The EU Anchor Thesis:
Transition from Socialism, Institutional Vacuum
and Membership in the European Union

Nauro F Campos
UCL, ETH and IZA
n.campos@ucl.ac.uk

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One of the strongest stylized facts of the transition is also one of the most unexpected: after 1989 Central and Eastern European and Former Soviet Union countries diverged massively. Institutions are a main reason. The EU anchor thesis posits that the prospect of membership in the European Union (EU) played a key role in filling in the institutional vacuum that followed the collapse of socialism. This chapter examines this thesis and assesses the relevant bodies of evidence, focusing on whether the prospect of EU membership accelerated institutional development and, if so, whether this was indeed associated with improved economic outcomes.

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1. Introduction

The biggest enlargement in the history of the European Union (EU) took place less than twenty years ago. Few anticipated it would so clearly mark the end of the transition from socialism as well as so fundamentally transform the European economy and the European Union.

The fall of the Berlin Wall is one the defining moments of the 20th century. It signposts the beginning of the end of the socialist experiment in Eastern Europe. This collapse was a process that took almost two years to complete. It ended with the implosion of the Soviet Union in 1991. This collapse marks the beginning of a fundamental transition from state socialism to market capitalism, from authoritarian centrally-planned economies to democratic regimes supported by market-oriented economies (Roland 2000).

The Eastern Enlargement, when eight former Soviet Bloc countries became fully-fledged EU members in May 2004, brings the transition from socialism that started in 1989-91 to a close. Why? Because a wedge opened between Central and Eastern European (CEE) and former Soviet Union countries (FSU). This great divide became perhaps the most robust stylized fact of the transition despite being among the least expected at the beginning of the process (Berglof and Bolton 2002). Central and Eastern European starkly diverged from former Soviet Union countries despite being broadly comparable across many dimensions, including per capita incomes. In CEE, the fall in per capita output was substantially smaller than in the countries that emerged from the Soviet Union, reform programs went deeper, privatisation programs were more extensive, labour markets adjusted earlier, financial sectors emerged faster, international trade re-orientation was swifter, democracies matured quicker, and the happiness gap closed first. Institutions provide one of the key explanations for this divergence.

What were the key stylised facts that characterised the period from the fall of the Berlin

Wall to the 2004 Enlargement? Campos and Coricelli (2002) identify seven key stylised facts. There was a large output contraction accompanied by massive capital depreciation and huge changes in the labour force. There was substantial structural change and re-orientation of international trade. There were a rise in poverty and inequality, both were practically inexistant before then. They also tried to call attention, early on, on the fact that a defining stylized fact of transition in its first decade was the emergence of what they called an "institutional vacuum."

Although it was clear that a wedge was developing, few would have imagined the role EU membership would end up playing in its creation. We now know that for those countries that did not join the EU, the institutional vacuum remains. Because of EU accession, the wedge developed. On one side, economic dynamism and institutional renewal; on the other side, economic stagnation (chiefly for those countries without natural resources) and institutional vacuum. While at the start of their transition FSU countries had, for instance, incomes per capita marginally lower than those in CEE that eventually joined the EU, the gap that opened since is yet to close.

The EU Anchor thesis posits that the prospect of membership in the European Union played a key role in filling in the institutional vacuum that followed the collapse of socialism (Berglof and Roland, 1997, 2000; Roland and Verdier 2003). Because such prospect was higher in Central and Eastern European countries than in the former Soviet Union countries, the gap between the two groups of countries grew.

What was the impact of the 2004 EU enlargement on the New Member States? Accession was instrumental: it meant better institutions, more labour mobility, more trade, better integration in global value chains, greater levels of technological development. The negotiations for EU membership helped not just to anchor but also to fine-tune institutional change. Financial integration fuelled this exceptionality by facilitating capital and people flows (Friedrich et al

2013).

In turn, the EU also changed enormously because of the 2004 enlargement. Diversity across member countries increased sharply: the lowest GDP per capita was 67% of EU average before enlargement and decreased to 48% afterwards. Labour mobility increased and Europe witnessed an unprecedented rise in cross-border banking acquisitions in new members. Deeper integration of both capital and labour, together with a push for more democracy and efficiency of EU institutions, created huge opportunities for the EU. Unfortunately, any potential longer-run positive effect of enlargement risks being neutralised by the lingering effects of the Great Recession and the difficulties at the EU level in providing a coherent policy response. Many European countries became the target of populist parties and politicians - in new and old member states alike (Guiso et al 2019) and a commensurate response is yet to come forward.

This chapter is organised as follows. Section 2 examines the EU Anchor thesis. Based on the *Conclusions of the Presidency of the European Council* before 2004, we document that the Enlargement process was characterised by huge uncertainty, and, although, in hindsight, it may seem carefully planned and executed, it was not the case. There was still considerable uncertainty about the process until the Treaty of Amsterdam was signed in 1997 and there was uncertainty until even later about which countries would join when. Moreover, although the accession process affected many areas and early attention focused on the effects on the continued reform efforts regarding stabilisation, liberalisation and privatisation, it has since become clear that the longer-lasting and most consequential effect has been mostly in terms of building-up key institutions (such as the judiciary, bureaucracy and competition authority) in the candidate countries. Section 3 focuses on whether the prospect of EU membership did accelerate institutional development. It documents the initial institutional gap and how the EU anchor was instrumental in closing it.

Section 4 investigates whether these new institutions fostered by the prospect of EU membership can be linked to better economic outcomes. Section 5 concludes.

2. An Enlargement Like no Other

The European integration project that started out in 1957 with the signature of the Treaty of Rome has experienced four main enlargement episodes. New members were admitted in 1973 (UK, Ireland and Denmark), in the 1980s (Greece in 1981 and Portugal and Spain in 1986), and in 1995 (Austria, Finland and Sweden). As it can be seen, in each of these three enlargements only three countries became fully-fledged members. This is a relatively small number and accession was managed without much need for bureaucratic machinery. Incumbent member states took a leading role in the first and second enlargements, while European institutions like the European Commission took a somewhat larger role in the third enlargement. This was not because the countries of the third wave were unprepared to join, but instead because this enlargement occurred at the same time of the Single Market and the Fall of the Berlin Wall, which very much complicated the process (Tatham 2009).

The Eastern Enlargement, the fourth one, was unique in at least three fundamental ways. Firstly, this Enlargement had a much larger number of candidate countries compared to all previous Enlargements (this is true even accounting for the fact that Norway was also a candidate in 1973 and 1995, as was Switzerland in 1995). Despite the relatively large numbers, there was broad consensus that the benefits of the Eastern Enlargement would be larger than its estimated costs and that these benefits would accrue to both Eastern and Western Europe (Baldwin et al., 1997).

The second reason the 2004 Enlargement was unique is that the number of policy areas that the transition economies had to negotiate was considerably larger and more detailed than had been the case in previous rounds. The 1973 Enlargement followed the completion of the Customs Union and the 1995 Enlargement occurred once the Single Market was in place, yet when the transition economies started their accession process, the *acquis communautaire* already had about thirty chapters, each one covering a different policy area.

The third aspect that makes the Eastern Enlargement unique is partly a natural consequence of the larger number of candidates: the accession process became more formalised and managed more explicitly by the European institutions (European Council 1994, p. 12), while member states took on a much smaller role.

However, it is important to stress that, a more structured accession process does not mean that it was all clearly defined and designed from the outset. The opposite would perhaps not be a bad characterisation. Based on an analysis of all the *Conclusions of the Presidency of the European Council* before 2004, we document that the Enlargement process was characterised by huge uncertainty.

In the early and mid-1990s there was still considerable uncertainty surrounding the accession process. There was still considerable uncertainty about the process until the Treaty of Amsterdam was signed in 1997 (European Council 1997) and there was also uncertainty about which countries would join when, until even after Amsterdam. There was not much clarity at the start, to put it mildly, about the timing, about the process itself and even about the identity of future members.

In the early 1990s, a much optimistic forecast was that some Visegrad countries would be able to join the EU before the turn of the century (European Council 1993). By 1997, the educated expectation was that the first candidates would join by 2002. It is only later that 2004 was chosen as the official year for a first wave of Enlargement (Tatham 2009).

The uncertainty about the timing was also associated with much uncertainty about the process itself. The early 1990s were ambitious times at the European Community: let's not forget the concurrent deepening (Single Market) and broadening (Sweden, Finland and Austria as incoming members) that were already much burdening the European institutions, stretching their capacity to design, manage and implement policies. On top of this, the external environment was also rather eventful with the reunification of Germany, the collapse of the USSR, and the violent large-scale conflicts first in the Gulf and then in the Balkans.

By the middle of the decade, the Commission took full charge of the accession process and agreed, designed and put in place a system of monitoring the accession of an unprecedentedly large set of candidates.

In addition to when and how, uncertainty about who also lingered. A hypothetical experiment may conveniently sum this up. Imagine what would be the answer if someone had in 1997 asked the following question in Prague, Budapest, Tallinn and Sofia: "what do you think are the chances that your country will be a full member of the EU by 2004?" We can speculate that the average response from Wenceslas Square would have beeen 70%, while that from Erzsebet Ter would have been 65%. In late 1998, the average response in Sofia would perhaps not have been too far away from that in Tallinn, with both surely indicating probabilities well below that in Visegrad countries.

Uncertainty about which countries would join when was difficult to dissipate. Indeed, as late as December 1999, the official view was that "Cyprus, Hungary, Poland, Estonia, the Czech Republic and Slovenia" had made satisfactory progress with the negotiations, but that the

"European Council ha[d] decided to convene bilateral intergovernmental conferences in February 2000 to begin negotiations with Romania, Slovakia, Latvia, Lithuania, Bulgaria and Malta on the conditions for their entry into the Union and the ensuing Treaty adjustments" (European Council 1999, p.1-2). Clarity about the more precise composition of what later became known as the "two waves," that is, regarding the decision to have 10 members joining in 2004 and Bulgaria and Romania joining at a slightly later date, only came in late 2001 (European Council 2001).

The Copenhagen Criteria and the Commission managing and monitoring the accession process were effective in utilising this triple uncertainty (how, when, who) as leverage to accelerate the pace of transformation in Central and Eastern Europe. This strategy, in large part, reflects some key characteristics of the EU, in particular its weak enforcement powers but powerful incentives for outsiders to join (Berglof and Roland 2000).

The prospect of EU membership (as well as the risk of delayed membership or even the threat of exclusion) was instrumental because it prompted rapid institutional transformation. Many have argued that the prospect of EU membership and membership itself is a major source of benefits in terms of productivity, technology, trade, labour mobility and capital flows. However, the longer-lasting benefits of accession have stemmed from the extraordinarily rapid institutional transformation we witnessed in the run-up to 2004.

Various studies compare the EU anchor thesis with other plausible alternative explanations (such as initial conditions, democracy, civil society, structural reforms, culture, etc.). Many authors initially expected that the prospect of EU membership would have a substantial effect on the design and implementation of structural reforms by relaxing political constraints. We must clarify that we are here distinguishing between key structural reforms such as privatisation, internal (price) and external (trade) liberalisation from other that were earlier on usually referred to as "secondgeneration reforms," which could be better described as institutional change (Babecký and Campos 2011). Taking this into account, we start by noting that Beck and Laeven (2006) provide one of the first systematic attempts to understand institutional development in the former socialist economies. Their econometric evidence highlights that countries' historical experience under socialism (more entrenched socialist elites and more years under socialism) as well as those countries with larger endowments of natural resources were less likely to show a consistent build-up of what they term market-compatible institutions. They also show evidence that the prospect of EU membership is associated with countries developing market-based institutions at a faster rate (2006, p 162). The econometric evidence offered by Di Tommaso et al (2007) support these findings, highlighting the role of liberalisation and of economic and political legacies in fostering institutional development in the transition economies. They also report robust evidence that the "signing of a partnership or association agreement with the EU" raises the level of institutional development (2007 p. 875). Schweickert et al (2011) study the impact of incentives related to potential EU and NATO membership on institutional change in 25 transition countries up to 2008. They show econometric evidence that EU membership is a key driver of institutional development even when accounting for economic liberalization. Schönfelder and Wagner (2016) investigate whether being a member of the euro area or an EU member state or a candidate country of the European Union drives institutional development. They find a differential impact: although there is evidence that the prospect of EU membership is indeed associated with rising institutional development, being an EU member state does not. In more recent work, Schönfelder and Wagner (2019) examine the impact of membership status but instead of investigating the absolute level of institutional development, they look at the effect in terms of convergence in institutional development. They find that the prospect of EU membership is a powerful driver of both beta and sigma convergence in institutional development.

3. The Institutional Channel

Does the prospect of EU membership foster institutional development? Here the three key institutional dimensions we will discuss are the capacity and independence of the public administration (bureaucracy) and of the judiciary (rule of law.) Furthermore, we also analyse competition policy capacity and independence, issues that have not received due attention in the past but have come to the fore recently (Gutierrez and Philippon, 2019).

We have seen how the EU Anchor thesis postulates that the prospect of membership in the European Union played a key role in filling in the institutional vacuum that followed the collapse of socialism, with highly differentiated effects in Central and Eastern European and the former Soviet Union countries.

The prospect of EU membership turned out to be a major driver of institutional change. But can this be gauged? From 1997 onwards, the EU implemented a system of regular standardised monitoring in a range of institutional areas which corresponded, to a considerable extent, to the individual chapters of the *acquis communautaire*. The *Progress Towards Accession* reports that the European Commission published every year for every candidate country offers a unique vantage point. Quantifying these annual reports yields a longitudinal dataset that captures changes in the nature, direction and speed of convergence of these key institutional areas. These reports provide invaluable details allowing to trace the national paths in meeting the institutional requirements of EU membership - from the transplantation of laws and regulations to the creation of regulatory organisations endowed with necessary powers, resources and personnel.

By quantifying all progress towards accession, Bruszt and Campos (2019) constructed a panel of new de jure (independence) and de facto (capacity) institutional measures for 17 EU candidate countries yearly since 1997.[1] The analysis concentrates on three key institutional areas --the judiciary, bureaucracy, and competition policy-- and include measures of potential inputs and outputs into each of these three areas.

Figure 1 summarises these measures. It displays the yearly averages of six key outcome measures, namely the capacity and independence of the judiciary, of the bureaucracy, and of competition policy for all (post 1995) 17 EU candidate countries. For instance, judiciary capacity refers to access to the necessary resources and expertise, while independence is defined in terms of appointment and promotion of judges. EU norms establish basic parameters for the functioning of the judiciary, emphasizing workload and bottlenecks of the judicial system.

[Figure 1 about here]

These are categorical variables taking values between 1 and 4; with 4 indicating levels of institutional development comparable to those of established EU Member States and 1 reflecting severe deficiencies in moving towards EU norms. We divide the countries between those that joined the EU (New Member States, NMS) and those that have not (Candidates). For most of the former, data are available yearly between 1997 and 2005, while for the latter between 2005 and 2013. In the figure, we overlap these nine-year windows.

This rich data provides detailed empirical evidence of a powerful EU anchor in terms of

[1] The 17 candidate countries are divided in New Members States (NMS) and Candidate Countries. NMS are: Bulgaria; Croatia; Czech Republic; Estonia; Hungary; Latvia; Lithuania; Poland; Romania; Slovakia; and Slovenia. Candidate Countries in the sample are: Albania; Bosnia; Kosovo; Macedonia; Montenegro; Serbia; and Turkey.

institutional development. The prospect of EU membership seems to have been a formidable driver of institutional change among candidate countries, for both those joining early and late. Moreover, the prospect of EU Membership fostered a narrowing of the gap between these countries' levels of institutional development and that of EU existing members.

The EU anchor seems to have been especially powerful regarding the independence of competition policy authorities and judiciary capacity, both increasing dramatically in a relatively short period of time. There seems to be also strong evidence of the effects the prospect of EU membership has had in terms of the capacity and independence of the civil service (bureaucracy) as well as regarding competition policy capacity. Out of six key dimensions, in only one case (namely judiciary independence) we see weak evidence of institutional development in the run-up to EU membership. This is interesting: it can be either because most of the relevant changes took place at the very beginning of the transition (and hence before 1997; notice that such a caveat needs also be considered for all institutional dimensions) or because this was indeed lagging (as students of populism in Central Europe may nowadays fear).

It really cannot be stressed enough that the institutional change documented above happened over nine years, not nine decades, and it was not preceded by a violent or long international war. This makes it a truly extraordinary evolution.

There are at least four other aspects worth mentioning because they raise interesting questions for future research. Firstly, the levels at the end of the time-windows for the new member states and for candidates tend to be higher for *de jure* (independence) than for *de facto* (capacity) dimensions. It would be nice to have similarly detailed institutional data for earlier members so as to compare entrants progress with the situations within the EU.

Secondly, neither new member states nor candidate groups seem to have reached, at the end of the period of analysis, average EU levels (a score of 4) in any of these six institutional dimensions. On the one hand, this attests to the quality of the data and to the political nature of the accession decision. On the other, it highlights the need for a fuller political-economy understanding of the accession process.

Thirdly, although there is surprisingly little difference between new member states and candidates at the outset, the speed of convergence of the latter group has been much slower. This may point towards variation in the credibility of the prospect of EU membership to act as an anchor over time. Something we still know little about.

Last, but not least, these reports stop once a country joins the EU. Yet the impression one gets is that progress has slowed after accession or, put differently, once a country is inside the EU, the impact of this anchor fades or even disappears.

4. Effects of EU Membership

The previous section has shown that across a variety of institutional domains one can observe much bigger improvements among countries on their way to join the EU compared to those for which the prospect of joining is more remote. The next natural question is whether the effects of these institutional improvements prompted by the possibility of EU membership are indirect or direct (that is, whether they can be identified directly in terms of growth and productivity.)

There is a disappointingly small literature presenting econometric estimates of the benefits from EU membership. More precisely, there are very few papers or books that answer questions, such as “what would be the level of per capita income in a given country had it not joined the EU?”. Many believe, incorrectly, that this literature is vast because of the many papers on the benefits from trade liberalisation, from the single market, and from the euro (see, among others, Baldwin and Seghezza (1996), Baldwin (1989), and Frankel (2010), respectively.) Yet, papers on the benefits of membership itself are few and far between.

There are at least two main reasons for this paucity. Badinger and Breuss (2011) note that "[g]enerally it is easier to conduct ex ante studies on economic integration than to analyse the outcome ex post. This is also documented by the much larger number of ex ante studies. Some of the rare ex post studies, in particular those on the Single Market, are somewhat disillusioning. The expected pro- competitive effects and the implied growth bonus from the Single Market appear to have not been fully realised so far. To some extent this also applies to EMU" (2011, p. 308). On the other hand, Sapir (2011) argues that while the literature on the static benefits of integration is vast, that on the dynamic benefits is scarce.

Moreover, the majority of these studies are quite candid about the fragility of their estimates. Henrekson *et al.* (1997) estimate that membership may increase growth rates by about 0.6% to 0.8% per year but note that such estimates are "not completely robust" (1997, p. 1551). Badinger (2005) estimates that "GDP per capita of the EU would be approximately one-fifth lower today if no integration had taken place since 1950" but cautions that these are "not completely robust" (p. 50). Crespo *et al.* (2008) find large growth effects from EU membership, but warn that country heterogeneity remains a real concern. Indeed, country heterogeneity is one of the most common reasons invoked for the lack of robustness of these effects.

Campos et al (2019) use the synthetic counterfactuals method (SCM) to estimate EU membership benefits – on a country-by-country basis – in terms of economic growth and productivity. Synthetic counterfactuals are used to estimate what would have been the levels of per capita GDP and productivity if such country had not become a fully-fledged EU member. Notice that although EU membership is ultimately binary (membership is yes/no), economic integration is a continuum. There are many areas over which economies integrate (finance, goods, services, policies, etc.) and it is plausible that this process varies across areas and over time.

The synthetic control method estimates the effect of a given intervention (in this case, joining the EU in 2004) by comparing the evolution of an aggregate outcome variable (growth and productivity) for a country affected by the intervention vis-à-vis that for an "artificial control group." The latter is a weighted combination of other units (countries) chosen so as to match the treated country, before intervention, for a set of predictors of the outcome variable.

Because accession implies lengthy negotiations, it means that the prospect of membership is announced in advance. Therefore, anticipation effects are potentially a very important issue. In particular, they may lessen the relevance of the official date of EU accession as a 'treatment'. This is particularly important for the 2004 enlargement. For this reason, Campos et al (2019) present results not only for both growth and productivity, but also for both the actual date of enlargement (2004) and also for a date that marks the start of the officially monitored accession period (that is, after 1998).

Figure 2 shows estimates of the benefits of joining the EU for the eight former transition economies that did so in 2004. What is the magnitude of these economic benefits? Campos et al (2019) compute the difference between actual and synthetic counterfactual in per capita GDP for the whole period, using the first ten and the first five years after accession. This allows them to compare the results from the 2004 enlargement to those from previous enlargements.

[Figure 2 about here]

There is considerable heterogeneity across countries. Estimates of the net benefits of joining the EU are clearly much larger in, for instance, Lithuania and Latvia than in Slovakia and Slovenia. Yet they are all positive across the board. For the first ten years post-accession, these estimates suggest that if these eight countries had not joined the EU, their per capita incomes would have been approximately 15 percent lower. These range from 31% for Latvia to a mere 0.3 percent for Slovakia and are particularly significant for the Baltics and Hungary.

This exercise answers another interesting question: are these 15% net benefits from the 2004 enlargement different (larger or smaller) than the benefits from previous enlargements? A key caveat in this case is that because enlargements were spread over time, the set of incumbent countries, the 'accession criteria' and the economic and political context all changed substantially between 1973 and 2013. With these in mind, Campos et al (2019) estimate that smaller benefits accrue to the Scandinavian enlargement (about 4%), while the estimated benefit for the 1973 enlargement and for Spain is smaller but comparable (12%) to that of the 2004 enlargement, while that of Portugal is larger (20%). They find negative returns for only one country: Greece.

5. Conclusions

The sharp dividing line which opened up during the transition between the CEE and FSU countries was among the least expected developments that followed the fall of the Berlin Wall. It is remarkable that not only differences emerged over a large range of issues, but also how long they persisted. It is a huge challenge to explain this divide because it is surely a product of various and complex reasons.

However, one reason that we believe played a large role is the prospect of joining the EU, which influenced differentially the countries of CEE compared to those of the FSU, with the notable exception of the Baltic states. The institutional vacuum that appeared early in transition was successfully filled in some countries (CEE and Baltics) but not in others (rest of the FSU) and this has had political as well as economic implications (EU membership for the fomer, and faster growth and greater productivity for the latter).

This chapter has shown evidence that not only the prospect of EU membership fostered institutional development in CEE (but not in FSU countries), but it also had significant effects on economic growth and productivity. The chapter documented the initial institutional gap and how the EU anchor was instrumental in closing it in the countries that actually joined the EU (even when compared to other candidate countries that have not yet joined). We showed that institutional development prompted by the prospect of EU membership are clearly documented for the judiciary, bureaucracy and competition policy. Further evidence is now available that shows that CEE countries experienced deeper institutional development which translated into faster GDP and productivity growth. These results strongly suggest that the EU anchor thesis is a credible explanation for an important part of the starkly contrasting transition experiences observed following the collapse of communism, especially when comparing CEE and the Baltic states versus the rest of the FSU.

A number of suggestions for future research emerge from this analysis. Firstly, it is important to promote the construction of more granular measures of institutional change, covering both a broader range of institutional aspects, as well as more countries and years. Secondly, and once better measures are available, it will be important to try to establish more solidly the relative roles of EU membership, on the one hand, and liberalisation and initial economic, political and social conditions, on the other, as main drivers of institutional development. Thirdly, further theoretical work should be carried out to provide a clear conceptual as well as empirical understanding of the direct and indirect (via institutions) effects of EU membership on productivity.

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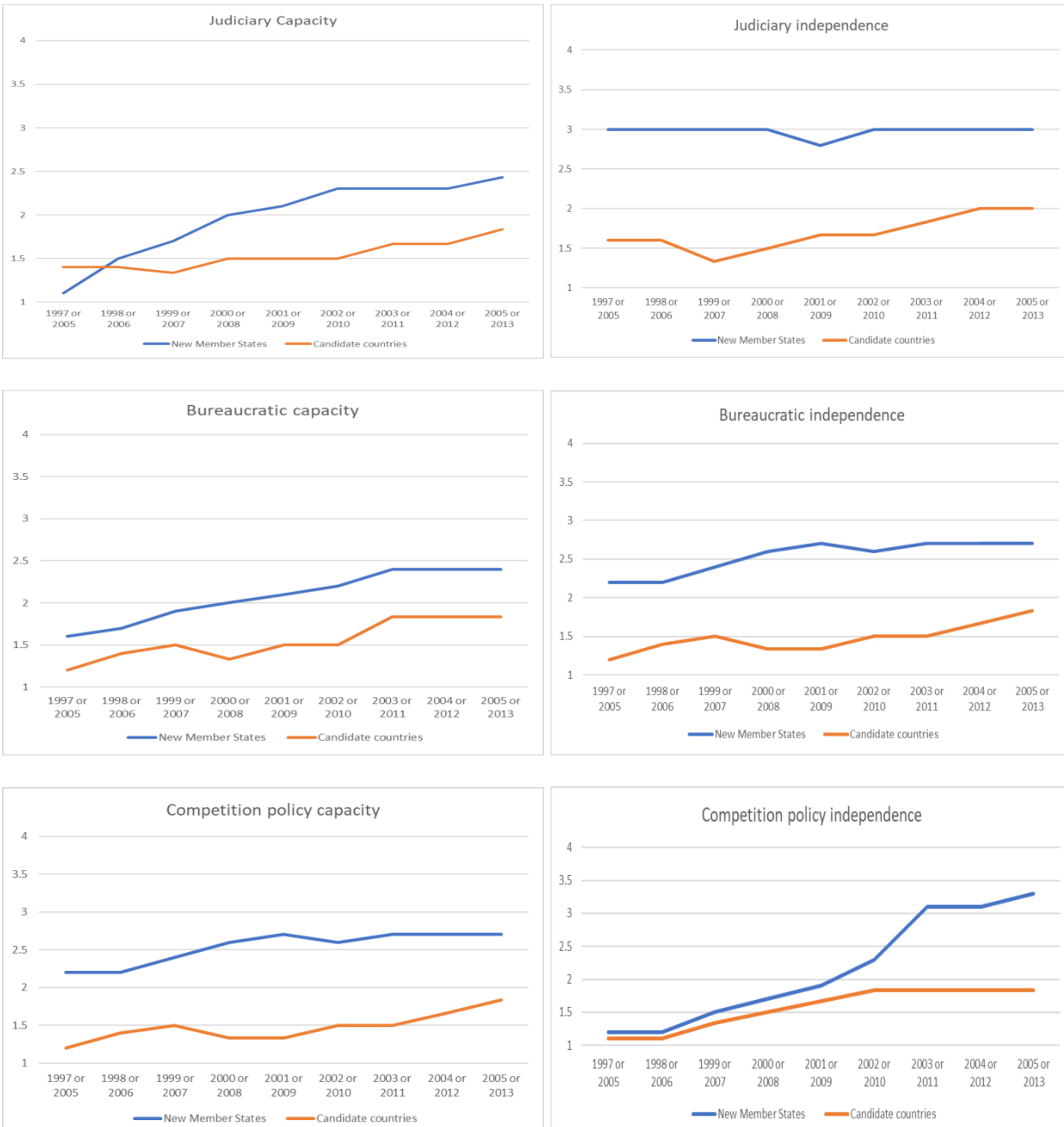
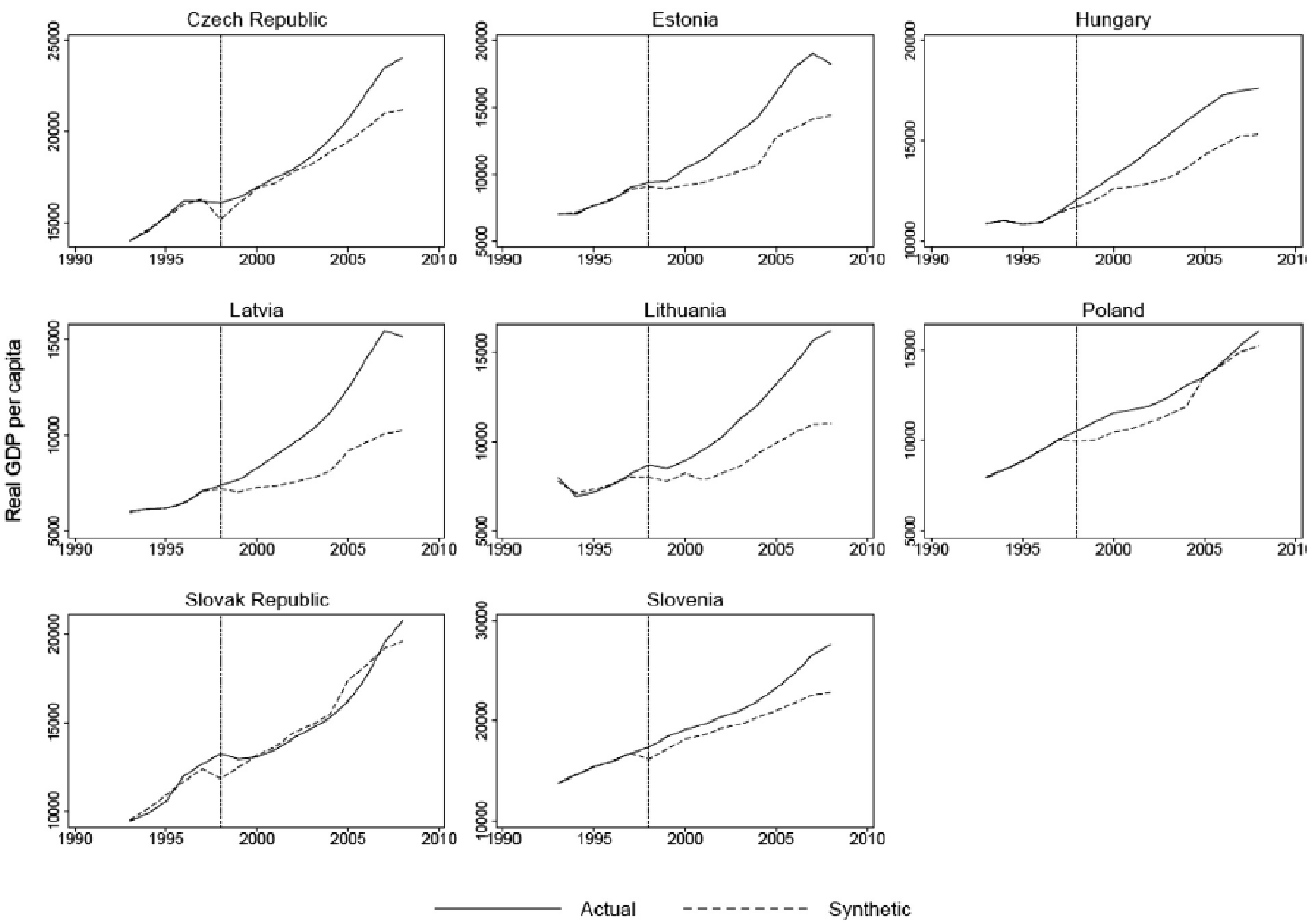
Figure 1. The Institutional Lift from The Prospect of EU Membership:
Yearly Averages for New Member States (1997-2005) and Candidate Countries (2005-2013) of Six Key De Jure (Independence) and De Facto (Capacity) Institutional Dimensions



Source: Bruszt and Campos (2019)

Figure 2. The Effects of The Prospect of EU Membership on Per Capita Income: Synthetic Counterfactual Estimates for the Eight Central and Eastern European Former Communist Countries That Joined the European Union in 2004



Source: Campos, Coricelli and Moretti (2019)