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# Promoting Transition in the Wider Europe: Challenges, Policies, Prospects

**(Draft version as of March 2006; please do not quote)**

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When communism collapsed in Central and Eastern Europe, the EU wanted to promote the neighboring region's transition towards democratic market economies. In order to achieve democracy, stability, prosperity and peace the EU offered aid, trade, political dialogue, and, to some countries, association and eventually accession to the EU itself. In the post-9-11 world, the EU's greater intention is to be a source of stability in a world full of – partially – new threats (terrorism, failing states, diseases, crime, drugs). In particular, it wants to export stability to its neighborhood, the "Wider Europe" (EU 2003a and 2003b) which encompasses the post-communist and the Mediterranean countries. The goals and policies defined in 2003 largely continue approaches the EU has adopted since the collapse of communism.

After more than fifteen years the results of these approaches are highly diversified ranging from the relative success of the new EU member states of East Central Europe (including the Baltic states), to delayed reforms and violent conflicts in South Eastern Europe and the Commonwealth of Independent States (CIS). This paper intends, first, to look at the political and economic structure of the neighboring countries, second, to assess the appropriateness of the EU's policies to promote transition, and, third, to discuss the prospects for successful transition in the light of the structural problems exposed in the first section.

## 1. Challenges: A neighborhood of difficult transitions and failing states

If you exclude Switzerland, Norway, and Iceland, the EU's neighborhood within Europe consists of states that are mostly new and to some degree failing. Of the 27 post-communist states (8 new member states, 7 Balkan countries, 12 CIS countries, not counting the two semi-states Kosovo and Montenegro) only two, namely Poland and Hungary, are old states whose borders, territories and citizenship did not change since 1989 while all others emerged from fragmenting federations (Soviet Union, Czechoslovakia and Yugoslavia).

### 1.1.State failure and slow transitions

Many of these states have been and remain unable to perform one or more of the three core state functions satisfactorily: welfare, security, and representation (Milliken 2002). Even the new member states are still poor young democracies. Beyond the borders of the enlarged EU, poverty, as a rule, increases in proportion to distance from Brussels (see Table 1). Current candidates for EU membership Bulgaria and Romania could not join the EU in 2004 because they were late reformers whose transition process had started slowly. The western Balkans still have to overcome the consequences of war and ethnic strife. In the former Soviet Union, segments of the old communist nomenclature have managed to relabel and redesign their rule: behind the fragile façade of democracy and a market economy political and economic power remains highly concentrated.

**Table 1: The pyramid of poverty below the EU (in $)**

| Region/country | Per capita income at exchange rate parity | Compared to the EU | Per capita income at PPP | Compared to the EU | ERDI* |
|---|---|---|---|---|---|
| EU 15 | 21 000 | 100 | 24 000 | 100 | 1.0 |
| 8 new member states** | 4 590 | 22 | 10 900 | 46 | 2.3 |
| Bulgaria + Romania | 1 730 | 8 | 6 130 | 25 | 3.5 |
| Western Balkans | 1 770 | 8 | 6 770 | 27 | 2.0 |
| Ukraine, Belarus, Moldova | 787 | 3 | 4 700 | 20 | 6.0 |
| Russia | 1 744 | 8 | 6 862 | 29 | 3.9 |
| Caucasus | 623 | 3 | 2 760 | 12 | 4.4 |
| Central Asia | 741 | 3 | 3 480 | 14 | 4.7 |

*Source*: World Bank, World Development Indicators 2003; for EU-15 the value given for EMU has been adjusted.
*Notes*: * ERDI= Exchange Rate Deviation Index; ** without Cyprus and Malta (no data);

The size of the income gap between the EU-15 and its neighbors is still enormous and increases in proportion to geographical distance. Measured in exchange rates, the disparities range from 22% of the EU average for the new member states to 3% for the Caucasus. Based on purchasing power parities (ppp), the gap diminishes substantially ranging from 46% to 12%. The difference between exchange rate parity and purchasing power parity which is expressed by the Exchange Rate Deviation Index (ERDI) in the last column of Table 1 has important implications for relations between the EU and its neighbors. The higher the deviation, the more attractive Europe becomes for migrant workers, in particular commuting ones because they can live even on low European wages several times as long in their home country, while European investors can pay low wages there which still allow the employees to live decently because of the multiplied purchasing power. Aid spent on local inputs also goes a long way due to that deviation. Elites in transition countries able to get their hands on revenue from rich countries – be it aid, export revenues, or loans – will be even more tempted to monopolize these (rent) incomes because of their enormous real value in domestic markets (see below).

However, most countries in Wider Europe are not only relatively poor, but often also not full-fledged democracies and involved in conflicts. These factors form a triple set of state failures which are interlinked and mutually reinforcing, as Table 2 shows.

**Table 2: Interdependence of the three state functions of security, welfare, and representation/democracy**

| Impact on / Condition | Security | Welfare | Representation/democracy |
|---|---|---|---|
| Security | | Security (peace, monopoly of force, secure property rights) is a necessary condition for welfare (Collier 1998). | Security (peace, monopoly of force) is a necessary condition for democratic representation. |
| Welfare | Welfare reduces conflicts and provides the necessary resources to produce security. | | Welfare increases the capacity and propensity to political participation (Lipset 1959; 1960; Putnam 1993; Inglehart 1997; Diamond 1999) and prolongs the life expectancy of democracies (Przerworski 2000). Clever authoritarian regimes can slow down this process (Bueno and Downs 2005). |
| Representation/ democracy | Democracies do not go to war against each other (Spanger and Wolff 2004) Domestically, they allow the non-violent resolution of conflicts (Hegre 2001; Spanger and Wolff 2004), in particular regarding redistribution (Boix 2003). | Democracies promote (or at least do not prevent) growth (Barro 1997: 49–87; Przerworski 2000, Gylfason 2006). The same holds for democratic transitions (Rodrik and Wacziarg 2005). Democracies control monopolies (Olson 2000), promote social justice (Merkel and Krück 2003) and offer a better supply of public goods, including social peace (Kurzman et al. 2002). They They attract more foreign direct investment (Jensen 2003) and make aid more effective (Kosack 2003). | |

The syndrome of interdependent and mutually reinforcing state failures is the consequence of various historical influences, in particular the legacy of communism. Communist dictatorships hardly cared about democracy except in name and were not able to deliver sustainable prosperity in spite of some apparently high growth before 1980 while security was achieved by brutal repression through an oversized military and police apparatus. Almost by definition, a transition towards democratic market economies should have improved this situation by guaranteeing representation, opening up opportunities for economic development and creating the political institutions to solve conflicts peacefully.

Actually, progress in transition is closely correlated with economic success (as given in table 1). The indicators on economic transition given by the yearly Transition Reports of the EBRD show this with regard to economic transition. More complex assessments of political and economic transition like the Bertelsmann Transformation index make the same point regarding other core state functions. Democratization measures by Freedom House confirm the same picture. (see Table 3)

**Table 3: Transition indices**

| | Bertelsmann Transformation Index | | Transition Report | Freedom House |
|---|---|---|---|---|
| **country** | political transformation | economic transformation | | |
| Czech Rep. | 9,45 | 9,00 | 33 | 2 |
| Estonia | 9,40 | 9,18 | 34 | 2 |
| Hungary | 9,40 | 8,93 | 35 | 2 |
| Latvia | 9,90 | 7,43 | 32 | 2 |
| Lithuania | 9,25 | 8,79 | 32 | 2 |
| Poland | 9,20 | 8,61 | 33 | 2 |
| Slovakia | 9,20 | 8,93 | 33 | 2 |
| Slovenia | 9,55 | 9,36 | 33 | 2 |
| Bulgaria | 8,45 | 7,50 | 31 | 3 |
| Romania | 8,20 | 7,57 | 28 | 4 |
| Albania | 7,25 | 5,96 | 26 | 6 |
| Bosnia and Hercegovina | 6,80 | 6,43 | 24 | 7 |
| Croatia | 9,10 | 8,32 | 30 | 4 |
| Macedonia | 7,55 | 6,61 | 26 | 6 |
| Serbia and Montenegro | 7,40 | 6,50 | 24 | 5 |
| Armenia | 6,10 | 6,43 | 27 | 9 |
| Azerbaijan | 3,80 | 5,21 | 24 | 11 |
| Georgia | 6,10 | 5,36 | 27 | 6 |
| Belarus | 3,97 | 4,96 | 16 | 13 |
| Moldova | 5,40 | 4,71 | 25 | 7 |
| Russia | 5,70 | 6,57 | 26 | 11 |
| Ukraine | 7,10 | 6,82 | 25 | 5 |
| Kazakhstan | 4,18 | 6,79 | 25 | 11 |
| Tajikistan | 3,60 | 3,39 | 21 | 11 |
| Uzbekistan | 3,13 | 3,79 | 21 | 14 |
| Kyrgyzstan | 4,08 | 5,43 | 26 | 9 |
| Turkmenistan | 2,58 | 3,82 | 12 | 14 |

*Source*: Columns 2 and 3: BertelsmannTransformation Index 2006, Gütersloh (www.bertelsmann-transformation-index.de) Values range from 1–10 (democracy and market economy), with 10 “perfect”.
Column 4: EBRD Transition Report 2005, p.4. Values give the sum of 9 indicators each ranging from 1 (=planned economy) to 4 (market economy); subsequently the sum varies from a minimum of 9 to a maximum of 36.
Column 5: http://www.freedomhouse.org/template.cfm?page=15&year=2005 Values give the sum of 2 indicators (political rights and civil liberties) each ranging from 1 (free) to 7 (dictatorship); subsequently the sum varies from a minimum of 2 to a maximum of 14.

Why did these countries perform so differently and what are the causes of slow or lacking democratization and development? The next section 1.2 intends to give some answers.

### 1.2 Rentier economies as impediments to democratization and development

Table 2 presents substantial evidence which supports the mutual positive feed-back of democratization and economic development. Obviously, such a virtuous circle does not always work as economically successful authoritarian regimes such as China, Vietnam or Saudi Arabia prove (Bueno and Downs 2005). It is useful to look at some intervening variables. According to Boix (2003) and Acemoglu and Robinson (2006) two factors basically determine the political system of a society: the extent of inequality in income and wealth distribution and the structure and character of wealth. This second factor – "asset specificity" – distinguishes between societies in which the wealth of the rich is resources-bound (for example, land, minerals, oil) and those in which it is predominantly mobile (for example, financial capital).

If inequality is great and assets immobile the rich fight against democratization since they fear that the poor majority would force through redistribution by taxation (or even expropriation). If inequality is modest, however, and assets quite mobile moderate taxation is to be expected since otherwise the assets will flee. In that case democratization is probable. In poor agrarian societies above all the distribution of land – that is, immobile capital – plays an important role. The rich elites compare the costs of democratization with the costs of oppression, which will increase with the strength of the opposition. The second major factor determining democratization is the willingness of societies to start a conflict in order to change institutions and policies (Acemoglu and Robinson 2006; Burnell 2004). In particular, a functioning civil society internally or external pressure can increase the costs of continuing authoritarian governance and make democratization more attractive.

More generally, it is the extent to which a country is a rentier economy which strongly influences its economic and political development. Rentier economies are societies in which a large proportion of incomes is the result of rents rather than of work and innovation in the form of wages and profits. More specifically, a large part of government revenue consists of rents rather than taxes on wages and profits. Rents usually originate from various sources, such as natural resources, foreign aid (so-called "geopolitical rent"), or contrived rent through political manipulation of prices (Auty 2006). Such rents are well known from classical economics where they are used to explain differences between equilibrium prices under perfect competition and "value," such as the consumer surplus or monopoly rents or rent from land. To the extent that these monopolies are created by public policies, including the protection of certain property rights, they usually lead to rent-seeking behavior on the part of economic agents. They can increase their income thanks to protection by barriers to entry or trade barriers and are willing and able to bribe government officials to get it. Corruption is thus often rife in rentier economies.

States often intervene in markets in order to change the distribution of income by allowing rents, which are often easier to legitimate or to hide than direct subsidies or transfer payments. Democratic market economies, too, are obviously not free of rents. Elsenhans (2001) gives a broader definition of rents as income beyond the equilibrium income of production factors as determined by productivity. In many poor countries, the "marginal" population, whose productivity is below its reproduction costs, relies on rents to survive. This more general type of rents can also be found in developed democratic market economies in the form of welfare payments to less productive citizens (handicapped, sick, elderly, unemployed). Neglecting these nuances, Table 4 presents some stylized characteristics of authoritarian rentier economies by comparing them with democratic market economies.

**Table 4: A comparison of two ideal-type political economies**

| | **Democratic market economy** | **Authoritarian rentier economy** |
|---|---|---|
| Government | Elected, accountable | Self-appointed elites, without accountability and responsibility |
| Status of citizens | Citizens with rights, in particular the right to vote | Subjects and victims of violence, members of patronage networks |
| Change of government | Competitive, free, fair elections | Heritage, putsch, revolution, regime change |
| Opposition | Legal political parties and civil society, decentralised power | Illegal resistance movements, (regional) warlords |
| Media | Pluralistic, critical | Censored, *gleichgeschaltet* |
| State revenue | Taxes | Rents (customs duties, commodities, aid) |
| Beneficiaries of state activities | More or less everybody: (changing) majorities, protection of minorities | Patronage networks based on families, ethnicity, religion, or region (nepotism) |
| Public administration | Rational bureaucracy; occasional corruption | Part of the patronage network, endemic corruption |
| Major source of income | Labor and entrepreneurship | Access to rents, jobs in the state sector, politically protected and controlled market niches |
| Shadow economy | Increasing, but still below 20% of GDP | A major pillar of the survival strategies of the population |
| Foreign economic relations | Open, liberalized | Politically controlled, important source of rents |

*Source*: Dauderstädt (2004).

In post-communist transition economies, the process of systems change, such as the privatization of former state-owned enterprises or the establishment of new market price systems (including regulatory frameworks), creates specific opportunities for rent-seeking. In particular during the first transition phase there are enormous opportunities for the private appropriation of former state-owned assets while hard budgetary constraints are not yet in place (Ganev 2005; Hellman 1998; Knaus 2006; Wittkowsky 2006). In the end, transitions stopped and polities remained stuck in constellations characterized as “feckless pluralism” or “dominant-power politics” (Carothers 2002) or, even worse, collapsed into violent conflict and civil war as happened in the Balkans and the Caucasus.

Violent conflicts may result from a sudden end of repression when the societal conditions for democracy are weak. Free elections require functioning institutions (minority rights, checks and balances) which in turn are not legitimate unless they result from or are confirmed by elected representative bodies. In the absence of that democratic institutional framework, voting may lead once more to violence (Snyder 2000) or to illiberal democracies (Zakaria 2003). The availability of rents may, if not trigger, at least sustain violent conflicts. The distribution of rents is likely to provoke greed and grievances: greed obviously because of the amounts involved, grievances when certain groups feel excluded. Additionally, external, international actors who want to control or exploit natural resources and the rents originating from them might cause conflicts.

Empirically, resource-rich countries have been significantly more conflict-prone than others (Berdal and Malone 2000; Sala-I-Martin and Subramanian 2003; Ross 2004). Collier and Hoeffler (2006) have shown that the duration of civil wars depends on the availability of ways of financing rebel armies. Sources of finance usually include natural resources, smuggling, drugs, and the arms trade, which all benefit from rents, the latter from rents originating from government policies that limit supply. The high incidence of conflicts, civil war, and terrorism in rentier economies makes these resource-rich countries more likely to be subject to international intervention. Interventions by the international community in the case of state failure, civil war, or terrorism sometimes result in the establishment of protectorates.

Within Wider Europe, the degree to which societies fit the "ideal-type" authoritarian rent economy described in table 4 varies substantially, too (see table 5). Politically, they range from dictatorships like some Central Asian republics to semi-authoritarian regimes such as Belarus, and more or less defective democracies (Merkel 1999) like Albania, Russia, Ukraine, the Caucasian republics or Turkey. Economically, the countries of East Central Europe tend to be more industrialized and tax-based with relatively open economies and a regulation-based public administration. Less developed countries in Central Asia depend much more on revenues from commodity exports and aid which in turn feed their patronage systems.

**Table 5: Indicators of rent seeking in the neighbouring economies**

| | Share of commodities in total exports | Taxes on international trade as a share of total government revenue | Non tax revenue as a share of total government revenue | Import duties as a share of total tax revenue | aid (as a share of state expenditure) |
|---|---:|---:|---:|---:|---:|
| Euroland | 5 | 0 | 7 | - | - |
| 8 accession countries | 9 | 1,9 | 8,2 | 1,6 | 2,8 |
| Bulgaria + Romania | 18 | 3 | 16 | 3 | 6,3 |
| Western Balkan | 11,2 | 10,5 | 14 | 6,8 | 1,3 |
| Ukraine, Belarus, Moldova | 10 | 5 | 12,3 | 4,7 | 13,7* |
| Russia | 62 | 13 | 15 | 5 | 1,5 |
| Kaukasus | 62 | 8 | 5 | 7,5 | 82,7** |
| Central Asia | 57 | 7,7 | 11,3 | 7,6 | 66,8*** |

* because of Moldova (35%); Ukraine 4,7%, Belarus 1,1. ** only Georgia (lack of data);
*** only Kazakhstan (4,6%) and Tajikistan: 129%!
Source: Calculations by Marius Kaiser using data from World Bank „World Development Indicators" 2003;
Caution: These are unweighted averages within groups of countries and data have not been available in all cases.

Any attempt to promote further transition in these societies has to take into account the political economies on which they are based. Although they differ in size, there is always a modern sector that largely follows the rules of the formal global economy. However, it often consists of foreign investments, mostly in the raw materials sector and to a lesser extent in manufacturing and services. Besides the modern formal sector, there is a huge informal sector, including subsistence agriculture. The output of the informal sector allows many people to survive on extremely low wages. The public sector follows formal rules, but since they are often ambiguous and not adequate or enforceable, they barely conceal the endemic corruption and patronage which represent the true access paths to public goods. As this paper will argue, most policies of rich democracies assume markets and administrative and political structures that work rationally and follow the rules; as a result, they are bound to fail or to produce unintended consequences.

## 2. Policies to promote transition: Embedding markets, building states

Although the specific goal of promoting transition is relatively new and largely a result from the collapse of communism, the policies used to achieve that goal are, to a large extent, not new but traditional policies formerly adopted in the context of development cooperation. They aimed at correcting state failures (before the name) albeit largely focusing on economic development while the promotion of democracy and security was subordinated to the imperatives of the cold war. Early cases of promoting transition in the current meaning were the Mediterranean countries Greece, Portugal and Spain in the 1970s. After the collapse of communism, democracy and the market economy have been presented as panaceas to all the problems of the world. Given the interdependence of democracy and prosperity (see Table 2), turning all neighboring countries into democratic market economies has seemed the optimal way of producing stability.

All policies to promote transition involve not only governments, states and intergovernmental organizations, but also private actors (business, civil society) on both sides, within the EU and within the transition countries. Public policies include multilateral policies (by the UN, World Bank, IMF, WTO, and so on) that provide not only financial and technical assistance, but create a regulatory international environment that interferes substantially and deeply with domestic economic policy. Those multilateral activities are complemented by bilateral public policies that co-shape the economic development of the partner countries. The regulatory and policy framework created by multilateral and bilateral cooperation is filled by the activities of private enterprises (banks, investors, traders, and so on). Most public policies are designed to promote specific behavior on the part of the private sector, above all trade and investment. In fact, some private sector activities might rather harm than increase the welfare of the partner countries. In any case, most transnational activities, be they private or public, affect different groups and segments of the partner societies and economies differently, and will, in particular, redistribute wealth and income not only between but also within countries. Those effects usually lead to political conflicts that need further political management at the national or international level.

In this context, it rapidly became clear that the willingness and capacity to go through that transition varied widely within Central and Eastern Europe depending both on the domestic political dynamics and on the EU’s offer of accession. Both factors are difficult to separate as accession was conditional on a successful transition and, at the same time, the prospect of accession provided the strongest incentive to transition. While that virtuous circle worked well in the now new member states the traditional EU policies of trade, aid and political dialogue have coincided with slow or even reverting transitions in the CIS countries. In the former Yugoslavia, ethnic strife required a completely different response. Military intervention for humanitarian reasons had to complement the traditional toolset of non-violent democracy promotion and economic cooperation. It led to the establishment of protectorates in which rich democracies not only provided assistance to correct the two core state functions of welfare and representation (for example, by financial cooperation or election monitoring), but also to assure the third function of security, thus severely limiting the sovereignty of the occupied territories and returning to a form of, albeit liberal, imperialism.

In the following subsections we analyze the different policies the EU uses to promote transition. We start with the economic dimension and continue with the political one. If – as argued above – economic development leads to democratization every boost given to such development is also an indirect boost to democracy. This applies even more to economic support for young democracies since there is a closer connection between the survival of a democracy and its socio-economic performance. Support for young democracies is politically unproblematic. Supporting authoritarian regimes in their economic development, however, causes problems which, however, were and are readily overcome on geostrategic grounds – above all in the Cold War and today in the ‘War against Terror’. Whoever argues that dictatorships should not be supported or even should be punished must weigh up whether he might thereby be contributing to the perpetuation of the authoritarian regime in question. Proposals (for example, López 2000) to exert pressure on dictatorships through economic sanctions are therefore at least partly counterproductive since they check modernization and development processes which would increase the likelihood of democratization (Boix and Stokes 2003: 517–518). Conversely, there are certain liberal policies aiming at economic modernization which endanger democratization by undermining state capacities in favor of free markets. Such risks will be briefly discussed in the following section where appropriate.

**2.1. Creating and embedding markets**

Economic growth has historically been achieved by planned economies and authoritarian regimes, at least over certain periods, which indicates that neither free markets nor democracy is a necessary condition for growth. Still, in the long run, market economies and democracies are highly correlated with economic development (see section 1). However, market economies come in many "varieties of capitalism" (Albert 1992, Hall and Soskice 2001) which have showed a corresponding variety of performances. The most successful poor economies (including transition economies) used highly interventionist models of capitalism shaped by a developmental state. In Central and Eastern Europe, state intervention in the economy was held in low esteem after the communist experience. Since 1990, economic development has been volatile, and many countries have not yet regained the income levels of 1989, i.e. before the transition started. To a large extent, lack of growth coincided with sluggish reforms and slow transition.

External actors wanting to promote economic development traditionally used or proposed the following instruments: trade liberalization (2.1.1), foreign direct investment (2.1.2), capital account liberalization (2.1.3), migration (2.1.4), which relied preferably on private actors to take advantage of increases market opportunities. Given certain market failures and rising awareness that markets need to be embedded and regulated by public institutions (Amsden 1994), these policies were accompanied by aid (2.1.5) and political dialogue (2.1.6). The most important instrument, however, has been EU enlargement (2.1.7) with its offer to join the Single Market and, eventually, the European Monetary Union by adopting the Euro (2.1.8)

*2.1.1 Trade liberalization*

Trade liberalization is a corner stone of European integration within the EU (Single or Internal Market) and towards its neighbors. It points in two directions: first, the transition countries can and should open their markets; second, the EU opens its markets in order to offer the transition countries export opportunities.

The transition countries can take the first step themselves (for example, Estonia after 1992). According to classical trade theory such a dismantling of trade barriers at any rate increases prosperity, regardless of whether the (rich) trading partners really make market access easier or not. The assumed increase in prosperity requires, of course, that there is full employment and that the factors of production (above all, labour) released from the enterprises ruined by cheaper imports find new employment in other, mainly export-oriented economic activities. Already in the classical Ricardo model, however, free trade increases productivity which is likely to imply labour savings (fall in employment). Apart from that, a redistribution of wealth occurs between producers and consumers in the opening economy.

Alongside this probable increase in prosperity which obviously occurs only under certain conditions the advocates of free trade hope for a reduction in corruption and a drying up of rental sources, which often arise from the political-bureaucratic control of foreign trade (Sandholtz and Gray 2003). More important are the expected dynamic effects, consisting in the efforts of the domestic economy triggered by import competition. However, heightened competition can also lead to a decline in local suppliers, as well as to an accelerated passage along the *learning curve*. The experiences of successful countries such as Japan, Korea and Taiwan rather show that an appropriate measure of protectionism also belongs to catch-up and modernization processes. If a state forgoes the regulation of trade-determined redistribution of income it is likely to lose its general management capability and legitimation (Rodrik 2001).

The second step – the opening up of the EU market – offers transition countries obvious opportunities. In the ideal case, demand for the abundant low-skilled labour would increase in the transition countries. They would profit from liberalization by which inequality would decrease and opportunities for democratization increase (Boix 2003: 142–143). In the EU the converse mechanism (stronger demand for skilled labour, weaker for unskilled) would increase inequality (Reuveny and Li 2003: 579).

All these effects are usually overestimated, however, for a number of reasons: (1)The EU is protectionist in important but sensitive economic branches (including agriculture, steel, textiles and clothing). They protect the very sectors in which transition countries could become competitive soonest. (2) Progressive global trade liberalization (various GATT rounds, WTO) has lowered average tariffs so much that the preference differential has clearly decreased and offered trade preferences are almost meaningless, particularly since other cost factors such as exchange and inflation rates fluctuate a lot more. (3) Opening up markets does not give rise automatically to a corresponding supply capacity in a poor country. Domestic entrepreneurs and foreign investors make their production decisions on the basis of a wealth of other factors (including quality of the labour force, legal certainty, infrastructure, meso-economic environment) which take a long time to restore. (4) A large proportion of world trade is intra-firm trade. All countries, particularly poor ones, increasingly have to attract parts of international production networks and value chains to their territory. The aforementioned factors are decisive in this.

Commodity exporting rentier economies when they wish to profit from trade liberalization have to overcome a particularly difficult obstacle: the ‘Dutch disease’. This consists in the overvaluing of the national currency on the basis of high foreign currency inflows as a result of which all other exports lose their competitiveness. Tariff reductions in rich markets as a rule do not suffice to compensate for this disadvantage.

#### *2.1.2 Foreign direct investment*

Direct investments are a way of rectifying supply weaknesses which reduce the usefulness of trade liberalization. Conversely, liberalization increases the attractiveness of a location when products for further processing can be imported tariff free and end products do not face any trade barriers in the main destination countries. Since investors have a high regard for property rights the guarantee of the rule of law is often regarded as an essential attraction for foreign investors. However, its effects are readily overvalued, above all in relation to poor countries (Kosack and Tobin 2006; Mencinger 2003; Milberg 2004; Nunnenkamp 2004). Some successful countries such as Japan, Korea and Taiwan received little foreign direct investment, while others (for example, Singapore) had a great deal of it. In the investment phase a boom can likewise lead to an overvaluation of the currency, which is eventually followed by a financial crisis if investor confidence is shaken (as happened in the Asian crisis in 1997 or in the Czech Republic in 1996). In the production phase the classical problem of indebtedness (debts cannot be serviced if the investment turns out to be un- or less profitable) does not exist, but instead the distribution of value added can turn out to be even worse than in the case of the much maligned credit financing. Foreign investors often pay higher wages than domestic enterprises, but in general foreign direct investments impair income distribution (Reuveny and Li 2003). So, for example, in Ireland the wage ratio has fallen dramatically and payments to foreign investors reduce the gross national income (=income of Irish people) by around 20% as against Irish gross domestic product (= value added in Ireland).

### *2.1.3 Liberalizing capital movements*

Liberalizing the capital account is another economic policy often suggested to transition countries. Many countries have to some extent liberalized capital movements by, among other things, allowing their citizens to hold their savings and incur debt in foreign currencies. National holdings of foreign currencies have increased substantially. The impact of this freedom on growth is ambiguous, as several crises (e.g. Czech Republic in 1996, Asia in 1997) have shown. Currency competition, combined with open capital markets, has led to high levels of real interest rates in many poor countries with comparatively weak currencies (that is, virtually all currency areas except USD, Euro, Yen, British Pound, and Swiss Franc) which in turn curtail economic growth. (Herr/Priewe 2005)

The main advantage is obviously better access to capital (foreign savings) which improves one of the supply-side conditions of economic growth. If foreign investors overestimate the profitability and underestimate risks, the influx of capital can lead to asset price bubbles and inflation in general, which are difficult to control. Rising interest rates, a usual countermeasure implemented by national monetary authorities, might even attract more foreign capital. A subsequent implosion of the bubble often triggers a more profound recession than the fundamentals of the economy justify. A further disadvantage is the real appreciation of the national currency, either by the aforementioned inflation or by a stronger exchange rate, which reduces competitiveness and increases imports. The backlash, when foreign and domestic investors realize the decline of sales opportunities, can lead to capital flight. Since nationals, in such an open economy, can also move their savings into other currencies, capital flight can turn into a run on the national currency and exacerbate the crisis (Crook 2003).

### *2.1.4 Migration*

The EU's immigration policy has been ambiguous due to the high level of unemployment in many old member states. Even the new member states are subject to transitory clauses regarding the free movement of labor. The allowing of migration is economically a mixed form of support since it also takes away important human capital from the country of origin. By reducing the labor supply migration can contribute to alleviate the marginality problem. Moreover, the remittances of guest workers, however, represent an important source of foreign currency for many countries of origin by means of which economic development is boosted in a decentralized fashion. After their return (if they in fact return) immigrants can contribute to the modernization process by means of the political and economic experiences of democracies and the corresponding expectations they bring with them. The admission abroad of victims of persecution on the one hand offers authoritarian regimes a practical safety valve by means of which to thin out the opposition, but it also makes possible the formation of groups of exiles who can influence the democratization process at home.

### *2.1.5 Technical and financial assistance*

Transition assistance continued a long tradition of development aid based on financial and technical cooperation. The EU started large programs like PHARE and TACIS. Almost all rich democracies offered aid programs albeit with different profiles and priorities (Dauderstädt 1996). Most of these efforts are subject to the same criticisms that apply to development aid in general. At the latest in the 1980s liberal critics (Bauer 1981) had pointed to the ineffectiveness, even the harmfulness of development aid. Experience shows that there is no connection between aid received and growth (World Bank 1998; 2001). That did not and does not exclude positive effects in the immediate environment of particular projects. More recent studies are more positive, although they discern a slight negative effect in very poor countries with a low degree of human development (*Human Development Index* – HDI), while in less poor countries with higher HDI the effect is positive (Kosack and Tobin 2006). Common to all analyses ultimately is that aid has a positive effect when the recipient country pursues ‘good’ policies and possesses ‘good’ institutions.

If that does not apply, development aid inflows lead only to another variant of the Dutch disease and become a source of rent incomes. Aid flows in the first place to governments and so to the elites who are mainly responsible for the underdevelopment of their country and are the main beneficiaries from the situation. Traditionally development cooperation was rarely able to free itself of the predominance of foreign-policy, economic and institutional constraints and to really force through developmental policies and institutions against the ruling elites in the recipient countries there. This demand was formulated at the latest in the 1980s and the instrument of choice was political dialogue (see section 2.1.6).

In summary, economic instruments reveal themselves to be contradictory. Trade policy and capital inflows (including aid) only work in a political field in which a development-oriented state seeks stability and appropriate distribution structures (for example, East Asia). There economic development does lead to democratization in the long run. In the course of economic liberalization necessary state control capacities should not be undermined. Among other less-development-orientated states the political conditions for successful development and effective aid must first be created.

### *2.1.6 Economic policy dialogue*

Political dialogue continued what the International Monetary Fund, in debt crises in relation to short-term fiscal, monetary and currency policies, and the World Bank, with its structural adjustment programmes in the medium term, had long been doing. In this the donors linked pledges of credit to conditions (conditionality) which mostly demanded a mix of policies known as the *Washington Consensus*. It included a solid monetary and fiscal policy, and often devaluation, trade liberalization, deregulation and privatization.

The successes were rather modest. One of the main problems was coordinating the different donors which often pursued different interests. This divergence of interests has diminished, but not ceased since the end of the Cold War. The second core problem was the reduced effect when proposed reforms collided with strong elite interests in the partner countries. Often only superficial reforms supervened which formally created new economic freedoms which, however, were not used or again were used only by the still powerful elites. This has led to demands for political reforms in the narrower sense (participation, democracy) being more strongly expressed in dialogue (Spanger and Wolff 2003).

The major content of the political dialogue, the *Washington Consensus*, has anyway lost much of his convincing appeal as model pupils such as Argentina have failed miserably after initial successes. Major studies (Herr/Priewe 2005; Isham 2005) show that many of its policy prescriptions are doubtful and some obvious success stories such as China seem to follow a quite different strategy (already named *Beijing Consensus*).

Not least, in transition economies, liberal reforms have led and continue to lead frequently to a strengthening of inequality when powerful actors translate political power into market power. This could be seen very clearly in the post-communist transition societies in which income and wealth distribution deteriorated dramatically. The withdrawal of the state from economic policy often demanded by liberal advisers undermines their capacity for action and legitimation in other important areas (Fukuyama 2004). With that, however, the prospects of a sustainable democratization diminish.

#### *2.1.7 EU accession*

EU accession has been the strongest incentive to complete transition for all candidate countries. The success of the new member states and the progress of other applicants confirms this. EU membership not only required the transition to a market economy but also shaped the specific variety of capitalism of the new member states. The question, however, remains if this variety is the optimal environment and foundation for rapid catch-up growth.

Theoretically, EU membership affects the chances for growth in an ambiguous way. From a free market perspective, the EU is overregulated and requires suboptimal policies from its members (Achten 1996, Jamieson and Szamuely 1998). Liberal Estonia, for instance, had to introduce customs tariffs and agricultural subsidies in order to join the EU. From a developmental perspective, the EU prevents certain policies which have been successfully used by Asian tigers such as protected export promotion, managed capital markets, interventionist industrial policy or strategic undervaluation of the currency (Amsden 1994, Eatwell et al. 1997, Wade 2005).

Empirically, the experience of poor countries which joined the EU has been mixed, too. In the short term, the new member states performed well, but in the long term, their success will depend more on the EU. While the EU has aimed at reducing income disparities among its regions and countries, it did so without much success. Already after its first enlargement, in 1972, the EU (then EEC) started its regional policy in order to improve social and economic cohesion. In spite of huge expenditures, income disparities between regions could not be reduced (Europäische Kommission 2001, 2004; Funck and Pizzati2003; Tarschys 2003). Some regions which received outstandingly high amounts of aid from both, the EU and its own central government, such as the Mezzogiorno (Southern Italy) or Eastern Germany, remained poor and with high unemployment. There has been some convergence of income levels between member states while disparities within member states increased. That convergence occurred during the late 1990s and was due to the monetary union (and not to regional policy). Monetary union decreased interest rates in the poorer member states which in turn led to higher investment, consumption and growth.

Ireland’s economic miracle is the main and highly ambiguous exception to the rule of slow convergence within the EU. Ireland increased its per capita GDP from 79% of the EU average in 1995 to 142% in 2005. It achieved this outstanding performance by the clever use of EU funds to create a good infrastructure and to train the workforce and by attracting large amounts of foreign direct investment (FDI) by offering low corporate taxes. Multinationals have located various activities to Ireland and increased the locally registered value added through transfer pricing in order to save taxes. The Irish success is paid by the Irish people whose national income is 20% lower than its GDP (these 20% are profits transferred abroad) and by workers and treasuries in other countries who lost their jobs and tax revenues. (Dauderstädt and Witte 2001).

*2.1.8 Adopting the Euro*

Transition countries' catching up depends not only on productivity growth and structural change but it also implies closing the income gap (see table 1) by means of a real appreciation of the local currency, which can occur through higher inflation and/or nominal appreciation (revaluation). Historically, growth in the external value of the local currency has been responsible for a large proportion of overall catch-up (Artner and Inotai 1997). The exchange rate policy of transition countries has to carefully balance the risks of overvaluation and undervaluation. Undervaluation ensures price competitiveness and thus increases export demand. It also allows lower domestic interest rates. But a low external value foregoes potential welfare gains and can harm employment in the EU which is the main market for the transition countries' exports. Overvaluation, on the other side, endangers competitiveness and can destroy jobs in the exposed sector. A liberalized capital account (see section 2.1.3) can increase these risks when international investors and speculative capital flows drive the exchange rate up or down beyond realistic productivity and inflation differentials.

Countries and international financial institutions have recommended and tried various exchange rate regimes in order to prevent such crises. All regimes have their advantages and disadvantages. Historically, the Bretton Woods system of fixed exchange rates and state-controlled capital accounts has presided over a period of strong convergence and high growth on the European and Asian periphery. The collapse of the Bretton Woods system in 1972 coincided with the start of a period of lower growth and less convergence, though the causality remains an open question. In a fixed exchange rate regime, catching-up works through higher real growth plus higher inflation, while in a flexible exchange rate regime the nominal appreciation of the currency is possible and more important. Flexible exchange rates, however, bring with them the risk of overshooting and massive shocks to the real economy.

In the present system, most countries have, according to the conventional wisdom, the choice between flexible rates or a strong fix by a currency board or even the adoption of a strong currency like the USD or the Euro instead of their national currency. Intermediate solutions like a peg are considered risky because they are virtually impossible to defend against strong trends in global financial markets. Different exchange rate regimes imply different roles for national monetary policy and different ways of managing the balance between nominal and real convergence. For the neighbouring countries which usually trade chiefly with the EU the exchange rate vis-à-vis the Euro is most important. As already mentioned, the intra-EU periphery (that is, Greece, Spain, Portugal, Ireland) has benefited substantially from joining Economic and Monetary Union, which has brought about low real interest rates. Adopting the Euro is thus a very attractive option, though basically only for the new member states. Actually, some transition "countries" such as Montenegro or Kosovo use the Euro while others have pegged their currencies to the Euro and/or have currency boards.

### 2.2 Building and transforming states

Democratization has been the other core component of transition – besides the establishment of a market economy. While promoting economic development is, at least in the long term, a no-regret strategy for democratization, policies aiming at building or transforming states depend on the stage of the democratization process. Democracy assistance in the narrow sense (2.2.2) aims at building institutions and supporting democratic forces. In the extreme cases of state collapse or massive state failures, state building by the international community (2.2.3) is a necessary prerequisite for democratization. In the case of authoritarian states, cooperation and political dialogue can use carrots and sticks to promote not only economic but also political liberalization (2.2.1). In the case of more or less democratic regimes, cooperation will primarily aim at improving governance in order to increase the legitimacy of the regime. Better economic results due to better economic policies help stabilizing democratic regimes and improve the chances of democratization of authoritarian regimes (see above section 2.1). In Central and Eastern Europe, the offer of EU membership has been a strong incentive to democratize (see 2.2.4).

### *2.2.1 Political dialogue*

The right choice of carrots and sticks depends on an accurate knowledge of development dynamics and the phase of the transition process. Dalpino (2000) argues that in the case of incipient liberalization (also when democratization in the narrower sense is not planned) above all cautious, cooperative strategies are more helpful, while the direct demand for democracy can be counterproductive. Risse et al. (2002: 198ff) show on the example of the imposition of international human rights norms that sanctions are effective above all when they create room for already existing and mobilized civil society opposition groups. If, on the other hand, the government still has the situation under control material sanctions can even have a counterproductive effect. Sovereignty itself is a major obstacle to the enforcement of democratic reforms (Schwarz 2004) On the other hand, in phases of transition in which the government makes concessions sanctions must give way to incentives, positive support and dialogue, in order to boost – almost pro-cyclically – opening-up processes. The fact that economic sanctions have historically been only a partly effective instrument (Hufbaur and Oegg 2001) may presumably be attributed to the poorly targeted use of this instrument.

With this the central problem on the donor side is addressed which above all applies to negative measures (diplomatic pressure, economic sanctions): a coherent and consistent policy will usually not be generally realized on the grounds of the priority of economic and strategic interests (see Herman and Piccone 2002: 11; see also, however, the more positive results of Hazelzet 2001). Against this background the indirect path of influence plays an important role: i.e. via non-state actors which operate at the interface between civil society and the political system, support parties and democratic forces and promote political dialogue and in comparison to governments have to pay less attention to other foreign-policy interests.

### *2.2.2 Democracy assistance*

Assistance in the building of democratic institutions begins rather with the founding norms and regulations which determine how political conflict concerning power, distribution of resources and legitimation unfolds. The field of action is broad and encompasses assistance in the drafting of a democratic constitution, the preparation and implementation of elections, the building of rule-of-law institutions and parliamentary bodies, as well as local government structures and reforms of the security sector corresponding with democratic rules. Outside the state itself, it encompasses the assistance to political parties and organizations of the civil society that underpin the democratic state by articulating interests and transmitting them into the state (Carothers 1999, Diamond 1999, Santiso 2001; Sandschneider 2003).

In the application of these instruments, consequently, the challenge of choosing target groups arises to a lesser extent since not political actors but rather structures are in the foreground. The intervention problematic is likewise less distinctive since as a rule institutional reform is carried out with the consent of the ruling elites. However, it is a challenge to take proper account of specific interests, conflicts and power relations and to avoid a technical application of pre-established models (see also Carothers 1999: 333f). Democratic institutions must be adapted to the respective societal conditions and problems. This applies particularly to ‘divided societies’ with ethnic cleavages or even conflicts and a lack of collective identity. Precisely during periods of democratic transition the demands of individual ethnic groups may gain impetus and ethnicisation and even conflicts grow (Snyder 2000). Models of democracy introduced in an attempt to do justice to ethnic cleavages and group boundaries can also contribute to consolidate these boundaries (Pfaff-Czarnecka 2004). Existing power relations and identity structures are also to be taken into account when it comes to institutional solutions for giving equal rights to women.

### *2.2.3 Intervention and protectorates in conflict-ridden societies*

In some conflict zones, where genocide, war or terrorism was to be feared, the international community intervened and used force in order to protect human lives and rights, to impose democracy, and to promote reconstruction and development. The ensuing protectorates such as Bosnia, Kosovo, let alone Afghanistan or Iraq had mixed results. The term "protectorates" is used here to describe territories that are under international administration. Thus, sovereignty in protectorates is often limited and core state functions such as security or economic policy are executed by international agents. Usually, protectorates suffer from political and economic problems that make the transition towards a democratic market economy particularly difficult:

Politically, the intervening powers remained the rulers of last resort, cancelling laws made and decisions taken by democratically elected domestic bodies if they opposed their goals and principles. The resulting regime has been called liberal imperialism or absolutism by some observers (Knaus and Martin 2003; Schwarz 2002). At the same time, returning power, even on a low administrative level, to the purportedly less criminal, rather technocratic segments of the old elites regarded as mainly responsible for the conflicts, oppression, and human rights violations has been hardly acceptable, but often ultimately unavoidable.

Another specific feature of post-conflict societies is the need to transform former combatants into either "normal" citizens or members of the new security forces. This comes under the heading of disarmament, demobilization, and reintegration (DDR). Providing jobs to former fighters offers many opportunities for rent-seeking and patronage. Mostly, these jobs will be found in the new dual (that is, internationally sponsored) public sector. Again, economic and social problems are superseded by political ones when the income and societal position of former combatants depends on foreign aid sources.

Economically, the protectorates have produced artificial economies dependent on aid and the spending power of the occupation forces and administration. A rentier economy of a special sort emerges which depends on aid flows. The international administration is financed by international funds which flow into the territory either (1) directly into the state treasury, (2) in kind, or (3) as monetary demand for local goods and services. The prices of the latter rise dramatically, together with the incomes of those locals who could supply them (owners of decent housing, English speakers, taxi drivers, bodyguards, and so on). Locals on local incomes lose purchasing power and become relatively poorer. Usage of labour and capital switches to serve the occupiers' needs. The subsistence sector will be more and more neglected. A shift back to export-oriented and self-sustaining development seems more and more illusive as the local currency becomes over-valued due to continuous inflows of capital and inflationary pressures stemming from the occupiers' demand overhang. The economy sucks in imports and has no competitive exports to offer.

The distorting effects of international spending are so great because their value is so high in comparison with national spending. The huge discrepancies between the per capita incomes of the rich countries which usually intervene and those of the poor countries where intervention takes place are compounded by the differences between exchange rates and purchasing power. International spending is made up largely of international salaries which tend to be even higher than domestic salaries in rich countries as they have to compensate for the costs and risks of expatriate employment and scarcer skills, such as language or intercultural competencies. Consequently, the cost of international state building is orders of magnitude higher than the usual domestic cost of running a government: The Hague tribunal costs more than the Serbian national justice budget and the cost of the American military presence in Iraq is higher than Iraq's national income (Dauderstädt 2003).

Post-conflict economies usually have different sub-economies which pose additional challenges to a transition to a market economy (Ehrke 2003; Verkoren 2006; Wennmann 2005):

- An informal economy encompassing a black market underground economy and a traditional subsistence economy – depending on the stage of development.
- A criminal sub-economy consisting of smuggling, trade in drugs and arms, and so on, often based on the militia structures of the former conflict.
- A foreign "enclave sector" catering for expatriates working for the international administration (see above).
- A small formal market economy, often marginal.
- Remnants of a state-owned public sector, in some cases from a former planned economy in which ownership status is ill-defined and a probable source of corruption, murky privatization, and/or asset stripping (Wittkowksy 2006).

This structure makes it difficult to regulate and tax economic activities. Establishing a minimum of political control may reignite old conflicts.

Post-conflict societies are usually also in need of a large reconstruction program because of the destruction they suffered during the previous conflict. Reconstruction might be funded to a large extent by foreign assistance. Not coincidentally, the term "reconstruction" forms part of the name of some of the largest international donor banks (IBRD, EBRD). The distribution of grants and credits is a potential source of patronage. In conflict-ridden societies with deep social or ethnic cleavages between former civil war enemies the decisions regarding the allocation of such aid funds are highly sensitive and could potentially trigger new conflicts. Obviously, such decisions cannot be left to the "market," that is, to private banks choosing borrowers on the basis of collateral and income prospects, leading to adverse selection. Conversely, decisions taken on political grounds risk the spending of money without getting value in the form of real reconstruction (Verkoren 2006).

### *2.2.4 EU accession*

In 1993, the EU decided at its Copenhagen summit that candidates for membership had to meet several criteria including democracy, respect for human rights, and a functioning market economy. This conditionality has accelerated and strengthened the process of democratization in all applicant countries. In some cases, domestic power struggles were strongly influenced by the EU's non-approval of certain political forces, for instance in Slovakia. EU demands were often more exacting than those made within the old member states, for instance regarding minority rights.

EU accession also had a substantial impact on state building in the candidate countries. Institutions were established and policies shaped in order to comply with the *acquis communautaire*. The EU expected accession countries not only to translate EU law into national law but also to ensure its implementation by building the necessary administrative and judicative capacities. EU regulation covers not only economic affairs such as the Single Market but, within the Second and Third Pillar, the Common Foreign and Security Policy and the Area of Freedom, Security and Justice. Accession countries thus have become subject to a process which is now widely called "Europeanization" (Agh 2003, Bohle and Greskovits 2006, Börzel and Risse 2000, Grabbe 2001, Lippert and Umbach 2005).

## 3. Prospects of transition

The preceding section 2 assessed a broad variety of policies which are supposed to promote the transition towards democratic market economies. The huge differences of performance over the region and the general poor economic results of transition raise doubts about the effectiveness of these policies. Not all policies were offered to all countries, notably the prospect of EU accession. Most policies have important repercussions within the EU, too, which are harming the interests and thus provoke the opposition of some segments of the EU societies. Nonetheless, the main cause of policy failure lies in the interaction between those policies and local conditions which are – to put it mildly – not conducive to transition. In the following two sections, this interaction will be analyzed more in depth leading to an assessment of the "toolbox". Finally, the core question of successful economic and social development will be considered in a framework of overall European economic integration.

### 3.1 Weak policies facing tough challenges

All policies achieve certain outcomes though usually far less beneficial ones than expected. Unintended side effects abound. In particular, economic liberalization often does not enhance the chances of democratization when it undermines state capacities and increases inequality. But the root cause of many policy failures are the societal structures of rentier economies presented above (see section 1). In rentier economies, large sections of the society depend on patronage networks and will support the ruling patrimonial regimes in order to secure continued economic support. A transition towards democracy and a market economy faces a double challenge. The dependent population will often continue to support and thus vote for the old rulers - at least for some time; and without substantial productivity rises and the redistribution of assets, the liberalization of the economy is likely to lead to more unemployment, poverty and inequality due to the basic marginality of many citizens. Most of the traditional instruments to assist or enforce changes from abroad have a mixed impact on basic state functions (see table 6). As mentioned before, more interventionist policies such as aid and policy dialogue, let alone EU accession might lead to democratization in formal way such as elections or democratic institutions while materially shifting power not to the people but to foreign actors. In the best case, these actors are multilateral agencies – notably the EU itself – which, however, exhibit the usual democratic deficits of all institutions of global governance: they are barely subject to judicial or parliamentary scrutiny, the executive power is correspondingly unaccountable and not transparent, and voting weights reflect state power rather than people power (are not proportionate to population size).

**Table 6:** The inadequate toolbox

| Instrument | Impact on state functions | |
|---|---|---|
| | Democracy | Prosperity |
| Trade liberalization | (+) | (+) |
| FDI | (+) liberal rights | (+) |
| Aid | + formal / – material | 0 |
| Capital account liberalization | 0 | ? |
| Adopting the Euro | 0 | ? |
| Migration | 0 | + |

| | | |
|---|---|---|
| Policy dialogue-Economics | + formal / – material | 0 |
| Policy dialogue –Politics | + formal / – material | 0 |
| Democracy Assistance | + | 0 |
| Intervention and Protectorates | – | – |
| EU accession | + formal / – material | ? |

Note: 0 means neutral, + positive, (+) weakly positive, **–** negative, ? unclear/open

Moreover, the lack of effectiveness is partly due to more fundamental conflicts of interest:

- Economically, the most effective policies to support growth in transition countries harm at least some sections of the population in EU, usually the less qualified workers and labor-intensive industries. They thus face stiff opposition, in particular at times of mass unemployment. Conversely, the continued "Dutch disease" of commodity exporting rentier economies might be in the short-term interest of countries consuming raw materials and exporting manufactured goods. International investors also benefit from risky capital account liberalization in emerging markets (Crook 2003).
- Politically, the international system continues to rely on the basic Westphalian model of sovereign states. Meddling in the internal affairs of other states still is against the basic rules although the reality of globalization has led to a real integration of societies where actors of one country widely and deeply influence the development of other countries in many fields including economics, media, politics. But the "organized hypocrisy" of sovereignty (Krasner 1999) protects the power of governments and elites on both sides and will thus be directly confronted but in extreme circumstances. Additionally, paramount foreign policy goals like the war on terror sometimes seem to require the cooperation with regimes opposed to transition.

Changing other countries from abroad is never easy. In many neighboring countries, the EU is facing a conundrum of mutually reinforcing problems that have grown over a long history and will not change easily in the short term. Interfering with local developments can do as much harm as good. In any case, the EU will exert a strong influence on the development of its neighborhood not only by deliberate policies but by the interaction of markets and societies. To shape these relations in a way that reduces risk and increases the chances of transition would be an important first step. The most crucial choice in this context concerns the offer of EU membership. Accession not only requires a rapid and profound transition but also offers the strongest incentives to complete transition.

### 3.2 Democratizing the neighborhood

The obstacles to democratization from within and from abroad are formidable. Democracy promotion therefore needs patience. It must focus on long-term structural economic and social changes rather than on hasty liberal reforms introducing formal freedoms of markets or elections that will materially be exploited by unchanged powers and interests (Czempiel 2004). The EU is looking for policies to transform authoritarian rent economies into peaceful democratic market economies. In the short term, there might be a dilemma as that transition implies a certain amount of destabilization. Regime changes seldom occur without disruption. The post-communist transition in some Central European countries was exceptional in this regard. Nation-building within the collapsed federations of the former Soviet Union and Yugoslavia was already troublesome and conflict-prone. Some societies suffer from enormous tensions that threaten to explode if they are released in an uncontrolled way. Change should occur as rapidly as possible because it is driven by the emergence of threats such as migration or crime, but also as slow as necessary. State failures have to be corrected without creating new and worse ones. Pragmatism should prevail over an ideology-driven insistence on ideal-type reforms such as elections and free markets without adequate institutional and societal foundations.

Democratization should be a long-term goal rather than an immediate concern of European stability export. There are many ways to consolidate young democracies and to support the improvement of defective democracies, ranging from diplomatic measures to democracy assistance (Carothers 1999; Burnell 2000; Diamond 1999; Youngs 2002). The institutions of more or less democratic states and those segments of civil society that support democratization can be strengthened through advice, support in kind or money, and links to like-minded partners elsewhere in the world. Appropriate auxiliary activities include promotion of the rule of law (cooperation with judiciaries and law enforcement agencies), and support for political parties, election monitoring, independent media, local and regional government, and so on. All these approaches are feasible and currently part of the EU's approach where partner countries are at least slowly opening up or already open.

The promotion of democracy becomes more difficult the less a given regime is open and the more slowly it introduces liberal reforms. In the present global political climate, most regimes at least start off with some reforms, often in the field of economic policy. Foreign actors should use low-profile approaches such as non-governmental organizations, local partners, and indirect funding, and avoid premature insistence on human rights and elections in order to promote more openness (Dalpino 2000). Approaches must be carefully adapted to the specific relationship between authoritarian regimes and their societies, which might not always be ready for democracy (Burnell 2004). Economic sanctions are ambiguous. Insofar as they lead to less growth, they undermine the long-term prospects of democracy and in the shorter term they are likely to harm the innocent majority; however, they also reduce the economic resources at the disposal of ruling elites, in particular drying up the international sources of rent income from aid or commodities. But Europe will forgo the supply of commodities only in the rare instances they can be easily substituted, as in the case of "blood diamonds" from Africa. Boycotting Russian gas or Central Asian oil is hardly a realistic option for promoting democracy there. A less radical measure could be to collect data on the international revenues (like aid and royalties from commodities) of ruling elites and make them publicly accessible, above all to the citizens of the partner countries. Informed citizens will probably demand a less selfish use of these revenues.

Elections are rarely the beginning but rather the endpoint of democratization. They should usually start at the local and regional levels where a structured public sphere exists, and issues and candidates are familiar. At the national level, they need more preparation: in the case of divided societies, credible constitutional safeguards against the oppression of minorities have to be established; political parties have to be created, with clear programmatic profiles and a sufficiently qualified cadre of politicians and experts to offer a realistic choice; the media should cover the campaign in a way that allows voters to develop their views and take an informed decision. The administrative process of voter and candidate (party) registration and election management and supervision must be transparent and accountable. A doubtful election undermines the legitimacy of parliaments and governments elected in this way.

However, the chances of democracies developing and surviving are small if the basic societal and economic conditions are missing. The probability of democratization and/or the life expectancy of democracies rises when distributional tensions are low because either income and wealth are not extremely unequally distributed or the assets are unspecific, that is, not easily expropriated or highly taxed. Societies with a very unequal distribution of very specific assets like land or commodities are unlikely to become stable democracies (Boix 2003). Further-more, legitimacy results not only from due process but also from favorable outcomes. Good governance, providing growth and social justice, is the best way to stabilize democracies (Przerworski 2000). In the long run, rapid growth will lead to modernization, urbanization, more education and information, and eventually more participation, as the East Asian countries (for example, Korea and Taiwan) have shown.

### 3.3 Promoting growth in the Wider Europe

Therefore, economic development is obviously a cornerstone of stability and the best long-term policy for democratization. Europe, however, seems hardly to be in a position to offer a model for promoting growth. Its own growth is weak, with the possible exception of Ireland. A strongly growing European economy would probably be the best help Europe could offer to its neighborhood: convergence within Europe was strongest when Western Europe grew rapidly in the 1950s and 1960s, with countries like Greece, Portugal, and even Poland catching up faster than during the 1980s (Dauderstädt and Witte 2001). A booming EU economy would offer markets for goods, services, and labor. Resistance to the adjustments required by the development of its poor neighbors would be much weaker. Europe would be more ready and willing to use the most effective policies, such as more open markets, a liberal immigration policy, and further enlargement. Unfortunately, the EU's overall performance is characterized by declining growth, stubborn unemployment and rising inequalities (see table 7).

**Table 7: Growth, unemployment and the share of wages in GDP in the EU-15**

| **Year** | **1961-1970** | **1971-1980** | **1981-1990** | **1991-2000** | **2001-2005** |
|---|---|---|---|---|---|
| Growth (in %) | 4,8 | 3,0 | 2,4 | 2,1 | 1,6 |
| Unemployment (in %) | 2,0 | 3,8 | 8,5 | 9,4 | 7,8 |
| Wage share (in % of GDP) | 72,3 | 73,9 | 72,1 | 69,2 | 68,4 |

Source: European Economy 4/2004.

These features can be explained by the effects of integration, in particular with poorer countries. The following five processes have a decisive effect on the distribution of welfare and work between poor and rich countries in the integrated Wider Europe

1. The productive Ricardo process: All countries participating in international trade increase their productivity by specializing according to their comparative advantage. Without a rise in global demand that process implies less employment.
2. The distributive Ricardo process: Employment and welfare gains are distributed between countries according to the terms of trade (i.e. exchange rates). The country with the weaker exchange rate forgoes welfare gains but wins jobs.
3. The Samuelson process: As Paul Samuelson recently showed, the rich countries' gains are likely to be reversed when the poor countries approach the productivity levels of the rich. (Samuelson 2004)
4. The Heckscher-Ohlin process: Integration also redistributes income between different groups within the countries involved and creates losers and winners of integration. In rich countries, unskilled labor will be among the losers; in poor countries, skilled labor and capital should be the losers. In the long run, factor incomes should equalize.
5. The Milberg process: All above processes neglect factor movements which accelerate and modify the same processes. Actually, multinational enterprises locate production steps at lowest-cost locations. They create transnational value chains that substitute high-wage labor by low-wage labor, increase inequality within all countries involved, and might even decrease overall productivity. (Milberg 2004)

Europe has exacerbated the impact of these processes by macroeconomic policies aiming at stability rather than growth and employment (Bofinger 2003). Europe has also relied often on the protection of traditional structures and producers. It neither easily gives up old industries that are no longer competitive nor is very dynamic in developing new industries. Jobs lost to migration, import competition, or relocation are too extensively replaced by paid leisure (early retirement, unemployment benefits) or jobs in the shadow economy rather than by new employment. While perhaps preventing social unrest this trend further undermines state finances and capacities. This way, the EU tends to create its own marginal population in the form of a poor rentier class which depends on state transfer payments because its productivity is lower than the wages it would require to have an appropriate level of reproduction within its domestic societies.

At the same time, the poor countries use their undervalued currencies, the higher domestic purchasing power of their low wages and their low taxes to strengthen their international competitiveness and to attract production to their territories. Enterprises benefit from welfare transfers from traditional sectors including subsistence farming and the public sector while this distribution limits the purchasing power of workers ands states. Subsequently, the Wider Europe faces an underconsumption syndrome which is fed by the real subsidizing of labor in the East and the welfare state rentier economy of the West which both alleviate employers from paying full reproduction wages let alone wages which grow in line with productivity and inflation and guarantee a sufficient expansion of demand to absorb the output of an increasingly productive Europe-wide production system.

Better macroeconomic management to ensure growth at home and to prevent debt crises in partner countries (as in the Czech Republic and Hungary in the mid-1990s) is a key policy with which to achieve prosperity. Such a policy should include the control of speculative capital flows and overshooting exchange rates, which should be easier thanks to the euro. More general, unfettered competition on deregulated global currency markets undermines national accumulation processes and forces peripheral countries to adopt higher interest rates as their citizens hold large shares of their assets in foreign currencies (Herr 2004). Although politically rather unrealistic, Europe could provide a more growth-inducing environment for its neighborhood if it recreated a regional Bretton-Woods-type system anchored by the euro. Europe should not avoid having trade deficits with neighboring countries and should tolerate a slight real undervaluation of their currencies. Commodity exporters such as Russia or Central Asian countries will have difficulty in achieving this without using a mix of import duties and export subsidies to correct the impact of the so-called “Dutch disease.”

The development of many resource-rich countries has been shaped by an unholy alliance of consuming states, corporate actors, and domestic elites which has served all parties rather well. It is basically the rise of conflicts and terrorism rather than concern about continued underdevelopment and poverty that has led to second thoughts on the part of the West. Its readiness to confront the two other parties of the alliance has depended to a large extent on the substitutability of the raw materials concerned and on the spillover effects of the local conflicts threatening Western interests. In some cases, campaigns by NGOs (such as the Extractive Industries Transparency Initiative or The “Publish What You Pay” Campaign) have shamed and pushed governments, multilateral organizations, and private companies into action. Enforcing transparency, accountability and democratic control over rents from natural resources or aid through institutions such as oil or aid funds could be a major step to both better economic governance and democratization within in rentier economies and protectorates (Dauderstädt/Schildberg 2006).

Successful development depends to a large extent on the prudent management of the real exchange rate. Low wages in many poor countries depend on the – in international comparison and currency – low cost of wage goods which are essential for the reproduction of the labor force such as housing, food, transport, energy. Actually, local economies and societies are subsidizing labor in the international sector such as foreign owned or export oriented domestic companies. While these subsidies might attract foreign investment and work as an intermediary step of industrial upgrading it transfers welfare to foreign investors and customers. More important is the fact that it enables producers above-average profits which is a sort of rent that might be justified if it is used to continuously modernize and upgrade production systems and processes. While East Asian developmental states have tolerated or even encouraged and enforced the flow of such rents into the emerging modern industrial sector, most rentier economies that have depended on natural resources or foreign aid wasted the rents on consumption, imports and patronage.

It is not simply "free markets" that produce competitive companies but a socio-political environment which reduces risks and transaction and information costs, and fosters trust. To accompany private sector upgrading the transition countries have to improve the meso-economic and structural conditions for growth. EU regional and structural funds are supposed to contribute to that improvement but their effects have been limited (see 2.1.7). Aid can try to assist in developing institutional structures and building capacities but it has to contend with local power structures and mentalities that are often deep rooted. Financial aid should primarily support investment in education and health care. It should aim at raising the productivity of the poor by improving their access to capital and land. Agricultural land should be redistributed to reduce inequality, which in turn makes democratization easier (Boix 2003).

The success of the EU so far is political rather than economic. The EU has accepted poor countries that emerged from fascist (Portugal, Spain, Greece) or communist (Central and Eastern Europe) dictatorships and supported their transition towards democratic market economies. But the EU did not succeed to increase rapidly the income per capita in its poor regions and member states. The continuing income disparities are now endangering growth and social stability in the enlarged EU. Enlargement will only continue when a more expansive macroeconomic policy and more intensive regulation of transnational markets ensures that the potential welfare gains are fully realized and more equally distributed.

Given the present power constellations, this leaves few options for promoting transition. The most effective strategies – such as enlargement and opening up Europe's markets (particularly its labor market) – will be neither politically acceptable nor economically beneficial under current circumstances. The creation of a growth-oriented regional currency system along Bretton-Woods lines to reduce competitive pressures on weak currencies is politically unlikely.

Given that lack of effective promotion the elites in the neighboring countries will largely follow their own interests, supported by soft European incentives. However, in the short to medium term, they might benefit from a lack of reform rather than from a transition to a democratic market economy (Hellman 1998; Walder 2003). Actively undermining their power will be diplomatically difficult and could produce even more instability, at least in the short term. Europe remains a weak regional hegemon that will be limited to its weak, soft powers of persuasion, dialogue, and small carrots and even smaller sticks. The resulting slow and gradual change might be sufficient as long as bigger threats do not enforce a radical reordering of the EU's priorities.

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