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Chapter 2

WHAT DOES AN ENLARGED EUROPEAN UNION MEAN FOR CROATIA?

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ABSTRACT

Croatia missed the first wave of Eastern EU enlargementⁱ, but it is likely to start accession negotiations in 2005. It is gradually aligning its legislation with the EU *acquis* pursuant to the Interim Agreementⁱⁱ. Adjustment costs linked with the integration process coupled with the lack of a firm timetable for full EU-integration might give rise to euroscepticism, decrease readiness for reforms and slow them down. Delays in reforms related to transition and integration can endanger their effectiveness and impede development of the capacity to cope with market forces within the EU. This is the economic membership criterion. Hence, such developments can impede the fulfilment of EU membership criteria and also reduce the potential for exploiting the positive effects of integration.

Key words:

enlargement, European Union, Croatia, candidates, membership criteria

**The author is taking part in this project as an independent researcher, so the views expressed are not related to the institution in which she works. Helpful comments from Katarina Ott and anonymous referees are gratefully acknowledged.*

INTRODUCTION

The objective of the paper is to identify the major changes caused by the first wave of Eastern EU enlargement and their impact on the pace of Croatia's integration into the EU. It also examines the options for Croatian participation in the integration process in the period before full EU membership.

First we analyse EU requirements and how the enlargement is changing the level at which membership criteria are met. Next, we discuss the possible economic impacts of the enlargement on Croatia and its ability to integrate into the EU market. In addition to the economic aspects of enlargement, the paper identifies some of the institutional and negotiating issues that should be taken into consideration when revising the position of Croatia vis-à-vis the enlarged EU and the other candidate countries (Bulgaria, Romania and Turkey).

Based on the analysis of these elements, we argue that the EU enlargement will intensify the effects of Croatia's associated EU membership. Associated membership causes alignment costs which could prevail over benefits in the short run. Significant costs of the integration might give rise to euroscepticism and slow down the economic reforms necessary for exploiting the positive effects of integration in the medium to long term. Thus the establishment of association with the EU, coupled with the EU enlargement process, might lead to a slowing down of the integration process.

EUROPEAN UNION REQUIREMENTS

The Treaty on the European Union (TEU) says that any European state that respects the principles common to the member states (liberty, democracy, respect for human rights and fundamental freedoms and the rule of law) may apply to become a member of the Union (Article 49).

An applicant state can become a full member provided that the EU membership criteria are met. These criteria are defined by the conclusions of the Copenhagen European Council (1993).ⁱⁱⁱ Basically, the candidate must meet *political criteria* (stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities), *economic criteria* (the existence of a func-

tioning market economy, the ability to cope with competitive pressures and market forces within the Union) and *develop the ability to take on the obligations of membership*, including adherence to the aims of political, economic and monetary union. This means that a candidate must effectively apply the EU rules (adopt and implement the *acquis*) and policies before membership. *The EU*, from its side, *has to be ready to receive new members*. This means both that the EU's financial perspective enables implementation of the EU policies if new member states are included and that the EU's institutions are able to admit representatives of the new members into their work. Progress in negotiations is conditional upon membership criteria being met.^{iv} The necessary reforms should be taken in the pre-accession period, which is the reason why transition arrangements are limited in scope and duration.

As the European Council has repeatedly declared, the membership criteria are going to stay the same.^v But since the EU is changing, the benchmarks will change. Therefore we shall endeavor to identify the most striking changes caused by the EU enlargement.

Compliance with the *political membership criteria* has not changed upon the enlargement.^{vi} Meeting political criteria is necessary for the progress of integration, but further economic integration is conditional upon economic reforms.

Economic membership criteria require, first, the existence of a market economy and second, the capacity to cope with competitive pressures and market forces within the Union. The existence of a market economy refers basically to the "domestic policies" in the candidate country.^{vii} The capacity to cope with competitive pressures and market forces within the Union is changing as the relevant market (the EU market) changes. It requires a minimum level of competitiveness in the main economic sectors of the candidate country. The Commission evaluates compliance with the second economic criterion with respect to various elements, among which are the extent to which government policy and legislation influence competitiveness (trade policy, competition policy, state aid, support for SMEs) and the degree and pace of trade integration a country achieves with the EU before enlargement (volume and nature of goods already traded with member states).

As concerns the *requirement to take on other obligations of the membership*, enlargement is closely related to the internal development of the EU. Therefore, the candidate has to accept institutional changes, financial changes and policy reforms and align its domestic legislation with the new *acquis*. Reforms induced by the EU enlargement are nec-

essary for the functioning of the enlargement and for the development of the ability of the EU to absorb new members in the next round(s) of enlargement. For instance, new members had to align with the EU *acquis* at the cut-off date of 30 September 2003 (European Commission, 2004c:10). This cut-off date also applies to the finalization of negotiations with Bulgaria and Romania, while countries that have not started negotiations yet (Croatia) will have “more *acquis*” to align with in the pre-accession period.

From the EU side, the *capacity to absorb new members* is highly dependent on the success of the current enlargement process, a constitutional agreement and the new financial perspective. Revisions of the founding treaties agreed so far (TEU as well as draft Constitution, COREPER, 2004) have set some principles in the decision making of the EU, but have not provided answers as to how the institutions of the EU will change in the next rounds of enlargement.

EUROPEAN UNION REQUIREMENTS AND THE ENLARGEMENT PROCESS

The inclusion of 10 new member states on 1st of May 2004 marked the biggest wave of enlargement in Union history. These countries have reached a sufficient degree of compliance with the membership criteria, but alignment is not finished yet. There are still issues requiring enhanced efforts and areas of serious concern. The latter include areas affecting the internal market and those affecting the delivery of EU funds to beneficiaries in the new member states.

Bulgaria and Romania, candidates that have been included in accession negotiations, but were unable to finish them on time, are considered to be a “part of the same inclusive and irreversible enlargement process” (European Council, 2003). Their membership has been rescheduled for 2007^{viii}, which implies that they should sign the Accession Treaty by the end of 2005 at the latest and complete negotiations in the course of 2004. Since progress in negotiations is conditional upon meeting membership criteria, Bulgaria and Romania had to continue implementing necessary reforms. Bulgaria concluded accession negotiations in June 2004 (Bulgarian government, 2004). Romania is well advanced and will continue negotiations on the same basis and principles that applied to the ten new members.

Croatia's compliance with membership criteria before the enlargement was comparable with that of Bulgaria and Romania. Shortly before enlargement, that is, the Commission published its Opinion on the application of Croatia for membership of the EU (European Commission, 2004a). The method followed in preparing the Opinion was the same as that used in the Regular Reports. The Commission confirmed that Croatia met the political criteria set by the Copenhagen European Council (1993) and the Stabilisation and Association Process (SAP) conditionalities. The SAP conditions mostly explain the political membership criteria on an individualized basis.^{ix} Bulgaria and Romania also comply with political criteria.

As regards economic criteria, Croatia is a functioning market economy. It should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it continues implementing its reform program to remove remaining weaknesses (European Commission, 2004a:53). Similar wording was used in the latest Regular Reports for Bulgaria and Romania.

Croatia's ability to take on the other obligations of membership has been evaluated according to following indicators:

- the obligations set out in the Stabilization and Association Agreement (SAA), particularly those already in force under the Interim Agreement, which relate to areas such as the free movement of goods, competition and intellectual and industrial property rights;
- progress in adoption, implementation and enforcement of the *acquis*.

The Commission concluded that Croatia will be in a position to take on the other obligations of membership in the medium term, provided that considerable efforts are made to align the country's legislation with the *acquis* and ensure its implementation and enforcement. In Croatia, Bulgaria and Romania administrative and judicial capacity need to be further improved to allow proper application of the *acquis*. The quality of the legislation transposed in Romania has not always been adequate, and revisions are called for making the situation comparable with that in Croatia.

Comparison of the Opinion and Regular Reports shows that the Commission shares the view of the Government that it might be possible for Croatia to meet membership criteria in the medium term, as planned by the Government. The main difference between the Regular Reports for Bulgaria and Romania and the Opinion on Croatia is that

in the Opinion the Commission stated that integration in the single market and the adoption of the *acquis* would, *at this stage*, cause difficulties for a number of sectors, related to their ability to withstand the competition within the single market. The Commission underlined that addressing the identified weaknesses should contribute to higher investment and growth, thereby enhancing Croatia's competitiveness. Such wording allows for inclusion of Croatia in the EU *at a later stage*, and sets the ground for future opinions and Regular Reports that might conclude that Croatia is not capable of meeting the second economic criterion.

However, a later inclusion in full membership should not be regarded as indicating a deficiency in the Croatian economy. Namely, in terms of the "usual" development criteria, such as GDP per capita, energy consumption, life expectancy at birth, etc. Croatia is more advanced than Bulgaria and Romania (for more see World Bank, 2004), which are considered to be part of the first round of Eastern EU enlargement. Meeting EU membership criteria basically means a successful end of the transition process (for more see EBRD, 2004) and real convergence with the EU standards have been achieved. Hence, meeting membership criteria can be regarded as a goal and not as a condition for membership.

IMPACT OF ENLARGEMENT

In this part of the paper we briefly estimate the impact of enlargement on the fulfilment of membership criteria (which relate to both the enlarged EU and Croatia), the impact of enlargement on the Croatian economy and on the dynamics of Croatia's integration into the EU.

As identified earlier, enlargement changes the level to which a candidate country is capable of facing competitive pressures and market forces in the enlarged EU market, and the obligations of membership change with the development of the EU (new policies, a new *acquis*). From the EU's side, its capacity to absorb new members depends greatly on the development of new policies and the *acquis*.

Since the EU internal market is one of the major achievements of the economic integration within the EU, in this paper we proxy economic impact of enlargement on Croatian economy with the impact of inclusion of 10 new members in the internal market.^x

Impact of enlargement on fulfilment of membership criteria

Economic membership criteria

As the EU expands, its internal market grows. The removal of existing trade barriers^{xi} between old and new members and among new members increases the competitive pressures in the EU market, and by doing so can have an impact on the level to which a candidate meets the second economic membership criterion. These effects increase over time, so the time dimension of evaluating compliance with membership criteria becomes important.

The effects of enlargement require some time span to materialize. That is, “negative integration”, whose effects can be seen in the short run, has been achieved prior to enlargement^{xii}. The period which has elapsed since the enlargement is extremely short, so the impact of enlargement cannot be evaluated on the basis its actual effects (*ex-post*).^{xiii} Consequently, we identify here the “statistical” changes brought about the enlargement, which represent the new point of reference for estimating the “real” effects of enlargement (*ex ante*).^{xiv}

We focus on two elements used as indicators for meeting the second economic membership criterion: volume and nature of goods traded.

Firstly, after May 1st, trade with the EU means trade with 25 countries instead of 15, while CEFTA lost its most advanced members. For Croatia, the impact of the enlargement (from EU-15 to EU-25) is an increase in the proportion of its trade with the EU from under 60 to over 70% of total trade (Table 1).

Table 1 “Statistical” impact of the European Union enlargement on Croatian trade

	Exports, in % of total exports	Imports, in % of total imports	Trade, in % of total
EU-15	54.2	57.8	58.6
EU-25	67.6	72.5	72.8

Source: Boromisa (2004b)

Enlargement also caused a 10% increase of intra-EU trade and 9% decrease of extra-EU trade. Hence, one impact of enlargement is a decrease in the external trade of the EU-25, but this effect on the EU is

opposite to the effect on the individual trade partners. Hence, for Croatia, enlargement has caused an increase in the volume of goods traded with the EU.

Enlargement does not change the basic trade structure with the EU (nature of goods traded). The most important export products to the EU-15, identified at the level of 98 products according to the two-digit combined nomenclature (CN) that denotes the statistical classification of the EU were ships, clothing, electrical appliances and wood and wooden products. Exports were highly dependent on ten products that accounted for around 70% of the total Croatian exports to the EU-15. Import structure was more diversified, and the 10 most important import products accounted for around 60% of total imports. Export structure to the EU-25 has not changed significantly. The top ten export products according to the combined nomenclature remain the same, but their ranking is slightly changed. Export specialization has decreased, so instead of 71%, the top 10 products account for 67% of total Croatian exports to the enlarged EU. Import structure has changed less since the enlargement, and the top 10 products now account for 58% of total imports, as compared to the previous 61 of total imports.

Next, empirical research has shown that preparation for the single market was accompanied by a decrease in the share of inter-industry trade in Europe and a rise in intra-industry trade (European Commission, 1996). The same has happened in the candidates in the pre-accession period. The pace of trade integration with the EU has been highly positively correlated with EU changes in the export structure (IMF, 2000; see also Boromisa and Mikić, 2003). Thus more vigorous intra-industry trade implies lower specialization in different countries, lower adjustment costs and roughly similar industrial structures. The level of intra-industry trade between Croatia and EU has increased since enlargement, which implies a higher level at which membership criteria are being met.^{xv}

Briefly, after enlargement Croatia is meeting the economic membership criteria better, especially in the part relating to the volume and nature of goods traded.

Requirement to take on other obligations of membership

Croatia will have to align with “more *acquis*” in the pre-accession period. This obligation could not be avoided if Croatia were a full

member. However, the experience of the 10^{xvi} new member states shows that screening and compliance monitoring is in certain areas deeper for “would-be” members than for members. For instance, the comparison of the state aid scoreboard and policy reports containing infringements (e.g. in the telecom sector) with Regular Reports show that the “would-be” members have to comply with the rules more strictly than member states.

Next, the EU launched some new policies and revised existing ones during the process of the preparations for enlargement. These include a revision of “internal” EU policies (such as the Common Agricultural Policy, CAP) and policies towards third countries (the Mediterranean countries, Russia, Ukraine, Commonwealth of Independent States (CIS) and transatlantic partners). Instruments of the policy towards neighboring countries include the creation of free trade zones and cumulation of rules of origin. It is expected that by 2010 EU will create a free-trade zone with Mediterranean countries in which cumulation of rules of origin will apply. So when Croatia joins the EU, it will have to allow free access to the domestic market from more countries – not only the EU member states. It will also have to be able to compete with competitive pressures in the market of member states, which will be increased by the effects of enlargement and EU policies – all (or almost all) neighboring countries will have free access to the EU market. Also, liberalization of Croatian trade policy towards Mediterranean countries and CIS will be one of the elements upon which alignment with the EU rules and also compliance with the second economic criterion will be assessed.

Furthermore, the EU will develop some policies not directly related to the enlargement. Croatia will have to adhere to them as well. They might include some constitutional agreements, financial rules (including issues such as budget and state aid) and competition policy issues.

So in the pre-accession period Croatia will have to follow developments in the EU. However, in alignment with EU policies, caution is needed. For experience has shown that Croatia’s membership in CEFTA was too short to bring any benefits,^{xvii} while the arrangements achieved might be regarded as an obstacle in getting a “better deal” with the EU in negotiating revisions of the SAA in order to take account of the enlargement. That is, in order to take account of enlargement, some *technical adjustments* of the SAA were necessary. This led to the new protocol of the SAA (Protocol No. 7) being negotiated. Its

purpose is to adjust quotas to the enlarged EU. Technical adjustments were seen by the EU as simple math – adding the quotas defined by free trade agreements between Croatia and new member states to the quotas defined by the SAA. Croatia asked for an increase of quotas for quantities really imported from new members; quotas to CEFTA countries were not fully used, and not even defined to some countries, since they were not needed. Hence, technical adjustments, as seen by the EU, would mean increased quotas that would be used by the old member states and hence a further increase of Croatian imports from EU.

Finally, the EU is still developing, and can be considered as a moving target. Enlargement creates the need for further reforms within the EU and hence additional obligations of membership. However, it is not yet possible to identify how the enlargement affects the speed and direction of its movement.

Capacity of enlarged European Union to absorb new members

The enlargement from 15 to 25 underlines the need for defining the EU from the inside by a Constitution and along its edges by the adoption of a strategy on the wider Europe and the neighborhood. These two issues can also shape the process of the enlargement in the future.

The financial framework for the next round of enlargement depends on its size and coherence. Namely, the capacity of the EU to take on new members depends on the capacity of the EU to manage and finance its policies. Institutional arrangement depends on whether this will be the last round, or some new rounds are likely to happen in the near future. This is closely connected with the question of the borders of Europe. According to the earlier mentioned Article 49 of the TEU, further EU expansion awaits debate on the ultimate geographic limits of the EU.^{xviii} This is implicitly stated also by New Neighborhood Policy of the EU (European Commission, 2003b) which recognises that countries that *currently* do not have any perspective of membership in the EU might have such a perspective at a later stage. Which countries are “potential candidates” significantly influences capacity of the EU to absorb new members, which is one of the Copenhagen criteria. Institutional design for EU-28 (if Croatia is the only country in the next round of enlargement, and Bulgaria and Romania are included as part of this round of enlargement) is likely to be different from EU-29 (EU-

25 + Bulgaria + Romania + Croatia + Turkey), or EU of some 35, mostly small states (SAP countries, which are at present potential candidates: Albania, Bosnia and Herzegovina, Macedonia, Serbia, Montenegro and Kosovo).^{xix}

Next, it is difficult to predict whether EU-25 can work with its present institutions. This makes the time horizon for future enlargements more distant. The Constitution should facilitate the functioning of the EU and enable subsequent enlargement(s). Without a constitutional framework it will be quite difficult to reach an institutional agreement on the participation of Croatian representatives in the EU institutions.

This implies that based on the EU's capacity to take on new members there are two basic scenarios for inclusion of Croatia into the EU. The first is the *fast inclusion scenario* based on an EU political decision and does not provide a "regular" framework for the institutional design of the enlarged EU. It implies that Croatia will be the only country included in the round of enlargement. Its size would allow the granting of the same number of representatives to the EU institutions as to countries of a similar size. However, this solution does not enable the same approach for the subsequent rounds of enlargement, decreases the credibility of the EU and indicates that votes of a small, individual member basically do not matter. For if the inclusion of Croatia were to decrease the power of some countries in decision-making, it would be politically very difficult to achieve the needed unanimity.

Therefore, we consider that the fast-track scenario is not very likely. The more *distant membership scenario* is based on the presumption that the "normal" institutional approach will be followed. This implies that the EU will have to digest this enlargement first, so that the next enlargement will not happen before a constitution is agreed upon and ratified.

The institutional package related to EU-accession can be negotiated for Croatia alone, for Croatia and Turkey, possibly Macedonia and other SAP countries. This does not imply that the whole "block" is going to enter the EU in unison. However, it is likely that the EU will design the institutional structure for SAP countries and Turkey in a "package". Namely, SAP countries are rather small, so their membership can cause additional problems in voting, disturbing the balance between *big* and *small* member states.

Considering Turkey as an EU member state would probably be of interest to the "big" countries, since their number and influence would grow. On the other hand, an increased number of EU member states

increases the need for harmonization of policies and negotiating positions, since the negotiating strength of each individual member state decreases as the total number of member states increases (Table 2).

Table 2 Size of the European Union member states, Stabilisation and Association Process countries and Turkey

	Area (1000 km ²)		Population (mil)		GDP (billion USD)		GDP (USD per capita)
	Median	Average	Median	Average	Median	Average	
EU-15	132	216	10.0	25.3	251.6	594.9	21,192
New members	57	74	3.0	7.5	14.7	32.8	4,383
EU-25	79	159	9.0	18.2	13.1	370.1	18,392
SAP countries	51	53	4.2	5.0	4.4	7.7	1,537
Turkey		774		65.3		199.3	3,052

Source: Boromisa (2004b - based on World Bank data for 2000)

Table 2 illustrates how the average size of EU member states has shrunk as a result of the enlargement. While the average EU-15 member had a population of around 25 million and a GDP of almost 600 billion USD, the average member state of EU-25 has roughly 30% fewer inhabitants (18 million) and a 38% smaller GDP (i.e. 370 billion USD). For weighting the votes in the Council, the calculated median shows more. While half of the EU-15 countries had populations of over 10 million, in EU-25 more than half have over 9 million, which decreases the relative “weight” of the “big” countries. The SAP countries have populations of 5 million on average (4.2 median), so their inclusion would shift the balance further to the smaller countries.

To sum up, enlargement of the EU decreases its capacity to accept new members. The differences between the negotiating statuses of the candidates are correlated with the capacity of the EU to absorb them. In order to include representatives of new members in the EU institutions, an agreement and a new intergovernmental conference are needed. Hence, it would be more reasonable and efficient to initiate such a procedure for more than just one small country.

Economic impact of the enlargement

The net economic impact of the first round of the Eastern enlargement is expected to be small and positive (for more, see e.g.

European Commission, 1997). The expected economic *impact for the new members* should be large and positive. The *impact on the old members* (EU-15) is expected to be limited. The GDP of the 10 new member states amounts in total to approximately 4% of the GDP of EU-15 (Eurostat, 2004), which illustrates why the impact on the economies of the EU-15 is expected to be marginal.

The prevailing *impact on third countries* is also expected to be limited, but unevenly distributed. It depends on the region, sector, as well as the timing and success of measures aimed at alleviating possible negative impacts of enlargement—such as creation of free trade zones, which is the main instrument of the SAP and New Neighborhood Policy. The impact of enlargement is expected to be bigger in neighboring regions, and negative in traditional industries and agriculture (for more about this see Gros, Crum and Turmann, 2004; Bayar, 1998; Frandsen, Jensen and Vanzetti, 1998; European Commission, 1997; Boromisa, 2004b).^{xx}

Croatia is a neighboring economy, in which traditional industries are quite important. Hence, negative effects of enlargement can be expected. On the other hand, the EU enlargement is taking place during an extremely eventful period for Croatia: it has recently joined the WTO, signed the SAA and regional free trade arrangements (with CEFTA, EFTA and Western Balkans). These processes should help alleviating possible negative effects of the EU enlargement.

Hence, to estimate whether these processes will have a positive or negative effect some quantification is needed. Our quantification is based on two analyses – on the level of the economy as a whole and a sector-specific analysis. Both analyses, whose results are presented below, quantify trade effects of the EU enlargement and establishment of free trade zone with the EU.

At the level of economy as a whole we first estimate the *general* trade effects of the EU enlargement, i.e. the impact of enlargement on extra- and intra-EU trade. Next, we project the distribution and relevance of these effects for Croatia. Third, we estimate the effects of the establishment of a free trade zone with the enlarged EU. Finally we estimate the prevailing effect of establishment of a free trade zone between Croatia and the EU and the EU enlargement.

Sector-specific analysis includes an estimate of the impact of sector-specific trade barriers and an analysis of the position of Croatian exporters on the market of old and new EU member states based on several indices (e.g. revealed comparative advantages, terms of trade, quality gap).

General trade effects of the enlargement are classified as trade creation effect (increase of intra-EU trade) and trade diversion effect (decrease of extra-EU trade). We estimated that the EU enlargement could lead to increase of intra-EU trade (trade creation effect) 1.73%, reference value being “statistical” intra-EU trade. Trade creation is induced by elimination of trade barriers which create costs. We estimated trade diversion, i.e. decrease of extra-EU trade, 0.18% of the statistical value (for more see Boromisa 2004b). The results are in line with other studies that show that the impact of enlargement is likely to be limited (e.g. Baldwin, Francois and Portes, 1997; Keuschnigg and Kohler, 1999; Lejour, Mooij and Nahujs, 2001). However, these limited effects of enlargement might be very significant for Croatia, due its size compared to the EU. This can be illustrated by the fact that the estimated trade diversion effect (0.18% of statistical extra-EU trade after enlargement) is equivalent to 40% of the total exports of Croatia to EU-15. Hence, what is from the EU perspective a “small” trade diversion effect can seriously jeopardize Croatian exporters.

Based on the decrease of trade costs within the EU we estimate trade diversion effect of enlargement on Croatia as a 5.5% decrease of Croatian exports to the EU. Decreased trade costs (and prices) are expected to cause an increase of imports from the EU of 2.9%, the reference value being “statistical” exports and imports to EU-25 (Table 3).

Using the same approach (decrease of trade costs between the enlarged EU and Croatia) we estimate the impact of establishment of free trade with the EU-25 on trade between Croatia and EU as a 8.5% increase of imports and 2.5% of exports (Table 3). This result indicates that enlargement will intensify the effects of the establishment of a free trade zone. Previous research showed the establishment of free trade zone will lead to an increase of exports to the EU-15 of ca 2%, and an increase of imports by ca 7-8% (Kersan-Škabić, 2001; Samardžija, Staničić and Nikić, 2000; Madžarević, Šonje and Jurlin, 1997).

The estimated effects of enlargement and the establishment of a free trade zone taken together show a further increase in the short-term impact of the establishment of a free trade zone with the EU: the expected prevailing effect is a 3% decrease of exports (compared with statistical value of exports to EU-25) and an 11.4% increase of imports from EU-25 (compared with statistical imports from EU-25), as shown in Table 3.

Table 3 Short-term trade effects of enlargement and implementation of the Stabilization and Association Agreement on trade between Croatia and EU-25. Estimate on the level of economy as a whole

	Enlargement impact	SAA	Total (impact of SAA and the enlargement)
Export growth (reference value statistical export) %	-5.5	2.5	-3.0
Import growth (reference value statistical import) %	2.9	8.5	11.4

Source: Boromisa (2004b)

This analysis shows that enlargement is likely to intensify the effects of the establishment of a free trade zone and to increase the adjustment costs. The establishment of a free trade zone will also create the potential for exploiting better access to a bigger market. The projected trade creation effect (1.73% of intra-EU trade) is a result of increased demand in the new member states, which equals 9.5 times Croatian exports to these countries, while increased demand in the EU-15 is 1.05 times greater than Croatian exports to the EU-15. At the level of EU-25 increased demand is 2.73 times greater than statistical export to EU-25. Exploiting just a small part of this potential can have a significant positive impact on Croatia's trade balance and economy as a whole, but exploiting this potential is limited by the Croatian production and export structure.

A *sector specific* analysis of Croatian economy shows that in open sectors production structure corresponds to the export structure^{xxi}. However, this is not in line with the comparative advantages of Croatian producers. Hence, we estimated (summarized results are presented in Table 4) that the prevailing impact of implementation of SAA and the establishment of a free trade zone will lead to increased imports from the enlarged EU, while integration within the EU will cause fierce competition within the EU and some trade diversion that could be felt by Croatian exporters.

It might be concluded that the potential for *trade expansion* towards the enlarged EU for Croatian producers and exporters is in the short-run limited by their production capacities, which do not correspond with demand on the EU market.^{xxii} Generally, demand for sophisticated products on the EU market is increasing, while difficulties

can face producers of traditional products. Bearing in mind the Croatian export structure (sectors that create 5% of GDP contribute to almost 60% exports and export oriented sectors are traditional ones – textile, clothing, wood) it is likely that negative effects will prevail. This is the result of slow structural changes in Croatia, which during the transition period have been slower than in the new EU member states (IMF, 2000). The economic growth in Croatia in the transition period was boosted by domestic consumption. Hence, liberalized access to the Croatian domestic market, caused by implementation of SAA, is increasing competitive pressure on the domestic market. In the enlarged EU trade barriers between individual member states are being abolished. This decreases trade costs and leads to increasing competitive pressure on the EU market. EU enlargement and the establishment of a free trade zone are increasing competitive pressures in the most important markets for Croatian producers (domestic market and the EU market), so in the short run significant adjustment costs are to be expected. The results of the sector-specific analysis show that the obstacle to keeping up exports to the (enlarged) EU is production (and export) structure, and not the integration process as such.

Table 4 Sectoral estimates of short term trade effects of enlargement and implementation of Stabilization and Association Agreement

	Enlargement impact	SAA	Total (impact of SAA and the enlargement)
Export growth (reference value statistical export) %	-8.5	3.0	-5.5
Import growth (reference value statistical import) %	—*	7.9	7.9

** This estimate analyses the position of 98 products originating from Croatia on the EU markets (divided into two parts-old member state and new member state markets) and of products originating from these two markets in Croatia. The increases in imports from old and new member states were estimated separately, because the trade barriers applied by Croatia towards products deriving from the two separate groups were not the same. Changes in Croatian trade barriers to goods originating in the old members can be regarded as an effect of the implementation of the SAA, and changes with respect to tariff barriers applied to the exports of new members a result of the alignment of free trade agreements with the SAA. In order to make the comparison simple, the same reference value, statistical imports from EU 25, was used. This is the reason why the effects have been attributed to the implementation of the SAA.*

Source: Boromisa (2004b)

Restructuring is transition-related and should create conditions for sustainable growth. Also, the adjustment costs can be regarded as a preparation for inclusion into full membership, as building Croatia's capacity to cope with the competitive pressures of the internal market. This requires that the underlying economic environment is favorable and that the Croatian economy has flexibility and a sufficient level of human and physical capital, including infrastructure. In their absence, competitive pressures are likely to be considered too intense by some groups of society (which are likely to be affected by adjustment costs) and there might be a call for protective measures, which, if implemented, would undermine the single market. This could be seen from the EU side as a deficiency in meeting the second economic membership criteria, so such issues should be dealt with in the short run.

Sensitivity analysis of basic presumptions shows that further integration within the EU (like a further decrease of barriers within the EU, resulting for instance, from the introduction of the euro), or change of price elasticity towards products from third countries intensifies the impacts of enlargement. A change of perception of the domestic (EU) product also intensifies this effect, so in the longer run can make it more difficult to sell on the EU market.

On the other hand, the potential for exploiting the gains of integration (within the EU, e.g. for members, and towards the EU – e.g. for third countries) should increase over time. Whether this potential will actually be exploited depends on the capacity of firms and domestic institutions in the individual state and hence its own growth prospects. For a small and open economy (such as Croatia) gradual integration with a developed, neighboring and big economy (implementation of the SAA), creates the potential for exploiting the positive effects of such arrangement (Schiff and Winters, 1998). The potential for exploiting these positive effects of integration grows with the size of the integration. Hence, such a potential is estimated to be greater towards the enlarged EU than the potential estimated towards the EU-15 and CEFTA separately (more about this see Kersan-Škabić, 2001; Boromisa, 2004b).

Regional economic integration (with EU, CEFTA, Western Balkans) and enhanced cooperation with Mediterranean countries and CIS can help to make the adjustment costs tolerable and thus facilitate integration into the EU market (through re-directing some exports to these markets). However, this should be regarded as an accompanying measure. Integration into the EU is, due its size, level of development, geographic position and already established economic links with Croatia, economically the best option.

Next round(s) of enlargement

Croatia is likely to start accession negotiations in 2005, and will probably meet membership criteria to be included in the second round of Eastern enlargement. But it is not yet defined when this round will take place and which countries will be included.

So far, apart from Bulgaria and Romania, which are considered to be a part of the first round of Eastern enlargement, there are only two candidates: Croatia and Turkey, while SAP countries are potential candidates.

In December 2004 European Council concluded that Turkey sufficiently fulfils Copenhagen political criteria to open accession negotiations provided it brings into force specific pieces of legislation. It invited Commission to prepare necessary framework proposals with a view to opening negotiations on 3 October 2005 (European Council 2004b). Opening of negotiations, however, does not set the timeframe for membership nor answers the remaining institutional, financial or policy issues from the EU side. Experience from the first round of Eastern enlargement shows that a later opening of negotiations does not necessarily mean later membership (e.g. Slovakia, Lithuania, Latvia).

The next round(s) of the Eastern enlargement will be smaller than the current expansion. The sheer size of the last round of enlargement, as compared with that in which Croatia is likely to be included, shows that the EU will have much more capacity and experience to monitor progress than it had in the previous enlargement round.

The distant time horizon for full membership raises two issues of general significance: first, how the EU can give sufficient substance to the association process to keep it politically motivating, and second, whether and how the EU constitution and institutions can be made capable of absorbing many more small states, with the total rising maybe to 30 or 35 member states (more about these issues see Emerson, 2002; 2003)?

CASE OF CROATIA: WHAT SCENARIO FOR THE FUTURE?

Based on the extent to the commitment to Europe and on EU political will, four alternative scenarios for the future integration process, labeled as progression, regression, compression and secession

could be envisaged (Table 5). They do not answer the basic question of when Croatia is going to be included into the EU, but show the way that is the fastest.

Table 5 Scenarios for the future

		Croatia: extent of commitment to Europe	
		High	Low
EU political will	High	Progression	Compression
	Low	Regression	Secession

Source: According to Grimm (2004)

The *compression scenario* is basic scenario, identified earlier as distant membership scenario. Although the EU is willing to enlarge, the movement to a Constitution and new institutional solutions remains slow, the focus on regionalism and blocks is continued, accession negotiations continue, while policy coherence remains distant.

The *progression scenario* is based on the presumption that the EU accepts (i.e. all member states ratify) the constitution and vigorously supports the integration process. The focus is shifted from regionalism and blocks, so the SAP is individualized. Croatia's institutional capacity is created and remaining difficulties are dealt with.

In the *regression scenario* a consensus around greater Europeanization is found, but negotiations falter. There is little support for radical opening up of the EU.

In the *secession scenario* lip service is paid to Europe, but in practice no progress is made, financial perspective do not allow for further enlargement, member states increasingly challenge the decisions and orientations of the Commission, re-nationalising the EU is discussed, and bilateral agreements acquire more prominence.

By deciding to convene a bilateral intergovernmental conference with Croatia early in 2005 in order to begin negotiations, the European Council confirmed the principle of eligibility for all European democracies (European Council, 2004a). This can be regarded as indicating a high level of EU political will, so the progression scenario is possible if Croatia does its part. The progression scenario is not the same as the fast inclusion scenario, which we mentioned earlier, arguing that it is not very likely. Progression denotes the fastest possible, but it does not really mean fast (short run) membership in the EU.^{xxiii} Identifying the progression scenario with fast inclusion into the EU is the result of insufficient understanding of EU procedures and policies.

Confusing the progression with the fast inclusion scenario might lead to another misunderstanding – that the EU’s political will is fading, so that the progression scenario is not being realized, rather the regression scenario. Lots of reforms in Croatia, including not popular ones, are labeled “European”. So perception is that Croatia is doing its best, but the EU is just not willing to accept us. Such a perception, coupled with the lack of a clear date of accession might slow down reform implementation, in spite of the formal consensus around greater Europeanisation.

This simplified analysis of the complex process of the EU integration (which therefore should be viewed as tentative exercise) illustrates that it is quite simple to get from progression to secession. The path from progression to secession is highly dependent on information strategy and perception of the process of European integration. Simplified domestic policy will play a crucial role in the process of integration.

Labeling unpopular reforms as European, which is not always the truth, and simultaneously announcing EU membership as a Croatian “strategic goal” gives confusing signals. Why should Croatia want to be included into the EU while it creates costs? What is in it for Croatia, and when will the integration process bring some benefits?

It seems that no one is ready to say that Croatia needs reforms anyway. Including unpopular ones. But it is politically easier to say that Croatia needs them because the EU asked for them (or IMF, World Bank and other “bad guys”).

Still, it should be estimated how much membership can cost, and which sequencing of reforms is needed. Croatia should know its negotiating position – if EU membership is a Croatian strategic goal, is there anything to negotiate? Also, it should be clear what price Croatia is ready to pay for full membership (which could be distant). The issues already raised include agriculture, fisheries and eco-zones. The border with Slovenia has been recently mentioned (especially before the Slovenian elections) in the context of Slovenian support for Croatia’s integration into the EU. In the future new issues can arise, such as national treatment in public procurement and granting concessions (e.g. water but perhaps also gas and oil once Croatian oil company INA is privatised more than 50%, which should be, according to the INA Privatisation Act, upon accession to the EU).

Hence, although full membership is according to the so-far available analyses economically the best option, Croatia should be open

for “virtual membership” possibilities, such as political integration, economic integration and decision shaping without full membership.

Some of the models and sectors for possible economic integration and institutional cooperation with the EU are given in Box 1.

Box 1 Possible models of virtual European Union membership

1. Economic dimension

1.1. Trade and markets

Tariff free trade

Customs union

Single market (and avoiding hub and spoke relations)

1.2. Monetary regime

Semi-fixed parity with euro

Fixed exchange rate with euro, currency board regime

Euro as parallel currency in private sector

Full euroisation

2. Institutional dimension

Political dialogue

Participation in decision-shaping, but not decision-taking*

Implicit participation in decision making**

Observer status in EU bodies, e.g. in Economic and Social Committee, Committee of the Regions

Recognizing the authority of some EU institutions, e.g. European Court of Justice

* Active observers, as 10 new members in pre-accession period.

** e. g. Council of Ministers: A member state chosen by the associated state or entity may be mandated to speak on its behalf. In the voting of the Council of Ministers under the double majority proposed by the Constitution, the mandated member state may cast the population vote of the associated state or entity separately. A representative of the associated state or entity may attend as observer within the delegation of the mandated member state in open legislative sessions European Parliament. Inclusion in a neighboring constituency of a member state (for a micro state/entity), or an observer or full member (where population reaches average constituency size). A Commissioner in the European Commission will have relations with the associated states and entities in his portfolio of tasks.

Source: According to Emerson (2002; 2003)

As Box 1 shows, there are various options and their combinations for participating in the EU. The benefits of virtual membership include various sequencings of reforms. However, this implies that sufficient analyses exist, so the best option can be chosen. Also, for a small

country, virtual membership decreases costs, especially these in limited human capital. For instance, full euroisation would mean fully taking part in the euro area, but with no seat on the Governing Council of the European Central Bank; and possibility for limited minting of euro coins (like the Monaco euro).

CONCLUSION AND RECOMMENDATIONS

After the last enlargement, the EU is for a small and neighboring country, such as Croatia, even more important than before. The importance of other regional integrations has decreased. Therefore, full EU membership is probably the best long-term solution.

Croatia is likely to be included in the second wave of Eastern EU enlargement, but that wave might be more distant than officially expected by the Government. The time horizon of inclusion into the EU does matter. Hence, alternative options should be considered for the “pre-in” phase.

Also, declaring full membership as a strategic goal and ultimate objective can jeopardize the Croatian negotiating position and open space for increased pressure from some member states. The decision should be made: is there anything “more strategic” than the EU (such as fisheries and oil in Norway) and how much are we ready to pay for EU membership without knowing its timeframe?

Hence, to strengthen Croatia’s negotiating position alternative, “virtual” membership options should be taken into consideration, such as participation in the internal market (such as European Economic Area – EEA membership, like Norway, Iceland, Switzerland) and following the work of the EU institutions as active observers. Virtual membership options might be in the short run economically more viable than fast full membership.^{xxiv}

Raising the public awareness that there is a life outside the EU and that reforms are needed for successful transition and not because of the EU might help in keeping the pace of reforms and enable the meeting of membership criteria. Meeting the membership criteria should be regarded as Europeanisation, and hence as a goal and not condition.^{xxv}

The impact of economic integration into the enlarged EU (thorough implementation of SAA) is expected to be greater than the impact of integration into the EU-15. For the potential for exploiting the positive effects of simplified access to a large market grows with the growth

of the market. This potential is greater in new members than in the EU-15. However, the possibilities for exploiting this potential by Croatian producers are limited by production structure and adaptability of firms (i.e. by the ability to fulfil the second economic membership criterion). In order to exploit the positive effects of integration, reforms are needed. The reforms require the toleration of significant adjustment costs, especially in the short run. The enlargement intensifies this effect, so SAA implementation coupled with the impact of enlargement increases the pressure for reforms. Reforms are transition-related, and their result should bring benefits (enable sustainable growth). These reforms would have been needed even if the EU had not enlarged, and if the Croatia had not signed the SAA. Enlargement and establishment of a free trade zone hence highlight the need for reforms and might speed them up. In this context, the enlargement and the implementation of SAA can be regarded as beneficial processes for the Croatian economy, in spite of the fact that they create adjustment costs.

Hence, recommendations can be summarized as follows:

- examine the time frame for integration, i.e. how fast is it possible?
- identify alternative options for integration in the “pre-in” phase;
- define any strategic interests there might be that are unconnected with membership in the EU;
- in sequencing reforms consider the possible timeframe for EU membership;
- raise public awareness that some of the EU-related reforms are also transition-related (i.e. necessary anyway) and that by entering the EU reforms (and related costs) do not stop.

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- i *The first round of Eastern enlargement in this paper denotes the enlargement process that includes 10 countries of Central and Eastern Europe as well as Cyprus and Malta. This means that Romania and Bulgaria are, in line with conclusions of the Salonika European Council (2003) regarded as the part of the same round of enlargement.*
 - ii *Interim Agreement enables the application of the provisions of the Stabilization and Association Agreement (SAA) that are under the competence of the Community (such as establishment of a free trade zone). This enables gradual integration towards the EU in the period before ratification process is finalized.*
 - iii *More about membership criteria, see Boromisa (2004a:169-173).*
 - iv *This progress is monitored and evaluated regularly once a year by the European Commission and its main findings are published in Regular Reports. In the period after completing negotiations and before signing the Accession Treaty, candidates were also monitored. The main findings were published in the Comprehensive*

- Monitoring Report of the European Commission on the State of Preparedness for EU Membership of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia (European Commission, 2004c).*
- v *This is confirmed by conclusions of the European Councils in Copenhagen (2002), Salonika (2003), and Brussels (2004). The Salonika Council (2003) stated that “the pace of negotiations (with Bulgaria and Romania) will be maintained, and these will continue on the same basis and principles that applied to the ten acceding states with each candidate judged on its own merits. Building on significant progress achieved, the Union supports Bulgaria and Romania in their efforts to achieve the objective of concluding negotiations in 2004, and invites them to step up their preparations on the ground. Discussions or agreement on future policy reforms, or the new financial perspective, will neither impede the pursuit and conclusion of accession negotiations nor be prejudged by the outcome of these negotiations.” The Copenhagen Council (2002) recalled its decision from Helsinki (1999) that Turkey is a “candidate state destined to join the Union on the basis of the same criteria as applied to the other candidate states”. When Croatia was given the candidate status, the Council in Brussels stated following “The European Council... confirms that the negotiations will be based on Croatia’s own merits and that the pace of accession will depend solely on Croatia’s progress in meeting the requirements for membership”. So the European Council confirms that the criteria will be the same, but differences in wording might lead to conclusion that it acknowledges that the EU is a moving target and that the timeframe does matter.*
- vi *This is evaluated upon functioning of the institutions designed to respect liberty, democracy and human rights (parliament, executive, judiciary). They have to be stable and guarantee the rule of law, i.e. they protect individual rights and freedom in practice.*
- vii *The European Commission evaluates the effectiveness of a market economy on the basis of following: the equilibrium between supply and demand established by the free interplay of market forces (prices and trade liberalization); absence of significant barriers to market entry (establishment of new firms) and exit (bankruptcies, liquidations); the legal system, including the regulation of property rights; macro-economic stability achieved, including price stability, sustainable public finances and external accounts; the existence of broad consensus about the essentials of economic policy and sufficiently developed financial sector to channel savings towards productive investments.*
- viii *This date corresponds with the planned date for finalizing preparations in Croatia. Originally, it was targeted so as to catch up Bulgaria and Romania in the “next” round of enlargement.*
- ix *SAP conditions include conditions defined in the so-called “regional approach”, i.e. conditions defined by the Council in its Conclusions of 29 April 1997 and 21-22 June 1999, the content of the final declaration of the Zagreb Summit of 24 November 2000 and Salonika agenda. They include co-operation with the International Criminal Tribunal for the Former Yugoslavia (ICTY), regional co-operation and other related issues (such as refugee return, fight against corruption etc).*
- x *Such an approach can be explained by the fact that in the period before accession significant progress was made in terms of negative integration, i.e. elimination of customs duties and quantitative restrictions. Effects of other integration policies are likely to be felt in a longer period. A similar approach is also used in numerous studies, such as, Baldwin, Francois and Portes, 1997; Keuschingg and Kohler,*

- 1999; European Commission, 1997; Gros, Crum and Turmann, 2004. For summarized findings of these approaches see Boromisa (2004b:14).
- xi Integration into the EU means inclusion into the internal market, i.e. free movement of goods, persons, services and capital. However, in this paper we examine only product market integration. Removal of trade barriers means dismantling of existing barriers (e.g. tariffs, quotas, voluntary export restrictions) and harmonization of policies (e.g. agriculture, competition, trade and industrial).
 - xii Negative integration denotes the removal of discrimination in economic rules and policies, while positive integration refers to the transfer to common institutions. For more see Pelkmans (1997).
 - xiii Ex ante estimation of potential economic effects of enlargement is dealt with under the heading Economic impact of enlargement.
 - xiv This part of the paper relies on calculations in my Ph. D. thesis, while the data used are mainly Eurostat, and to the lesser extent IMF and Croatian Bureau of Statistics. If no source is explicitly stated, the default is Boromisa (2004b).
 - xv One of the indices that can be used for measuring intra-industry trade (IIT) is the Grubell-Lloyd index (GL) (more about IIT indices see Gullstrand, 2002). The GL index, calculated on the two-digit level of combined nomenclature, for Croatia towards EU-15 was 0.46, while towards the EU-25 is 0.5 (Boromisa, 2004b). IIT towards the EU-25 is greater than towards EU-15. Volume and nature of goods traded is one of the indices used to estimate readiness to meet economic membership criteria. Hence, according to this index, after the enlargement Croatia meets membership criteria better.
 - xvi Issue of the size of the next enlargement round is dealt with under heading Capacity of enlarged European Union to absorb new members.
 - xvii This concerns multilateralization of individual free trade agreements.
 - xviii Similar wording is also in the draft Treaty establishing a Constitution for Europe (COREPER, 2004), whose provisions follow the procedure established in the fifth round of enlargement (Article I-57).
 - xix By 35 I do not mean to imply that Kosovo will become sovereign state nor that Serbia and Montenegro will create two different states. This number is just an illustration of the possible total number of member states. It should be noted that Iceland, Lichtenstein, Norway and Switzerland may also apply for membership. Ukraine, Belarus, Moldova and some Black Sea countries, as well as Russia may also eventually become candidates.
 - xx In order to minimize possible negative effects of the enlargement, the EU is fostering regional integration in neighboring regions (Mediterranean countries, Russia, Ukraine, CIS) and by doing so is intensifying competition on these markets and as well in the EU market. Such a development, if Croatia does not intensify its efforts for economic reform, can significantly jeopardize its competitiveness on these markets and EU market.
 - xxi Openness is defined as share of trade/proportion of GDP. Out of 17 sectors according to national classification, five are subject to international trade and their share in GDP has in the period 1995-2001 decreased from 31 to 28%. Percentage of exports in GDP in the same period decreased from 49 to 24%.
 - xxii This can be illustrated by unit export price defined as value of total exports (in euros) over its quantity (in kg).
 - xxiii We would not speculate on date of accession, since it depends on too many factors, some of which are identified here. For the dates by which we consider Croatia is likely to be evaluated by the European Commission as capable of meeting member-

- ship criteria see, for instance Boromisa (2002). It should also be noted that the risk of delays in the ratification procedure rises with the number of the EU member states (i.e. number of national parliaments that have to ratify the accession treaty).*
- xxiv *This statement relies on the fact that there is no obligation to contribute to the EU budget before full membership. On the other hand, pre-accession funds (such as TEMPUS, CARDS) should be open for participants from Croatia. This should be analyzed in more detail.*
- xxv *However, one should be aware that some of the necessary, but politically tough decisions are “justified” as requirements for the EU. If other options are considered, new “excuses” for unpopular decisions such as decreasing public expenditure are to be found. This might lead to the government losing popularity, which is not the favorite option of (any) government.*

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