern Europe. The paper will make use of the data and findings of the Executive Opinion Survey conducted for the World Economic Forum, which are published in the Global Competitiveness Report 2008/2009. The analyses of economic governance and its impact on the level of country competitiveness and enterprise sector will especially lean on analyzing the WEF Survey findings and composite indicators on some issues such as government efficiency; property rights; ethics and corruption

1. Introduction

This paper examines to what extent the economic governance mechanisms and the quality of institutional arrangements determines the level of the country economic competitiveness at both macro and micro levels. We start from the assumption that EU institutional arrangements and policy orientations define the regime and framework of economic governance, We focus on comparative experiences of selected EU new member states from Central and Eastern Europe (Slovenia, Hungary, Slovakia and Czech Republic) and Croatia which is a candidate country in accession process to the EU.

As for the methodology used to measure and benchmark the competitiveness and the quality of institutions and economic governance mechanisms, we heavily rely on data and findings of the Executive Opinion Survey conducted for the World Economic Forum, which are published in the Global Competitiveness Report 2008/2009. The analyses of economic governance and its impact on the level of country competitiveness and enterprise sector will especially lean on analyzing the WEF Survey findings and composite indicators on some institutional issues such as government efficiency; property rights; ethics and corruption; and corporate ethics.

The second chapter focuses on existing conceptual and the EU policy umbrella and underpinning institutions that lies down and defines a framework for EU economic governance and competitiveness at both macro and micro levels.

The third chapter portrays the EU policy mix context and practice with particular focus on how the four new EU member states (two members of euro zone: Slovenia and Slovakia, two non-euro zone members Hungary and Czech Republic) have adjusted to it in the 2004-2008. We also make comparisons of set of effects on competitiveness of Croatia with four new EU members from Central and Eastern Europe.

The fourth chapter describes economic governance adjustment and convergence of Croatia and identifies remaining areas where adjustment to EU mechanisms is incomplete. The text of this chapter especially focuses on examining and analyzing evidence on how domestic and EU economic governance rules affect the level of competitiveness in Croatia at both country and enterprise sector levels.

In concluding fifth chapter we summarize the presented evidence on the increased but uneven levels of competitiveness and convergence to the EU single market of the selected countries. Since 2004 they have substantially decreased the income discrepancy with the EU-15 average as a result of high growth rates led by structural economic reforms mostly driven by the pressures of Europeanization of their economic policies and governance structures. However, the analysis suggests that nominal convergence does not necessarily optimize the business environment and that there is still a lot to be done in these areas.

2. The EU economic governance mechanisms and underpinning institutions and policies - brief snapshot on conceptual and policy framework

The quality of economic governance mechanisms in different EU member states vary significantly in accordance to their current orientations in national policy-making as well as to what extent the coordination, convergence and “Europeanization” of national and sub-national governance systems towards commonly agreed and supranational ones (Economic and Monetary Union) was implemented. The number and type of EU economic governance mechanisms vary accordingly across the member states (Scharpf, 2001, Marcussen, 2006; Marcussen 2008; Umbach and Wessels, 2008; Linsenmann et al, 2007) and the accomplished convergence and policy “Europeanization” levels so far are rather uneven. This refers especially in the case of the new EU members from CEE but also to candidate countries under “pressure of Europeanization” and policy transfer prior to accession (Lippert, Umbach and Wessels, 2001; Lippert and Umbach, 2005).

The current EU economic governance regime and practice as well as underpinning institutional framework reflects to a great extent the prevailing “soft” coordination methods as apart from the monetary policy, most economic policies remained in the competence of national policy-making. For that reason, the current economic governance mechanisms have leaned more towards the regime of soft intergovernmental coordination than implementing efficient and harmonized EU-wide mix of economic and social policies. The current economic governance also reflect divisions among member countries in views on functions of state and markets that is also present in economic theory and policy practice (Begg, 2008; Marcussen, 2006; Dyson, 2002; Umbach and Wessles, 2008; Dahausse, 2008). The divisions are also substantial between euro zone and non-euro zone members (Dyson, 2008).

In this paper we focus on how this affects the country competitiveness. The issues of economic governance and competitiveness are very much interrelated notions as they reflect well the general level of efficiency of an economy as a whole and especially of the business sector. In the EU context, two levels of economic governance do affect the level of country competitiveness: domestic economic governance mechanisms (policies and institutions) and the EU economic governance mechanisms for both member states and acceding countries such as Croatia. Additionally, at the country level, macroeconomic and microeconomic policy mix and governance mechanisms have a direct impact on their domestic and international economic competitiveness.

Apart from institutional framework that determines the general rules and code of conduct of market actors, the EU economic governance framework and its mechanisms are also dominantly reflected on conducting the following policy mix:

- a) macroeconomic policy (especially monetary, fiscal, competitiveness and state aid)
- b) social cohesion, employment and regional policy
- c) microeconomic policy

The current EU economic policy context which define general umbrella framework for economic governance mechanisms, is laid down by common economic reform and

competitiveness strategy - *Lisbon Strategy* (2000)¹ and **revised Lisbon Strategy** known as *Growth and Jobs Strategy* (2005)² which put competitiveness, economic growth and employment as core policy objectives.

In short, putting the focus on structural economic reforms, the Lisbon Strategy encompassed orientation towards four main reform targets: a) creating a dynamic knowledge-based economy driven by R&D and innovation that foster structural economic reforms; b) facilitation of higher investment by completing the internal market with market for services; c) social cohesion and modernizing European social model which will mitigate social exclusion and ensure full employment and d) ensuring appropriate macroeconomic policy mix which will be conducive to sustaining favorable economic growth taking care of environment constraints (Collignon (2003): 223-224). Additionally, the substantial reduction of administrative burden for business is also one of important policy objectives that should reduce business costs and boost micro competitiveness.

Originally, it was envisaged that these policy targets would be reached by 2010, but even nine years after its first launch, Lisbon process still lies somewhat “between the revolution and illusion”, (EC, 2008b, p.7) in neither failure nor success limbo or, as some authors put it, between ambitions and reality (Becker and Hishow, 2005). Given the fact that the most policies in question fall almost exclusively within the sphere of competence of the Member States, an open method of coordination (OMC) entailing the development of national action plans has been introduced as a main governance instrument. ”Besides the broad economic policy guidelines, (BEPG), the Lisbon Strategy provides for the adaptation and strengthening of existing coordination mechanisms: the Luxembourg process for employment, the Cardiff process for the functioning of markets (goods, services and capital) and the Cologne process on macroeconomic dialogue”.³

However, the mid-term review of the results held in 2005 showed that the indicators used in the OMC and policies implemented were not sufficient to attain the stated goals as they caused the objectives to become largely turbid and results generally unconvincing.

For this reason, the Council re-launched and revised Lisbon Strategy (under renewed name- Growth and Job Strategy and backed by redefined Stability and Growth Pact) with an objective to better focus policy efforts and commitments on the achievement of

¹ Council of the European Union (2000) *Conclusions of the Lisbon European Council*, SN 100/00, 23-24 March 2000. The Lisbon Strategy for the first time integrated the different policy coordination areas and objectives into the one comprehensive strategy aiming to put the EU on the top of most competitive economies in the world, while at the same time achieving the economic growth, more jobs and greater social cohesion. The adoption of this ambitious Agenda was motivated by the inadequate pace of economic growth and job creation especially when compared to the main global competitors such as the US. The document stressed the gap in productivity growth and technology progress & innovation as main causes behind sluggish growth.

² For which a report of an expert group was prepared under the guidance of Wim Kok, former Prime Minister of the Netherlands: *Facing the challenge: The Lisbon strategy for growth and employment*, European Commission, Luxemburg, Nov 2004, available at: http://europa.eu.int/comm/lisbon_strategy/index_en.html

³ Glossary of Europe, available at: http://europa.eu/scadplus/glossary/lisbon_strategy_en.htm

stronger and sustainable growth and the creation of higher quality jobs. In order to accomplish “*Europe of excellence*” based on socially and ecologically sustainable economic growth, what was needed apart from efficient coordination of policies were structural reforms underpinned by quick and smart growth-oriented measures which could deliver the desired outcome (Randzio-Plath, 2006: 51).

As far as the implementation of **renewed Lisbon Strategy** is concerned, the coordination process has been simplified. The renewed Program introduced novelties such as new three years cycle of economic governance mechanisms (starting with the 2005-2008) and Integrated Guidelines for Growth and Employment (IGGEs) which mainly combine the former Broad Economic Policy Guidelines (BEPGs) and the Employment Guidelines (EGs) and include orientation towards the following policy areas:

- Macroeconomic priorities and policy responses to identified challenges in order to underpin the economic stability and convergence of national economies;
- Microeconomic priorities and policy responses to challenges identified by member states;
- Employment priorities and policy responses identified by member states.

Based on these guidelines National Reform Programs (NRPs) were drawn up as a kind of three-year’ national strategy for delivering growth and jobs’ objectives in their economies. Renewed Lisbon Governance instruments within the OMC rely heavily on voluntary arrangements, leaving the individual member states to support the EU economic reform by own policies, taking more responsibility for it, and at the same time learning from other experiences (benchmarking), while viewing the Commission role more as a facilitator rather than the manager or controller of what is being done (EC, 2008b, p. 13)

The actual progress is being assessed by the European Commission on the base of the single Annual Progress Report with specific country recommendations on the sectors and policies where the progress was inadequate, but without the ability to sanction inadequate progress in economic reforms that underpin the Lisbon objectives or failures in meeting the policy targets. In short, the implementation of national reform programs lack effective control mechanisms as existent “blaming and shaming” mechanisms seem to be rather ineffective (Begg, 2008),

The implementation of Lisbon Strategy underlined the problem of economic policy coordination in the context of having rather divergent and complex policy objectives which guided economic government mechanisms. The efficiency of economic governance mechanisms and their consistency have been questioned and challenged many times by number of analysts (Begg, Hudson, Maher, 2003, Collignon, 2003; Dyson, 2006, Best, 2008 etc.). They determine to a large extent the inadequate accomplishment of the general competitiveness objectives of the EU internal market laid down by the Growth and Job Strategy (2005). The main question behind many critics is if the soft coordination policy implemented by the Open Method of Coordination, based on voluntary arrangements and dialogue, is actually sustainable and conducive to efficient economic governance and growth. The other important question examined is how to move from “Lisabonisation” of national policies and multi-level governance towards the real EU economic government with full legitimacy which will provide more efficient

mechanisms for obtaining EU-wide policy goals (Umbach and Wessels, 2008; Linsenmann; Meyer and Wessels, 2007; Meyer and Umbach; 2007). The critics also emphasize the inability of the policy system to deliver a coherent policy mix in such an overloaded agenda (Begg, Hodson and Maher, 2003; Becker and Hishow, 2005). For further and elaborate discussions on systemic “fault lines” of Lisbon Strategy as an umbrella framework for economic governance see for instance Wyplosz, 2002; Alssop, C. and Artis, M.J. 2003; Begg and Larsson, 2007; Begg and Schelkle, 2004; Dyson 2008.

The shortcomings of the current multi-level economic governance mechanisms are even more visible in the present economic and financial crisis which reveals a lot about economic and social governance in the EU. The arsenal of crisis management tools at disposal to the ECB is rather narrow as they are not backed by equivalent EU fiscal authority (Di Noia and Micossi, 2009).

The adopted “EU Economic Recovery Plan” (November 2008) gives only tentative and initial directions for economic and financial crisis management. Policy responses are left almost entirely to the individual member states, while the common and coherent EU-wide management of crisis’ effects is missing.

3. Selected empirical evidence from the new EU members and Croatia in adjusting to economic governance and competitiveness benchmarks

The post-socialist countries which joined the EU in 2004 have been in the continuous process of adjusting their political and economic governance systems, policies and institutions (legislative framework and soft rules) in order to converge to the existing EU practice, ever since they started their accession process as candidate countries. The pressure of Europeanization has “worked as a factor and incentive to shape and develop structures and institutions capable of meeting the obligations and needs of a future EU member state” (Lippert and Umbach, 2005). The EU membership negotiations also proved to be an important shaping power of national policies, institutions and governance structures (Lippert, Umbach and Wessels, 2001). The process could be characterized as the attempt to adjust to a “*moving target*” as the EU itself is undergoing the process of substantive change too⁴.

So how well did they do so far? Complying with the convergence criteria of new member states in fulfilling their obligations towards the Economic and Monetary Union (price stability, avoiding excessive budget deficits and exchange rate fluctuation) would not be in the focus of our detailed analyses.⁵

In this chapter we rather examine elements of coordination and macro and microeconomic policy coherence as well as underpinning institutions (rules and regulations) when analyzing the achieved levels of competitiveness of selected countries.

⁴ Slovak commissioner Jan Figel in an interview:” The EU is a moving target”, Friday 27 February 2004. available at: <http://www.euractiv.com/en/future-eu/interview-news-eu-moving-target-slovak-commissioner/article-116248>

⁵ The EU Convergence Report is published regularly every year or two by ECB. For latest See the EU Convergence Report, European Economy 3/08, DG Economic and Financial Affairs, EC, Brussels

The starting assumption of our analyses of economic competitiveness of the selected four new EU member states (Slovenia, Hungary, Slovakia and Czech Republic) and Croatia is that getting closer to the benchmarks set out by the policy coordination process they improve and increase their competitive advantages. Competition rules (both formal and informal); market structures; solid finance institutions and government policy efficiency are key elements of the business environment. The level of convergence towards the average EU levels of the new EU members is usually also reflected in the country global competitiveness rank (Marcussen, 2008).

The analysis that follows is based on the data from the Executive Opinion Survey, published by the World Economic Forum in the Global Competitiveness Report 2008/2009. Survey indicators measure „sentiment“ of business community towards certain institutional aspects that can not be measured by the hard data. It measures perceptions of the quality of institutions and policies i.e., on the level of achieved results as perceived by business community. The survey is conducted every year in almost all countries in the world at the same time, with identical set of questions and with controlled sample, providing for a sound base for analysis of general competitiveness as well as selected specific issues.

The existing standard „pillars“ of the GCR were not suitable for the purpose of this paper which aimed at getting into specific aspects of the **quality** of government and public policies that create environment for the private business. We have selected 24 survey indicators to construct 3 „pillars“, which denote quality of government policies at the macro level (1), micro level (2) and in building institutions (3). For the purpose of this analysis we have constructed these pillars as composite indexes, comprising of 8 indicators each. The analysis is focused on benchmarking the values of these indexes for the selected transition countries (Croatia, Czech Republic, Hungary, Slovakia and Slovenia) against the average score for EU15, or “old” EU members. The purpose of such analysis was to try to identify if the selected countries were successful in recent reforms. Therefore, we analyzed data for the last 5 years. Although often criticized as a methodological tool, we feel that benchmarking of the survey indicators within this framework is worth an effort as an explanatory tool, since the countries under review are catching up and aligning their policies with the EU *acquis*. Apart from that, these countries are rather close, historically and culturally and there should be no major differences in the factors creating framework for analyses.

a) Institutional Framework

The institutional framework is very important for the business community and ultimately for all citizens; their living standards and general quality of life. The link between quality of institutions and economic growth had been repeatedly studied and empirically tested (North, 1997; Rodrik, 2004; Pedersen 2008). At the business sector level, the link is most evident in investment decisions whereby investors take into account the quality of institutions as a very important factor for the ease of doing business and when assessing overall risk of future business conduct in one country.

Firms are generally keen to invest in countries with high respect and protection of property rights; developed legal framework and enforced rules of law; well developed public services without burdensome bureaucracy, redundant regulation and corruption. It is important that government policies are transparent, judiciary does not hinder business and there is a strong protection against crime and fraud. Apart from that some rules of conduct and institutional aspects within the “ethical behavior” were also included, with indicators of business ethics and public trust in (financial) honesty of politicians.

I.e. those created by the private sector subjects themselves are also very important.

These are precisely the elements we have taken into account when measuring the quality of current institutional framework that affects the decisions of enterprises and market actors. The findings of the analysis for the “Institutions” pillar, as well as for the 8 underlying indicators follow in Table 1.

Table 1: „Institutions“ pillar (% of the EU15 average), 2008/2009

	Slovenia	Hungary	Croatia	Czech R.	Slovak R.	average
Organized crime	97.9	93.7	85.2	98.4	89.1	92.8
Property rights protection	81.1	87.4	70.0	78.3	81.8	79.7
Ethical behavior of firms	80.5	67.9	72.0	68.0	70.0	71.7
Judicial independence	73.9	76.6	56.8	73.7	64.5	69.1
Diversion of public funds	79.3	61.0	66.7	55.4	62.2	64.9
Irregular payments in public contracts	89.5	58.5	67.0	51.0	56.1	64.4
Favoritism in decisions of government officials	69.5	52.7	61.6	53.3	48.9	57.2
Public trust of politicians	74.7	47.8	54.6	42.5	43.5	52.6
INSTITUTIONS	80.8	68.2	66.7	65.1	64.5	69.1

Organized crime - Organized crime (mafia-oriented racketeering, extortion) in your country: (1 = Imposes significant costs on businesses ; 7 = Does not impose significant costs on businesses); Property rights - Property rights in your country, including over financial assets, are: (1 = Poorly defined and not protected by law ; 7 = Clearly defined and well protected by law); Ethical behavior of firms - The corporate ethics (ethical behavior in interactions with public officials, politicians and other enterprises) of firms in your country are: (1 = Among the worst in the world ; 7 = Among the best in the world); Judicial independence - Is the judiciary in your country independent from influences of members of government, citizens or firms? (1 = No – heavily influenced ; 7 = yes – entirely independent); Diversion of public funds - In your country, diversion of public funds to companies, individuals or groups due to corruption: (1 = Is common ; 7 = Never occurs); Irregular payments in public contracts - In your country, how frequently would you estimate that firms make undocumented extra payments or bribes connected with the following: d. Awarding of public contracts and licenses: (1 = Common ; 7 = Never occurs); Favoritism in decisions of government officials - When deciding upon policies and contracts, government officials in your country: (1 = Usually favor well-connected firms and individuals ; 7 = Are neutral); Public trust of politicians - Public trust in the financial honesty of politicians in your country is: (1 = Very low ; 7 = Very high)

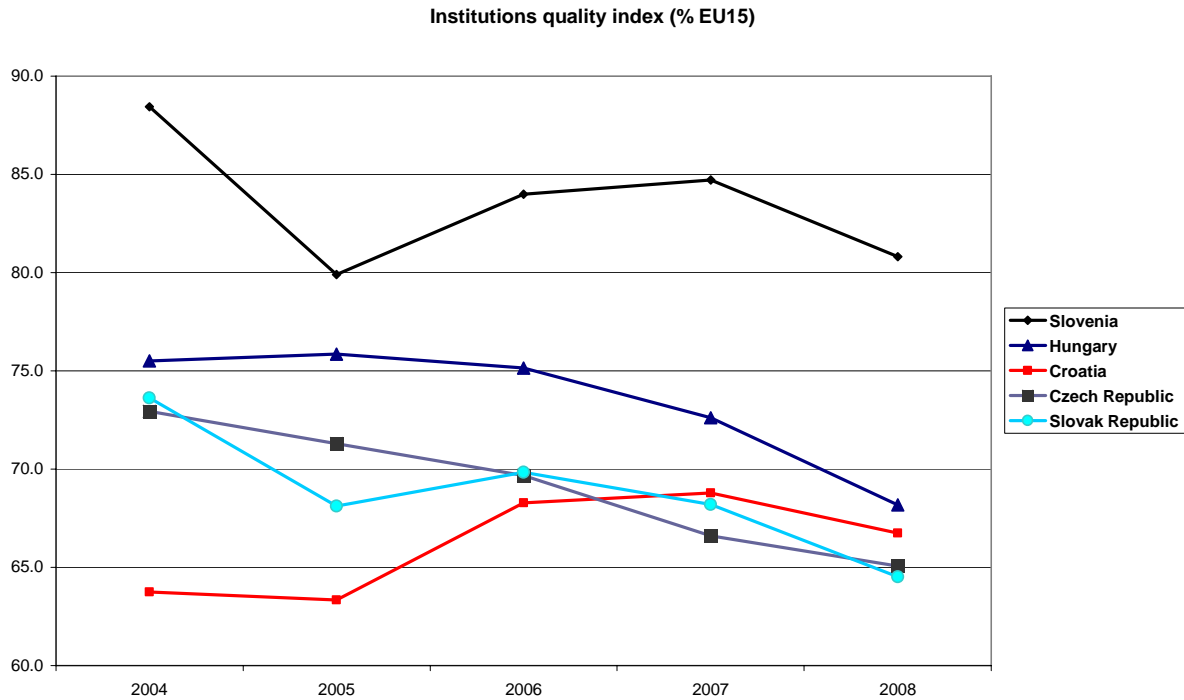
Source: Authors' calculations from WEF survey database

The perception is by far worst regarding trust in financial honesty of politicians and neutrality of government officials when deciding upon public policies and public procurement contracts. According to the knowledge of the surveyed executives, there is much irregular payments in public contracts and public funds as commonly diverted due to corruption. It is interesting to note that organized crime is perceived not to impose very significant costs on business in these countries, as compared to the EU15 average. A possible explanation may be that corruptive and criminal conduct is focused more to influence public funds and politicians, while private sector is relatively less exposed to organized crime.

Slovenia stood apart from the group of countries under review, with much favorable indicators, however, still below the EU15 average. The other 4 countries show very similar pattern of corruptive behavior of politicians and public officials.

The analysis of dynamics of the “Institutions” pillars is conducted for the most recent 5-years period (Figure 1).

Figure 1: Dynamic comparisons of the *Institution quality* index for the selected new EU members and Croatia, 2004-2008



Source: Source: Authors' calculations from WEF survey database

The dynamics of the perception of the quality of institutions proved to be rather interesting. Slovenia stood alone at a relative high level above 80% of the EU15 average, without clear trend component. However, three countries that were meant to be very successful reformers, i.e. Hungary, Czech Republic and Slovakia clearly and significantly lost their positions from 75% of the EU15 average towards rather low 65% level. Croatia recorded a significant improvement in 2006, joining the three other countries and it is rather remarkable how the 4 countries came close together, indicating how much they still have to work to improve their institutional framework.

b) Macroeconomic Framework

Although the *World Economic Forum* uses the composite “Macroeconomic stability” pillar, composed completely of the hard data indicators, we undertook somewhat different approach. By using the selected survey indicators we have tried to identify and measure certain underlying factors of the macroeconomic stability as well as to tackle certain policies connected with the quality and impact of budget spending (quality of education and infrastructure). Furthermore, we included also the indicator of general

macroeconomic framework using the survey question of the extent and effect of taxation and the question of how successful are government policies (and macroeconomic framework) in attracting foreign investment that bring new technologies and not only to exploit opportunities of market access and low labor costs. We have also included the indicator of soundness of banks, which recently proved to be very important for the macroeconomic stability. There are also other indicators of general regulation i.e. quality of antitrust policy and burden of government regulation.

The findings of the analysis for the “Macroeconomic policies” pillar, as well as for the 8 underlying indicators are shown in Table 2.

Table 2: „Macro policies“pillar (% of the EU15 average), 2008/2009

	Slovak R.	Czech R.	Slovenia	Croatia	Hungary	average
Extent and effect of taxation	154.2	110.9	94.0	93.7	59.7	102.5
FDI and technology transfer	115.3	106.8	73.7	78.3	106.1	96.0
Soundness of banks	100.3	91.0	88.2	91.1	85.0	91.1
Burden of government regulation	87.7	80.8	112.6	87.0	71.1	87.8
Quality of the educational system	70.9	97.3	91.0	76.0	66.6	80.4
Effectiveness of antitrust policy	86.2	87.0	79.4	65.9	80.6	79.8
Overall infrastructure quality	66.9	75.6	86.5	73.6	71.9	74.9
Government spending wastefulness	70.2	69.8	81.9	78.2	56.0	71.2
MACROECONOMIC POLICIES	94.0	89.9	88.4	80.5	74.6	85.5

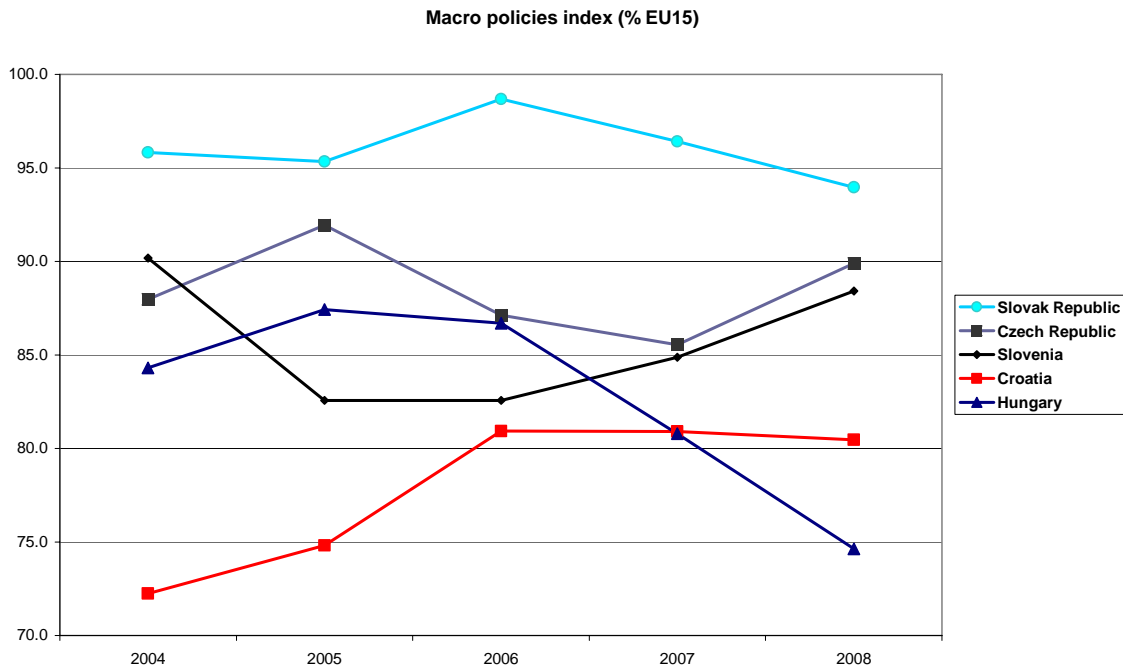
Extent and effect of taxation - The level of taxes in your country: (1 = Significantly limits incentives to work or invest ; 7 = Has little impact on incentives to work or invest); FDI and technology transfer - Foreign direct investment in your country: (1 = Brings little new technology ; 7 = Is an important source of new technology); Soundness of banks - Banks in your country are: (1 = Insolvent and may require a government bailout ; 7 = Generally healthy with sound balance sheets); Burden of government regulation - Complying with administrative requirements for businesses (permits, regulations, reporting) issued by the government in your country is: (1 = Burdensome ; 7 = Not burdensome); Quality of the educational system - The educational system in your country: (1 = Does not meet the needs of a competitive economy ; 7 = Meets the needs of a competitive economy); Effectiveness of antitrust policy - Anti-monopoly policy in your country is: (1 = Lax and not effective at promoting competition ; 7 = Effective and promotes competition); Overall infrastructure quality - General infrastructure in your country is: (1 = Underdeveloped ; 7 = Extensive and efficient by international standards); Government spending - The composition of public spending in your country: (1 = Is wasteful ; 7 = Efficiently provides necessary goods and services not provided by the market).

Source: Authors' calculations from WEF survey database

Rather good performance of the countries under review as compared to the EU15 countries for the macroeconomic policies could be attributed to a favorable perception of taxation (even better than in the EU). Regarding that, exception is Hungary, with very low value of the indicator (59.7%) of the extent and effect of taxation, indicating that business community in this country finds taxes as a very heavy burden. On the other hand, thoroughly reformed taxation policy in Slovakia and to a certain extent even in Croatia (with decreased share of profit and income taxes in the budget revenues), proved to be well accepted by the business sector. The role of FDI for transfer of technology is perceived to be very favorable, with clear exceptions of Slovenia and Croatia, countries that were not successful in attracting new “greenfield” investment, especially not in medium and high-tech industries. It may come as surprise that soundness of banks was perceived to be rather well in 2008, however it indicates that the business community believed that these banks (mostly owned by foreign banks) are well managed and controlled. Recently, the banks in these countries came under significant pressure in the

financial crises, although seemingly not due to their inherent low quality, but as a consequence of international turmoil and (in some countries) currency depreciation. The worst outcome is measured for the indicator of wastefulness of government spending, meaning that executives feel that much of the budget is spent for instance to state-aid without positive impact for the economy. Also, situation is not well regarding the scope and impact of public spending, and the overall quality of infrastructure, as well as quality of education, is perceived to be significantly worse than the EU average. The analysis of dynamics of the “Institutions” pillar is presented in the Figure 2.

Figure 2: Dynamic comparisons of the *Macro policies* index for the selected new EU members and Croatia, 2004-2008



Source: Authors' calculations from WEF survey database

The countries under review performed rather differently in the recent 5 years. In stead of Slovenia, the leader in this particular pillar is Slovakia, although losing ground in the last two years (with worsened satisfaction with the educational system, taxation and soundness of banks). Czech Republic and Slovenia show the “U” curve dynamics, with a significant upturn in the last year under review. Croatia had improved since 2006 and the reforms seem to have lost momentum since. Hungary recorded a significant downturn of the survey indicators showing that the business community became aware of some bad macroeconomic statistics and the reasons behind it, especially that the heavy tax burden is to a large extent wasted, not providing for high quality services of the public sector and administration.

c) Microeconomic Framework

Within this pillar, we included the survey indicators which create a direct impact on performance and opportunities of business environment, i.e. those set of rules and policies that directly affect the decisions of business sector.

This includes quality of auditing and management control by boards and small investors, as well as protection of the interests of minority shareholders, which recently and again proved to be a cornerstone of the transparency of business sector operation. The indicator on the rules governing the FDI is included as it shows perceptions of general quality of investment climate. Ease of access to loans should cover the quality of banking services and availability of finance to the business sector and not their soundness (included in the macro pillar), which is element of the overall stability and control. The pillar includes also certain specific government policies, reflected in labor-employer relations, protection of intellectual property and strategy for development of information and communication infrastructure (ICT).

The findings of the analysis for the “Microeconomic policies” pillar, as well as for the 8 underlying indicators are shown in Table 3.

Table 3: „Microeconomic policies“pillar (% of the EU15 average), 2008/2009

	Slovak R.	Slovenia	Czech R.	Hungary	Croatia	average
Impact of rules on FDI	111.9	77.6	102.7	98.8	76.8	93.6
Cooperation in labor-employer relations	99.8	93.1	96.0	91.1	77.6	91.5
Efficacy of corporate boards	100.6	93.4	97.8	84.4	81.3	91.5
Ease of access to loans	102.6	96.8	85.2	75.4	75.6	87.1
Strength of auditing and accounting standards	85.2	89.5	88.9	89.0	81.5	86.8
Government strategy for ICT	80.2	99.7	81.1	84.4	87.3	86.5
Protection of minority shareholders' interests	77.3	74.8	77.9	84.4	75.4	77.9
Intellectual property protection	66.4	79.2	71.3	74.2	66.6	71.5
MICROECONOMIC POLICIES	90.5	88.0	87.6	85.2	77.7	85.8

Impact of rules on FDI - In your country, rules governing foreign direct investment: (1 = Discourage foreign direct investment ; 7 = Encourage foreign direct investment); Cooperation in labor-employer relations - Labor-employer relations in your country are: (1 = Generally confrontational ; 7 = Generally cooperative); Efficacy of corporate boards - Corporate governance by investors and boards of directors in your country is characterized by: (1 = Management has little accountability ; 7 = Investors and boards exert strong supervision of management decisions); Government strategy for ICT - The government has a clear implementation plan for utilizing information and communication technologies for improving the country's overall competitiveness: (1 = Strongly disagree ; 7 = Strongly agree); Ease of access to loans - How easy is it to obtain a bank loan in your country with only a good business plan and no collateral? (1 = Impossible ; 7 = Very easy); Strength of auditing and accounting standards - Financial auditing and reporting standards regarding company financial performance in your country are: (1 = Extremely weak ; 7 = Extremely strong – the best in the world); Protection of minority shareholders' interests - Interests of minority shareholders in your country are: (1 = Not protected by law ; 7 = Protected by law and actively enforced); Intellectual property protection - Intellectual property protection and anti-counterfeiting measures in your country are: (1 = Weak and not enforced ; 7 = Strong and enforced)

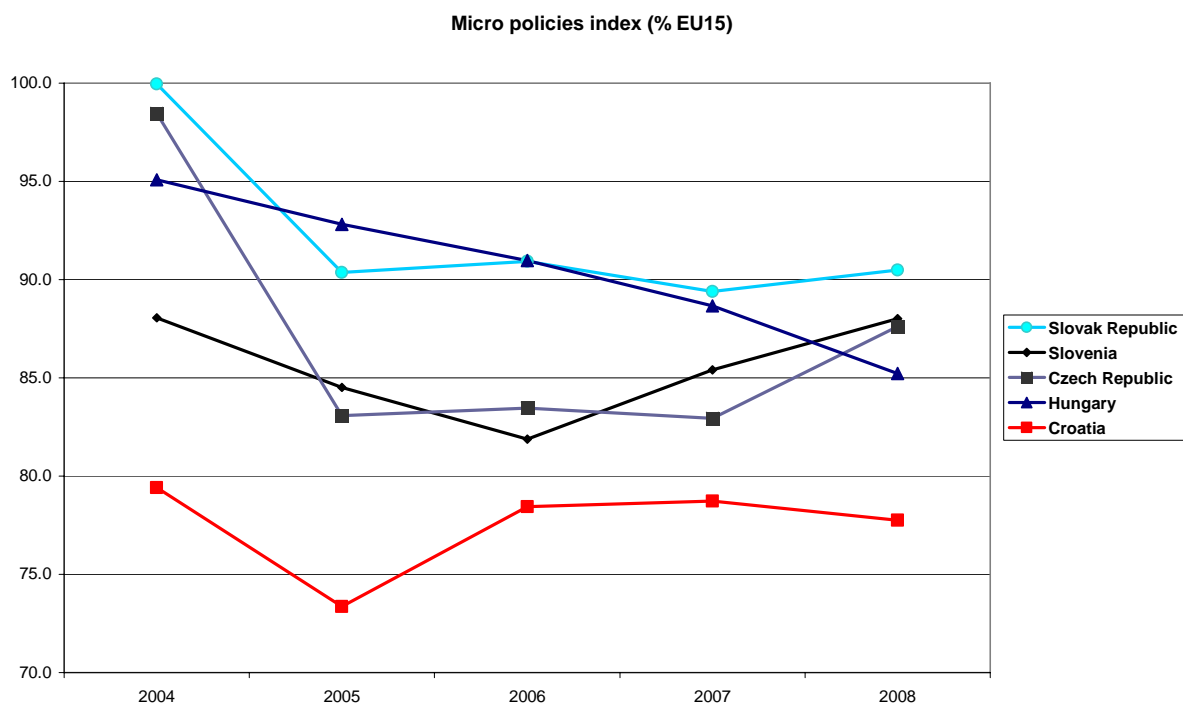
Source: Authors' calculations from WEF survey database

Again, FDI policies are ranked high in the list of microeconomic pillar indicators. The surveyed managers feel that the rules governing FDI generally encourage investment. However, this is not true for Croatia and Slovenia, which do not stimulate foreign investment successfully. It comes as surprise that in all countries (apart from Croatia) labor-employer cooperation is ranked high, however this may be a consequence of less than perfect situation in the EU15. Similar situation is also with efficacy of corporate boards.

The worst position is of the protection of intellectual property rights, meaning that piracy and counterfeiting is not successfully combated. Also, minority shareholders' interests are not well protected in the countries under review, which is somewhat better in Hungary and Slovak Republic. In Croatia this has been repeatedly reported in many surveys and studies of applied corporate governance standards and codes.⁶

The analysis of dynamics of the “Micro policies” pillar is also conducted for the last 5-years period (Figure 3).

Figure 3: Dynamic comparisons of the *Micro policies* index for the selected new EU members and Croatia, 2004-2008



Source: Authors' calculations from WEF survey database

In this case we have no clear “winner”; only Croatia is significantly lagging behind the other countries under review, however showing some improvements in 2005-2007 period. Hungary is visibly deteriorating its microeconomic policy environment, while the other three countries have somewhat recovered in 2008, after a significant downturn recorded in 2005.

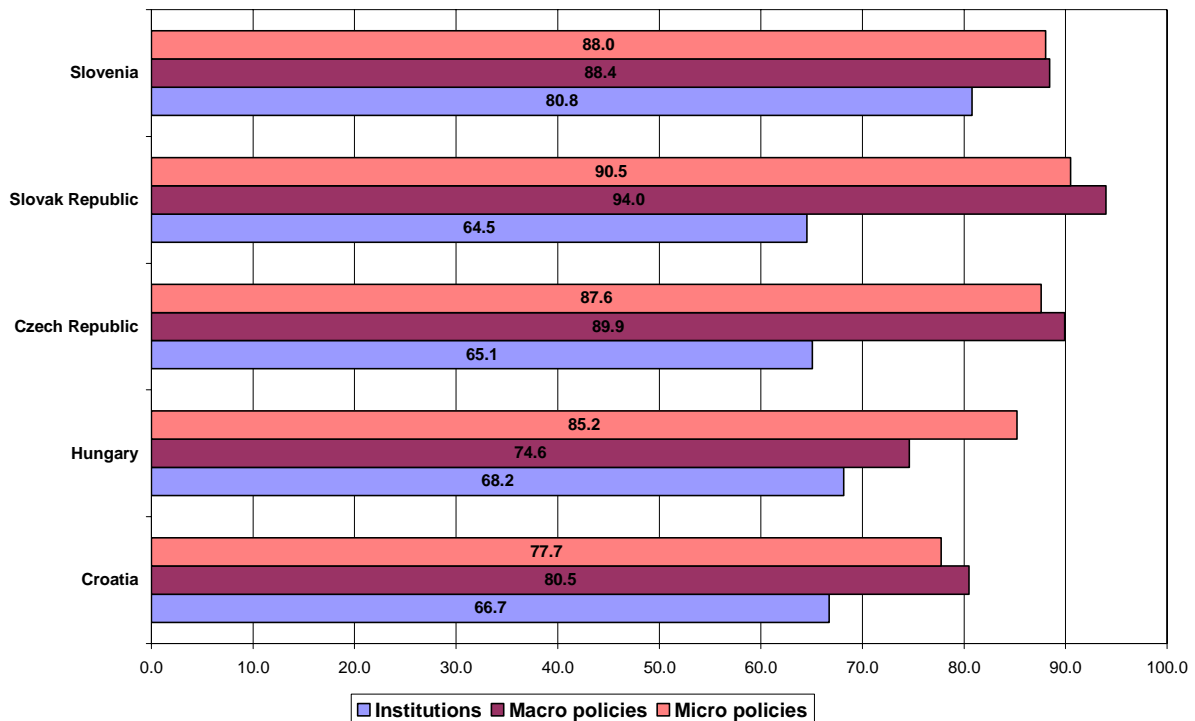
d) Concluding assessment of three pillars

The presented analysis indicated that, against a widespread opinion, the new EU member countries after the formal date of accession and candidate country Croatia, were not conducting straightforward reforms of institutions that affect directly the business

⁶ Cf. World Bank: “Corporate governance country assessment Croatia”, 2008.

environment. There are significant differences in dynamics of change, both in the level of the 3 pillars, benchmarked against the EU15 and between the countries under review. However, the differences between countries in the level of each of the indicators in the last year (2008) are not large. This may be evident from the Figure 4.

Figure 4: Three „pillars“ for the synergic assessment of the quality of governance and its impact on competitiveness in 2008/2009



Source: Source: Authors' calculations from WEF survey database

The presented data show that the government policies at the macro and micro level generally were at a similar level within each country. For Slovenia, Slovakia and Czech Republic, the level of indicators stood at a rather high level of 90% of the EU15 average. These two pillars stood for Croatia also close to each other, however at a level somewhat lower than 80% of the EU15 average.

On the other hand, the „Institutions“ pillar stood significantly worse than the other two pillars, for all countries under review. Apart from Slovenia that stood out at an 80% of the EU15 level the other 4 countries show strikingly similar performance, with the „Institutions“ pillar in a narrow range from 64.5% to 68.2% of the EU15 average. What follows is the conclusion that quality institutions in the countries under review are lagging significantly behind in the overall success in the alignment of the government policies and public sector performance to the standards of the European Union.

A detailed insight in the basic indicators that we used to construct these pillars, are showing that nominal convergence towards formal institutional rules would not necessarily mean that enforcement and respect of these rules on the ground would be smooth and imbedded. Croatian case demonstrates this quite visibly where the gap

between the adopted and enforced rules and norms is rather high according to the Doing Business study (World Bank, 2008).

4. Croatia and adjustment to EU institutions, economic governance and competitiveness: how much does it matter?

Croatia's convergence results were rather profound in the last 5 years according to the recent World Bank Convergence Report (2009). Croatia's main development objective is to reach 75 percent of the EU's average per capita income by 2013. Currently, at about US\$ 11,500 per capita, it stands at around 56 percent of the EU average in purchasing power standards.⁷

Croatia started its accession process to the EU in 2004 after the EU approved her candidate country status. The membership negotiations with the EU started in 2005 with an aim of intensification of the catching-up process, convergence and integration in the single European market. The adjustment process to *acquis communautaire* should bring to a substantial improvement in the policy and institutional (legislation and soft rules) framework for the Croatian economy and consequently also improved competitiveness rankings. For some areas of adjustment, different benchmarks were set in order to assess relative performance of a country towards meeting various EU standards in alignment with the EU *acquis*.

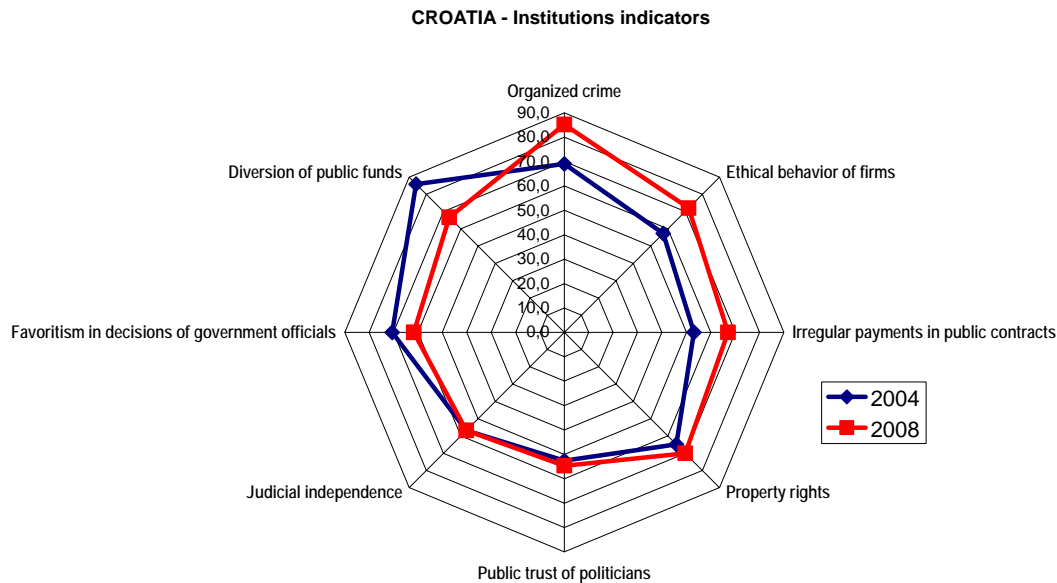
The selected WEF indicators, analyzed in the previous chapter, focused more on the effects of advancing the institutional setting and macro and microeconomic policy mix towards improving the institutional environment for business, with special focus on those institutions which seem not to function properly or fail to meet the expectations of business sector, such as efficiency of government policies, corruption, corporate ethics, protection of property and intellectual rights etc. In this chapter, we analyzed structural aspects of the position of Croatia's competitiveness towards the selected four new EU member states, to assess the progress in adjustments in selected areas of institutional; macroeconomic and microeconomic competitiveness.

Since 2005 to 2008, measured by WEF Global Competitiveness Index, Croatia has started to close the competitiveness gap against the group of four European new member countries - Slovenia, Slovakia, Czech Republic and Hungary. However, this is more attributable to the worsened position of the four benchmark countries, especially for Hungary, with a significant drop of rank by 14 places. Croatia improved its position by 7 positions (in real terms) in 2006 and remained rather stable since, near the rank 60 (WEF, 2008). The *poor effectiveness of public administration* and *corruption* are the main identified problems in the perceptions of Croatian entrepreneurs. *Inadequate levels of education and skills* of labor are also high among the identified obstacles for higher competitiveness of Croatian business sector.

⁷ Croatia Country Brief 2008, World Bank, available at: <http://www.worldbank.hr/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/CROATIAEXTN/0,,menuPK:301254~pagePK:141132~piPK:141107~theSitePK:301245,00.html>

Institutions proved to be a significant problem also as measured by methodology used in this paper. In this chapter we compared the outcome for the 8 survey indicators for the years 2004 and 2008 in order to identify the areas with the largest improvement, as well as those with more reform effort still to come (Figure 5).

Figure 5: CROATIA – “Institution” Indicators, 2004 and 2008 (EU15=100)



Source: Source: Authors' calculations from WEF survey database

The most notable improvements are recorded in the business impact of organized crime, with a move from 70% of the EU15 average in 2004 to a rather high level of 90%. Improvement is strong also for the business ethics and corruption for public contracts, indicating improved control of public procurement. However, the perception of corruption for general diversion of public funds has worsened, together with influence on the decision of government officials.

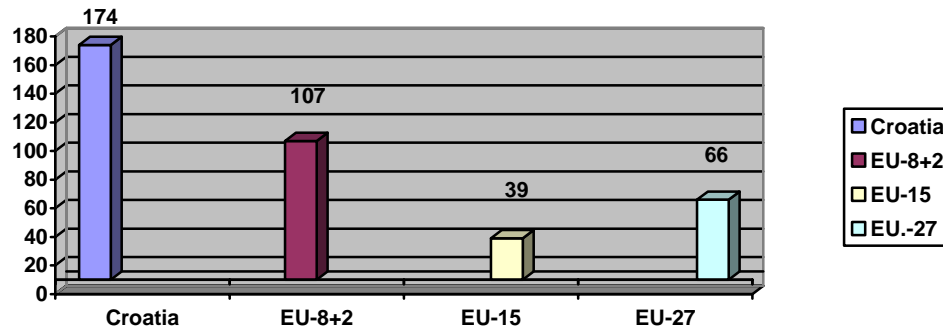
However, situation is perceived to be much worse in judicial independence, without any significant improvement.

Surprisingly, against the common perception and other surveys (Cuckovic and Bartlett), protection of property rights is ranked rather high at 80% of the EU average, with some improvement as compared to 2004.. The reality is however not that rosy according to the recent data of World Bank study.⁸ The lack of secure property rights has been one of the major obstacles reported by the entrepreneurs in Croatia. This is especially the case with registering the property of land or business buildings. The registering the property in Croatia is much more inefficient and lengthy procedure than in EU-15 and even if

⁸ Doing Business in 2009, World Bank and IFC.

compared to the other countries in the Western Balkans. For instance it takes 5 procedures and 174 days on average in Croatia to transfer the property title on land and buildings from one firm to another, while in the core EU-15 countries it takes only 39 days to transfer the ownership title.

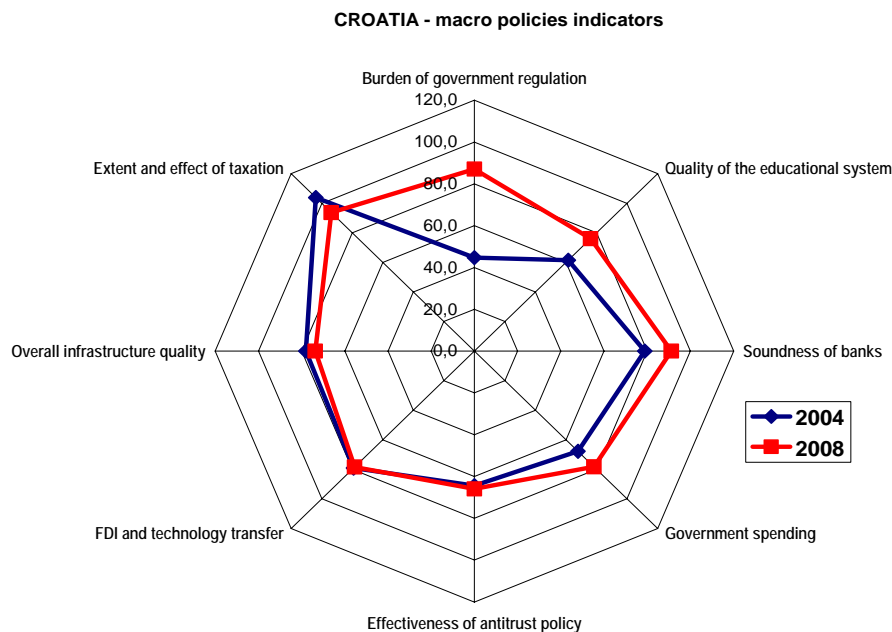
Figure 6: Property registration in days in Croatia and comparison with EU-15, EU-27 and EU-8+2



Source: WB, *Doing Business 2009*

It may be true that the business community gives some credit to the reforms that brought to a certain improvements in this particular area. For instance, property registration lasted for 956 days in 2005. Also, a significant improvement is recorded in cutting the number of unsolved court cases by half 2005-2008, which affects also enforcing contracts.

Figure 7: CROATIA – “Macro policies” indicators, 2004 and 2008



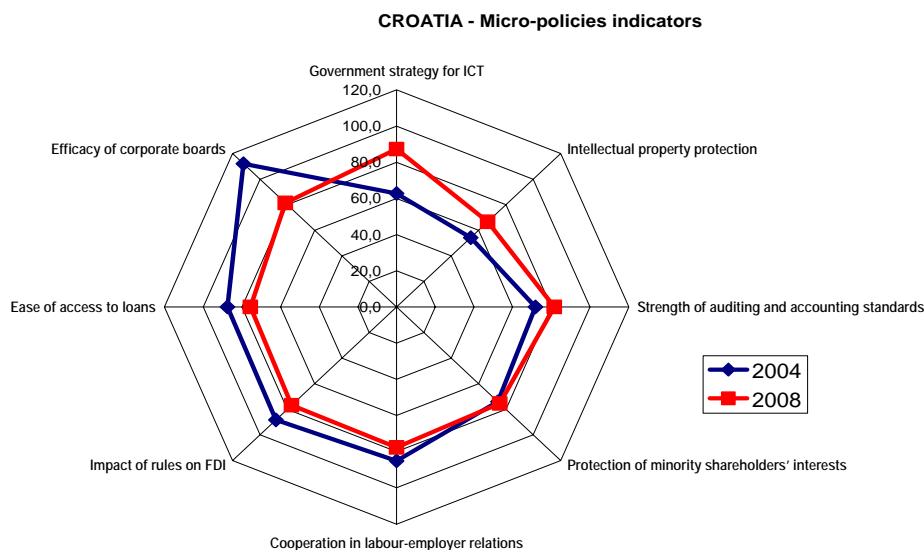
Source: Source: Authors' calculations from WEF survey database

The improvement of the indicator of burden of government regulation was immense. It seems that complying with administrative requirements for businesses (permits, regulations, reporting) became somewhat less burdensome, presumably due to increase of use of online services for getting permits and tax-filing, as well as initial cut of redundant regulation. Improvements are also visible in the quality of educational system, soundness of banks and (wastefulness of) the government spending.

Soundness of banks also improved. This proved to be grounded even after the recent international financial turmoil. In Croatia as the currency remained (relatively) stable and there was a proper response from the national bank. Therefore, the trust in soundness of banks remained almost intact, with only a temporary and insignificant withdrawal of deposits.

The worst position and without improvement in the perception of the business community remained in the effectiveness of antitrust policy. Complying with the EU competition rules is a precondition for Croatia to assume the abilities of full EU membership. In its annual assessment of the adjustments to the competition policy *acquis*, the European Commission Progress Report (2008c) also stressed the remaining open issues in the Croatian anti-trust and state-aid policy. Although aligning the antitrust and state aid legislation has considerably progressed, dealing with abuses of the rules is still inefficient due to low administrative capacity of the agency responsible for competition and state aid policies. In addition, although progress has been achieved as regards state aid in some subsidized sectors such as steel sector; significant efforts are required in particular as regards restructuring aid to the shipyards, which must be addressed in the context of their foreseen privatization.

Figure 8: CROATIA – “Micro policies” indicators, 2004 and 2008 (EU15=100)



Source: Source: Authors' calculations from WEF survey database

The indicator with the strongest improvement in the period under review is the government strategy for ICT, which is surprisingly well perceived. A possible explanation may lay in visibility of policies providing for more competition in telecom services.

A notable improvement is recorded for the protection of intellectual property; however, this remained the worst ranked indicator. It is interesting to note that the perception of the efficacy of corporate boards worsened significantly, indicating that the business community became more aware of the problem of corporate governance. A significant improvement is still to come also for the protection of minority shareholder interests.

These problems were also identified by the World Bank (2009), whereby Croatia was ranked as low as 126th position according to the “Investors protection” indicator, measuring control mechanisms within corporate governance.

It seems that there is a rather different success among the many policies for improving national competitiveness of Croatia. Therefore, further reforms are needed not only in formally complying with the requirements of the EU membership, but in order to constantly improve the business environment. The need to improve competitiveness in various fields is already recognized and supported by Croatian government policy makers and the Lisbon Strategy goals are already built in several government strategic documents.⁹

Striving to achieve the policy targets connected with the EU membership would provide additional long-term impetus for economic growth, while also net costs might be significant. The cost-benefit analysis of the future membership effects on Croatia (Economic Institute, 2007) has shown that the first years of membership will produce significant burden to the national budget. Total yearly net budget contribution is estimated from €501 million in 2009 to €578 million in 2011, while that burden in percents makes for some 1% of the GDP per annum.¹⁰ However, the cited study shown that long-term benefits would be significantly larger than the costs.

Apart from that, recent studies demonstrated that achieving Lisbon targets also in the EU countries does matter significantly for Croatian economy, given the intensive economic links with the EU market. In estimating the potential economic gains for Croatia that stem from achieving targets of Lisbon Agenda, the recent results obtained by econometric simulation (Lejour, 2008), showed the effects on income, consumption, exports and real wages of reaching five selected Lisbon targets by 2015. These five targets are completion of internal market for services; reduction of administrative burden, increasing human capital; advancing R&D and increasing employment. Increasing the R&D expenditures, from 1.2 to 3.0 of GDP will have a strong impact on economic growth, which is estimated to be higher by 6% of GDP in 2025. In addition to that, increased EU employment itself should have the strongest effect on Croatian GDP growth, as much as 17.7% in 2025. Other EU policies should also significantly positive influence Croatian economy. If backed with implementation of Lisbon policies within Croatia, targeting the most problematic issues of institutional framework coupled with

⁹ Strategic Development Framework, 2006-2010, Central Office for Development Strategy and Coordination of EU Funds, <http://www.strategija.hr/Default.aspx?sec=122>

¹⁰ "Accession to the EU: Expected Economic Effects", Institute of Economics Zagreb, August 2007, p. 32.

those policies that would yield the most significant impact on growth, including innovation and R&D, the overall long-term impact on economic growth and advancing competitiveness after joining EU would be even more substantial (Economic Institute, 2007).

5. Instead of a conclusion

Over the past decade a number of quantitative empirical studies¹¹ analyzed the issue of convergence between the “old” and “new” EU members. Regardless the in-built inefficiency of the current Lisbon Strategy and Stability for Growth Pact frameworks for economic governance and competitiveness, they have proved to be powerful engines of convergence and structural reforms both in the new EU member states and in Croatia as a future member.

Since 2004 the countries under review have substantially decreased the income discrepancy with the EU-15 average, as a result of high growth rates and yields of structural economic reforms driven to a large extent by pressure of Europeanization of national policies and governance structures to get in line with the Maastricht; Copenhagen and Madrid Criteria for EMU. This proved to be the case especially for the two new members of the euro zone Slovenia and Slovakia where the institutional and monetary policy alignments to the EMU institutions, policies, norms and standards were most advanced. However, in Hungary which is not participating in euro zone, structural reforms were less successful. Similar situation also emerged for a number of other new EU members within the recent financial crisis what was reflected in the decrease of their competitiveness rank in 2008.

This paper also came out with findings that there are significant inequalities both between the general reform outcome among the new member countries and also among different factors of competitiveness. Although there is a general process of convergence to the EU level, as measured by the WEF Global Competitiveness Index, looking into more detailed indicators we have shown that the new members (as well as Croatia) still have much to reform, especially in the field of the quality of institutions.

Close examination of specific issues of institutional framework and some components of macroeconomic and microeconomic policy environment for business transactions show that nominal convergence and transposition of EU norms does not necessarily optimize the business environment and that there is still a lot to be done in these areas. The issue of policy transfer as a main vehicle of Europeanization and convergence to single market is another area of controversy which surpasses the scope of this paper, but seems very important to explore when assessing the competitiveness levels of the new EU member states,

¹¹Cuff, Iraj Hashi; Paul J.J. Welfens and Anna Wziatek-Kubiak (2007); Dogan, Nukhet and Saracoglu, Bedrye (2007).

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