

# COMMITMENT AND CREDIBILITY

## EU CONDITIONALITY AND INTERIM GAINS

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### Abstract

This paper examines the importance of credibility in the reform process of Central and Eastern European countries, and the political economy dynamics of how commitment to the goal of EU accession helps deliver it. It suggests that the implied commitment to meet EU accession conditions boosts the market credibility of these countries' reform programmes by tying their hands in policy terms. An analogy is drawn with the impact of Italy's commitment to meet the Maastricht conditions for EMU entry. The paper emphasises that 'interim credibility benefits' (especially a lower risk premium and more foreign direct investment) are central to explaining the importance and operation of such 'soft commitment devices'. It also analyses the partial dependence of such interim credibility benefits on the inflexibility of EU conditionality, and hence the trade-off between these interim benefits and potential costs of subordinating transition objectives to inflexible EU entry conditions.

**Key words:** commitment, commitment device, credibility, interim credibility benefits, political discount rate, EU conditionality, EU enlargement, Maastricht conditionality & Italy, transition (Central and Eastern Europe).

## 1. INTRODUCTION AND OUTLINE

Several studies of the relationship between EU enlargement and the transition process in Central and Eastern European Countries (CEECs) focus on the mechanisms of EU conditionality and the conditions for its success<sup>1</sup>. Some authors particularly emphasise the ambiguous impact of EU conditionality and possible clashes between accession and transition objectives (e.g. Mayhew, 1998; Grabbe, 2002)<sup>2</sup>. A general conclusion that could be reached from their arguments is that the needs of CEECs would be better met if the EU was willing to negotiate long transition periods for accession countries and be much more flexible on the conditionality it imposes on would-be entrants, tailoring the conditions to their particular development needs.

This paper offers a new approach to understanding the impact of EU conditionality. It helps explain why in practice relatively inflexible conditionality can be very effective in furthering both the transition and enlargement processes, and why so many of the CEECs have been prepared to stick to the reforms needed to meet EU conditions despite the high economic and political costs of doing so (particularly for governing parties). It does this by examining how a commitment by CEECs to the goal of accession, and the delegation of their choice of policy mix to the exigencies of EU conditionality, can lead to a self-reinforcing boost in the market credibility of transition reforms. Using a theoretical background provided by monetary policy literature, it explores the way that CEECs'

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<sup>1</sup> Useful examples include Grabbe (2002) with a broad ranging discussion of 'conditionality levers' and Schimmelfennig et al (2002) with its emphasis on 'reactive reinforcement'.

<sup>2</sup> As discussed in section 4, the debate often centers on whether or not the *acquis communautaire* - the EU's club rules which candidates are required to adopt - are a suitable template for transition reforms.

commitment to accession operates as a ‘commitment device’<sup>3</sup> to increase credibility by tying their governments’ hands in policy terms. The focus is on increases in the credibility in financial markets of economic and political reforms in CEECs, and it is argued that higher foreign direct investment (FDI) and a lower cost of capital represent good proxies for these increases. The significant scale of the credibility benefits of increased FDI and a lower cost of capital (or reduced risk premium) that can flow from the accession process is underlined in many empirical studies (e.g., Baldwin et al, 1997; Bevan & Estrin, 2000; Grabbe, 2001). The emphasis on this paper is on explaining the political economy dynamics and importance of securing these benefits in the period leading up to accession.

A ‘**commitment device**’ or hands tying arrangement increases the credibility of a reform programme by artificially raising the **short-term** costs of reneging on the policy path that *ex ante* seemed the best long-term choice. In this case, by committing themselves to the goal of EU accession, and thereby submitting themselves to benchmarking and sanctioning in Commission reports and to loss of face if their application is turned down, CEEC governments make themselves less prone to postponing difficult decisions on transition policy for short-term political gain. At the same time, the *de facto* delegation of the policy mix (now dictated by EU conditionality) simplifies the decision-tree for CEECs, and strengthens governments’ resolve to resist the demands of rent-seeking special interest groups. For these reasons, the hands-tying aspect of the commitment by CEECs to accession will (under certain conditions explored in the paper) bestow important ‘interim’ credibility benefits in the form of a lower risk premium and more FDI, by providing financial markets with more settled

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<sup>3</sup> For the term ‘commitment device’ in the context of enlargement, see Grabbe, 2002; in context of monetary policy see Cukierman (1992), and for broader usage, Benabou & Tirole (2002).

expectations about the trajectory of reform which the applicant states will follow.

The paper's main conclusion is that these **interim credibility benefits** of increased investment and FDI provided by the commitment of CEECs to accession are not only important in themselves; crucially, they also imply a second-order political economy advantage, namely that they further raise the **current** (or short-term) cost of reneging on the commitment to stick to the policy path leading to accession. When a CEEC government is deciding whether to push through difficult reforms necessary to meet EU conditions, it has to weigh the short-term costs of persevering not only against the potential loss or postponement of **long-term** benefits but also against the likely **current** loss of 'interim' credibility benefits. The potential loss of interim benefits becomes one of the main sanctions against policy backsliding; the need to retain raised levels of FDI and a lower cost of borrowing becomes a critical reason to stick to the reform path dictated by EU conditionality. Indeed, since credibility is often **self-reinforcing**, the interim benefits may continue to grow steeply, and with them the cost of revoking the commitment to necessary reform; this implies a strengthening over time in the disciplining effects of the commitment to accession, and a non-linear risk function attendant on any backsliding at a late stage in the process. CEECs in the final negotiations will know that if their accession is suddenly in doubt or the timing significantly postponed, very significant interim credibility benefits could be lost as the risk premium rises again.

In this way, the paper argues, interim credibility benefits are a crucial mechanism by which a commitment to meet the requirements of EU conditionality can align short-term rationality with long-term rationality; the potential for immediate loss of interim credibility benefits if necessary reforms are shirked helps align short-term with long-term incentives. As a result, interim benefits help overcome the problem that politicians

generally apply a high '**political discount rate**' to the future benefits of current virtue.

These conclusions about the credibility and disciplining impact of commitment to accession in the context of EU conditionality are tested in two ways in the paper: first, an analogy is drawn with the impact of Italy's commitment to meet the Maastricht conditions for EMU entry. This helps confirm and generalise the findings. It also helps establish an important but subtle distinction - between the '**soft**' **commitment devices** implied by public promises to tie one's hands irrevocably after meeting certain externally imposed conditions and 'hard' commitment devices in the form of actually tying one's hands permanently (e.g., by actual adoption of the euro or accession to the EU). Monetary policy literature usually only considers versions of the latter as likely to boost credibility. But the Italian example shows that a mere stated intention to enter the euro and meet the Maastricht conditions can be enough to lead to increasing interim credibility benefits and disciplining effects; and there are many parallels between this example and the CEEC's 'soft' commitment to accede to the EU having met the Copenhagen criteria<sup>4</sup>. Secondly, the paper reviews the findings of Bevan & Estrin (2000) which establish a link between progress in the accession process and FDI flows. This empirical evidence is at least consistent with the self-reinforcing interim credibility benefits which the argument of this paper predicts should flow from a commitment to accession.

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<sup>4</sup> The Copenhagen criteria were set out in the European Council Conclusions in June 1993. To be successful, membership applicants must have: 1. Stable institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities. 2. A functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. 3. The ability to take on the legal and regulatory obligations of membership i.e., the '*acquis communautaire*'.

Finally, the paper explores the paradox that, because the commitment to accession gives credibility to the reform process partly by virtue of tying CEEC governments' hands, it does so at the cost of leaving them with little flexibility to align the requirements of EU entry and of political and economic transition. In other words, it is, in part, the very incapacity of CEECs to negotiate wholesale changes to the conditionality to render it more palatable that helps give the accession process its teeth as a commitment device. It will also be noted, of course, that if the needs of transition and the requirements of accession are too divergent, a commitment to accession cannot itself be credible and can therefore do nothing to boost the credibility of the reform process.

## **2. CREDIBILITY AND COMMITMENT**

Credibility has been defined as 'the expectation that an announced policy will be carried out' (Drazen & Masson, 1993). This section briefly outlines why credibility is so central to the effectiveness of policy (including transition policy) and how the market credibility of government policy can be measured. Drawing on ideas from monetary policy literature, it discusses different ways in which credibility can be secured – either through the earning of a reputation for consistency or through the use of 'commitment technology'. Some general conditions required for delegation and rule-based regimes successfully to bestow credibility are also outlined.

### **2.1: The importance of enhancing credibility and how to measure it**

The importance of credibility in ensuring the effectiveness of government policy has long been emphasised in studies of monetary policy regimes (e.g., Blinder, 1999) and has been extended by analogy to many areas of political science and political economy (Majone, HPS, 1996). When a regime has credibility it will be able to alter the expectations of other actors favourably because it is trusted or at least believed. Credibility helps overcome the fear that a given policy may be short-lived because it is



‘time-inconsistent’; that is, it reduces expectations that the government may renege on the policy at a later date if policy makers come to have different incentives and a different perception of whether the policy is optimal (Majone, HPS, 1996). In the absence of credibility attaching to policy maker or policy, other political or economic actors will rationally expect policy inconsistency over time to match any time inconsistency of incentives, perceptions or preferences, and hence will act accordingly. This is likely to undermine the effectiveness of the policy even at the outset (Majone, HPS, 1996). For example, in the context of transition, a new policy of free capital or dividend repatriation (or even a complete abolition of exchange controls) may not succeed in lowering the risk premium on investment and encouraging more FDI if investors are concerned that the policy might be reversed when the country concerned experiences a run on the currency or other economic instability. In such a case, the policy will only work if it is credible either that the policy will not be time-inconsistent in any likely eventuality or that the policy-maker will have sufficient incentives (e.g., external sanctions or fear of loss of reputation) to stick with the policy even if it appears sub-optimal in itself at a later date.

A good proxy for changes in the credibility of government policy is changes in the risk premium for government debt or changes in the level of FDI. The risk premium is a measure of the costs of financing relative to a risk-free rate of return, usually measured as the basis point spread over US treasuries charged to other countries for dollar denominated debt issues<sup>5</sup>; and it reflects the degree of market uncertainty - particularly about the policy framework (Baldwin et al, 1997); or to put it another way, it is a function of market perceptions of the relative dangers of ‘time inconsistency’ of policy. Since it is policy credibility which allows for the settled market expectations which result in a lower risk premium, the risk

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<sup>5</sup> In other words, the risk premium measures the difference in interest costs between that paid by the US government and other borrowers in the same currency.

premium can be a good proxy for such credibility. Of course, the risk premium only reflects the credibility of policies that concern markets, but these include much more than economic policy, encompassing also the legal system, property rights and social and political stability. The risk premium for CEECs is therefore a function of how settled are market expectations of the trajectory of policy reform in these countries, and it reflects the credibility which attaches in markets to a broad swathe of transition policy. Changes in the level or growth rate of FDI are clearly closely related to changes in the risk premium, and by extension also represent good proxies for the credibility of a regime.

In the literature assessing the economic costs and benefits of the EU accession process, there is a heavy emphasis on the impact of the process in reducing the risk premium on investment in CEECs (Baldwin et al, 1997) and improving the climate for FDI (Grabbe, 2001). Baldwin et al point to the enormous impact that accession had on investment flows in Spain and Portugal in the 1980s and argue that a lower risk premium (and hence greater investment and FDI) is the main potential advantage of accession<sup>6</sup>. Moreover, Bevan and Estrin, in their study of the determinants of FDI flows to CEECs to date, note that these flows have already been heavily influenced by the early stages of the accession process; the result has been a further concentration of FDI flows on the front-runners for accession. These findings are discussed in more detail in section 3.2 as part of an examination of how commitment to the goal of accession boosts the market credibility of transition policy by tying the hands of CEEC policy makers.

## **2.2: Securing credibility from commitment: lessons from monetary policy literature**

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<sup>6</sup> Baldwin et al (1997) predict that the reduction in the risk premium implied by accession will lead to an approximate 17% rise in real incomes and 67% rise in the capital stock of the seven CEECs they consider.

It is relatively uncontroversial that a government or central bank must have credibility to be effective (e.g., see survey of central bankers and economists in Blinder, 1999) unless it can have recourse to coercion of its citizens (Majone, HPS, 1996); in particular, it must have credibility if it is to convince foreign investors. What is far more controversial is how best governments and central banks can secure and retain credibility. In summary, there are two broad methods discussed in the monetary policy literature:

- (a) The first is the steady earning of a **reputation for policy consistency** - both consistency over time in 'matching deeds to words' (Blinder, 1999) and the consistency or coherence of the broad mix of policies (Frieden & Jones, 1998). These two forms of consistency are linked, of course, since time consistency is only likely to occur if the policy regime is able to come up with a broad set of policies of at least tolerable internal coherence. So, for example, one could argue that the Bundesbank earned its credibility not only because it took great care to nourish its reputation for withstanding any short-term political pressures to compromise its legislated objective of low inflation, but also because other economic and political institutions in Germany reacted to this regime in such a way that Germany achieved a coherent and self-reinforcing policy mix. A regime which has over time impressed other actors with the consistency and coherence of its actions builds up reputational capital which pays handsome dividends in the form of trust and respect. The great value of reputation-based trust or credibility is that it allows the regime to be flexible in meeting its goal (Blinder, 1999); once it has the trust of other actors it need not follow preset rules slavishly on all occasions. Nor, however, must it risk doing anything that will squander its hard-earned reputational capital.
- (b) The second broad set of methods for securing credibility comes under the heading of '**commitment technology**' (Blinder, 1999).

These methods imply some degree of 'tying ones hands' (Jones, Frieden & Torres, 1998). This may involve setting rules that limit the discretion of policy makers (Kydland & Prescott, 1977) and/or align their incentives with the pursuit of the long-term policy objective (Blinder, 1999). Many commitment devices take the form of delegation to a group of policy makers (e.g., the European Central Bank) who are remote from the political process (Majone, HPS, 1996) and can therefore be expected to be insulated from the time-inconsistent preferences of politicians. More generally, credibility can be provided for policy by enshrining it in constitutional rules that are difficult for individual governments to change even when it suits their interests. These rules may involve sanctions for policy-makers if the pre-set goal is not met or may give positive incentives to meet it. Crucially all such commitment devices rely for their efficacy on the high costs of reversing the delegation or constitutional decision to set up a rule-based regime. Indeed they only work if at all times the costs to policy makers of remaining bound by the commitment are exceeded by the costs of reneging on the commitment (Frieden & Jones, 1998).

There are three conditions discussed in the monetary policy literature as being necessary if commitment devices are to yield credibility benefits. The first is that the rules being instituted (or the pre-set goals of independent bodies to whom discretion is delegated) must be sufficiently consistent and coherent in policy terms with the other strategic goals of the regime; otherwise it will not be credible that the costs of jettisoning the rules (or revoking the delegation) implied by the device will outweigh the costs of sticking to the commitment in all cases. The UK's ERM policy in 1990-2 is a good example of a commitment device that failed to bestow credibility despite the high short-term costs of revocation because there were both high short-term costs of sticking to the policy and very real

doubts about the long-term consistency and coherence of the resultant mix of UK policy (Frieden & Jones, 1998)<sup>7</sup>.

Secondly, there must (in a working democracy) be broad underlying public support for the long-term rule or constitutionally enshrined policy goal or institutional delegation (Jones, Frieden & Torres, 1998). The Bundesbank's credibility was partly a function of the extraordinarily high popular support in Germany for the primacy of an anti-inflationary strategy. The degree of popular support is a path-dependent variable and in Germany's case, of course, support for an anti-inflation strategy stemmed from a wish to avoid at all costs a repeat of the inflation of the 1920s, the disastrous consequences of which were seared into popular consciousness. This popularity presumably encouraged German governments and unions to internalise the anti-inflationary stance of the Bundesbank in their deliberations.

The third general condition for commitment devices to work is that the bodies to which discretion is being delegated, or are charged with enforcing the rules, must themselves have credibility - either reputation-based credibility or incentive-based. In other words, commitment devices based on delegation rely for their efficacy on borrowing credibility from the body to which discretion has been delegated, while rule-based regimes must have credible rule-keepers (e.g., an impartial legal system). Ultimately any system lacking sufficient reputation-based credibility - borrowed or otherwise - must ensure that credibility is gained by submitting to other mechanisms which do, and are seen to, align the incentives of policy-makers with the long-term policy goal in all or most eventualities. These may take the form of externally-directed sanctioning

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<sup>7</sup> For the related argument that credibility will only be enhanced if the country is actually able to deliver on the commitment in 'unfavourable circumstances', see Drazen & Masson, 1993.

or reward mechanisms (e.g., contracts to pay central bank governors on inflation results).

### **3. COMMITMENT DEVICES AND EU CONDITIONALITY**

It is time now to examine more fully the two political economy examples of commitment central to this paper – those relating to Italian entry into the euro-zone and the accession of CEECs into the EU. This section compares the use by Italy in the 1990s of a public commitment to the goal of EMU entry (and delegation of choice of policy mix to the exigencies of the Maastricht criteria) with the use by CEECs of commitment to EU accession (and delegation of choice of policy mix in their reform programs to the exigencies of *acquis* approximation, the accession partnerships and Commission ‘opinions’). Both examples help unpack the intricate nature of the ‘commitment device’ as a political economy policy tool – in particular the workings of a ‘soft’ commitment device involving a stated intention to submit to EU conditionality. Both examples also show how such a commitment device boosts the market credibility of government policy, and they demonstrate the central role of interim credibility benefits.

#### **3.1: Hard and soft commitment devices**

It is helpful to distinguish between ‘soft’ commitment devices (public promises to tie one’s hands irrevocably after meeting certain externally imposed conditions) and ‘hard’ commitment devices in the form of actually tying one’s hands ‘permanently’ to an external or common regime. It is essentially the latter that are envisaged in most of the monetary policy literature about commitment technology as a means of increasing (or borrowing) credibility and reducing the cost of capital.

A clear example of a ‘hard’ commitment device is that represented by the actual adoption of the euro or actual entry into the EU. The ‘hands tying’ implications of such a ‘hard’ commitment are fairly easy to understand.

After euro entry or accession, countries permanently sacrifice their ability to decide their own policy mix to suit their particular interests, by delegating discretion in perpetuity to an external or common regime (e.g., to the European Central Bank or the Council of Ministers / European Parliament). This allows them to escape many of the reputation consequences of a poor track record and to tap into the club's credibility. There may, of course, still be some forms of country risk (e.g. credit or default risk) which are not dissolved by joining the club in the absence of similar levels of credibility for government policy in remaining areas of national competence.

A good proxy for convergence in the market credibility of government policy is, as argued in section 2.1, convergence in the risk premium. The fact that convergence in credibility is not assured even by the 'hard' commitment device of accession to the EU is made very clear by looking at the risk premium of Greece which was still higher than for the Czech Republic in 1994 (Baldwin et al 1997); it is made equally clear by looking at Greece's poor track-record in investment (Baldwin et al, 1997) and FDI flows (Grabbe, 2001) since accession, compared to Spain and other new entrants. Of course, fewer areas are left to individual government discretion now than in the early 1980s, suggesting that the hard commitment device of accession might have greater and more even credibility benefits for all new accession countries. Indeed, the stunning impact of adopting the euro (and giving up all national monetary policy discretion by delegating policy to the ECB) on the credibility of Italian and Greek economic policy is clear from looking at the very tight spreads on government bond yields between member states that are now established. Markets take the view that the costs of undoing this hard commitment device - i.e., of leaving the euro-zone - would always be so high for any member state that it would try virtually any other options to avoid doing so. In this way, euro entry has almost completely removed market fear of time inconsistency in the choice of monetary regime.

Of more particular interest in this paper, however, is the role and nature of **'soft' commitment devices** - defined as public **promises** to tie one's hands irrevocably **after** meeting certain externally imposed conditions. It was Italy's publicly stated determination to tie its hands irrevocably by joining the euro, together with the implied need to meet tough entry hurdles - the pre-set Maastricht criteria - which locked the country into seven years of unprecedented reform of fiscal and wage behaviour; and it was this period of 'soft' commitment prior to entry which witnessed the transformation of Italy's credibility, risk premium and economic outlook. It can be hoped that a broadly analogous publicly stated determination by CEECs to tie their hands irrevocably by acceding to the EU, combined with the need to meet tough entry hurdles - the pre-set Copenhagen criteria - will similarly transform the credibility and prospects of CEECs in the final years before accession.

Now it might be argued that such so-called 'soft' commitment devices are not really an example of 'hands tying' at all, since a mere promise to commit to a policy is not in itself enough to establish credibility (Samuelson & Nordhaus, 1998). It might also be argued that all that is at work here is an overwhelmingly positive cost-benefit ratio for euro entry in Italy's case, and for EU entry in the CEEC's case, which ensures that rational policy makers and electorates choose to submit to the costs implied by the onerous entry conditionality in order to reap the huge benefits. By contrast, the next section demonstrates several reasons why the public commitment to the goal of accession (or EMU entry) does indeed act as a commitment device to increase credibility by tying governments' hands in policy terms and seriously raising the short-term costs of deviation from the path of reform.



### **3.2: The dynamics of 'soft' commitment devices: invested 'face', sanctions, delegation and interim credibility benefits**

One important reason why a stated intention to keep to a goal like accession may in itself raise the costs of reneging is the importance of **political 'face' and national 'honour'**. Indeed, it is the investment of face which initially makes a formal commitment more credible to markets than a mere policy. Politicians who have signed up publicly to a policy prefer to keep it even if, in other respects, the short-term costs of doing so are high; they and their electorates value face and national honour highly. As a result, so long as certain other preconditions are met (see section 3.3), the policy committed to may be more credible with markets simply because they sense that the potential loss of invested face represents a new short-term cost of reneging.

It should not be underestimated how important a cost is implied for any government which makes a high profile international commitment which it then cannot keep. The fate of John Major's government in the UK is proof enough of the huge political costs in terms of humiliation, loss of face and damage to political reputation of a failure to maintain an oft-repeated commitment (ERM parity) which was also not irrevocable (at most a medium soft commitment device). Similar considerations applied to Italy's stated intention to participate in EMU: once clearly articulated, a failure to join would have been a national humiliation for this founding member of the EU. In the current accession negotiations and preparations it may also be highly relevant that most of the applicants do not want the humiliation of seeing their neighbour enter before them. Investment of national pride in a bid for accession in itself raises the political costs of failure to make the reforms necessary to meet the entry conditions. The political maxim is the reverse of the usual school maxim: 'Better not to have tried than to have tried and failed.'

Another relevant factor is that the decision to try to adopt the euro implies a *de facto* delegation of choice of macro-economic policy-mix to the exigencies of the Maastricht criteria; and similarly, entering into the process of EU accession negotiations involves a *de facto* delegation by CEECs of choice of transition policy mix to the exigencies of the Copenhagen criteria. Indeed, CEEC government policy becomes dominated by the need to adopt the full body of *acquis communautaire* (running to 80,000 pages) and to meet other policy stipulations contained in Commission 'opinions'. It is precisely this aspect of the attempt to gain entry which most ties governments' hands. Given the overriding goal of euro or EU entry, governments are effectively locked into a Treaty-determined and Commission-directed reform path. As Grabbe notes, this may simplify the reform process by 'avoiding a lengthy search for a domestic consensus' (Grabbe, 2002) on what is the right set of institutions for each country to adopt. More crucially, a commitment to accession may bolster governments' resolve not to give in to special interest group lobbies (Grabbe, 2002). If EU membership itself reduces national governments' discretion and ties their hands by reducing the amount of subsidies and trade protection they can offer domestic interest groups (Bofinger, 1995) so, too, does any serious attempt to meet the EU's conditionality in the long run-up to the entry decision. This hands tying effect of committing to the goal of accession can be enough in itself to lead to significant 'interim' credibility benefits in the form a lower risk premium and more FDI. Particularly if the country concerned has invested considerable 'face' in its application, markets know with a fair degree of certainty that it will remain on the pre-set trajectory of policy implementation implied by EU accession conditionality; its scope for unexpected policy shifts to appease special interest groups and short-term voter concern is limited.

The *de facto* delegation of policy choices described here is partly effective in tying governments' hands and raising the cost of backsliding because of the **sanctioning and benchmarking mechanisms** inherent in the accession

process. The Commission regularly reports on the 'progress' of applicant states - often with the implicit (or explicit) threat that the reports (like the 'Opinions' published in 1997) will be used to assess their relative readiness to join the club (Mayhew, 1998; Grabbe, 2002). These reports (acting essentially like end of term school reports) imply heavy short-term incentives for CEEC governments to align policy to the requirements of EU conditionality. The Commission reports ensure that failure to reform in some area which has been highlighted by the Commission in its 'Opinions' as a key target for reform (e.g. privatisation), and slow progress in adopting the *acquis communautaire* (especially the EU body of regulation for the operation of the Single Market), will be subject to public criticism (Grabbe, 2002). Again this mirrors the role of Commission and EMI/ECB reports on member states' progress towards meeting the Maastricht criteria in the run-up to the decision on who should be allowed to adopt the euro. In both cases, negative assessments can have serious and immediate political repercussions for governments at home and imply heavy short-term financial market costs.

These market costs of negative benchmarking assessments relate to by far the most important disciplining aspect of a serious commitment to accession or euro adoption. As we have seen, such a commitment implies a *de facto* delegation of policy choices; it also helps raise the short-term costs of deviating from the path of reform because of the potential loss of invested face if the accession candidate is sanctioned by the Commission's public benchmarking and judged to be failing in its quest to accede; and as a result the commitment bolsters the resolve of governments to resist the pressures of rent-seeking groups for special favours that would jeopardise reform. For these reasons, the commitment tends to give the governments some **interim credibility benefits** in the eyes of markets; and these interim credibility benefits will be reflected in an immediate reduction of these countries' risk premium. Moreover, since a reduced risk premium (or lower interest rate spread) means lower borrowing costs and usually more

FDI<sup>8</sup>, these interim credibility benefits - even if small initially - are likely to be cherished by governments. As a result the need to retain them represents a critical reason in itself to stick to the reform path. The potential loss of interim benefits as a result of negative assessments by the Commission becomes one of the main short-term sanctions against policy backsliding. This is the crucial second-order political economy advantage of interim credibility benefits.

It should now become clear why a public commitment to EU accession - combined with the conditionality, sanctioning and benchmarking aspects of the accession process - changes the incentives of policy makers in CEECs in a more effective way than the simple positive long-term cost-benefit ratio of entry. Politicians apply a very high **political discount rate** to future benefits - much higher than the discount rate applied by economists. This is partly because complex predictions about future benefits do not necessarily resonate strongly with an electorate which is, as Olson reminds us, rationally ignorant (Olson, 1982); it is also because - particularly in conditions of uncertainty - electors may rationally prefer 'jam today to jam tomorrow'. Moreover, especially in complex and uncertain conditions the electorate may exercise the (irrational) privilege of willing the long-term end but not the short-term means. In this context politicians have every incentive to apply a high political discount rate to future benefits. This is why commitment devices are so important in giving politically-driven policy regimes credibility with markets. For such devices artificially raise the **current** (or short-term) costs of reneging on the policy path that *ex ante* appeared to give the best long-term prospects.

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<sup>8</sup> Bevan & Estrin (2000) and Grabbe (2001) note the large concentration of FDI on the frontrunners for accession status. Figure 1 of Bevan & Estrin shows an approximate doubling in the level of FDI flows to these countries in 1995 as the commitment to accession became more credible. See below for more detailed discussion of Bevan & Estrin's findings, particularly the positive impact on the growth rate of FDI to 'frontrunners' of being singled out in the Commission's 1997 'Opinions'.

In this way they can align short-term rationality with long-term rationality. In particular, the potential loss of **interim** credibility benefits if necessary reforms were to be shirked helps align **short-term** incentives with **long-term** incentives.

So, for example, when a CEEC government is deciding whether to push through legal reforms necessary for *acquis* approximation (or difficult privatisation) in the face of heavy short-term employment (and electoral) costs, it has to weigh these short-term costs of persevering with reform not only against the potential loss of long-term benefits but also against the likely current loss of 'interim' credibility benefits. If the reform is postponed, markets will anticipate the Commission's negative reaction and start to increase the risk premium on investing in that country again - implying immediate costs for governments in terms of higher borrowing costs and less FDI. As we have seen, the risk premium is a function of uncertainty about policy and is highly influenced by how settled appears to be the trajectory of reform (Baldwin et al, 1997). When markets are sure that a country is on track for accession, they can be fairly sure they know the future shape of a whole range of critical policies – competition law, trade policy, property rights etc., (Baldwin et al, 1997). But if accession is suddenly in doubt, or the timing postponed significantly, the risk premium will rise and interim benefits of credibility will be lost.

By contrast, if a CEEC continues to impress markets and the Commission with its progress, the interim benefits will continue to rise and with them the costs of revoking the commitment to accession. Indeed increases in credibility are often **self-reinforcing**. There are several reasons why this might be so in the case of progress towards accession. First, there may be first-mover advantages for those ahead in the race to accede. Secondly, confidence and credibility are inherently self-reinforcing, since the implied reductions in the risk premium (and hence in borrowing costs) lead, *ceteris paribus*, to more FDI flows and domestic investment which in turn further

improves market sentiment, the risk premium and credit ratings (Bevan & Estrin, 2000), creating a virtuous circle.

There is a third reason for a non-linear increase in credibility which is specific to soft commitment devices involving commitment to tie one's hands permanently after crossing a threshold of meeting EU entry conditions. The final goal - EU entry or euro adoption - involves strong threshold effects because entry is a once-for-all decision on both sides: actually clearing the entry hurdles by meeting the Copenhagen or Maastricht criteria, together with the decision that the new entrant should be irrevocably bound by EU treaties, implies a step-change in certainty and a hardening of the commitment device. However, in practice a step-change in credibility as measured by the risk premium in markets is unlikely to occur on entry itself. This is because markets progressively discount the gains in credibility implied by entry as certainty that the country will meet the conditions builds. The resultant increase in the interim credibility gains further strengthens the disciplining effects of the commitment to accession, as the scale of interim credibility benefits that could be lost on any reneging grows; and market perceptions of this further shift in the incentive structure in turn leads to a further increase in credibility. These feedback or virtuous circle effects imply that there may be a non-linear and self-reinforcing increase in credibility near the end of the accession process. They also imply a non-linear risk function attendant on any backsliding at a late stage.

The progress of Italy to euro entry exemplified exactly this non-linear (S-curve) increase in interim credibility benefits, as measured by convergence in the risk premium (i.e., bond yields) with Germany. After years of market incredulity, the first hard-fought gains in credibility in 1996 quickly snow-balled as euro-entry became a real possibility. These further credibility gains set off a virtuous circle in market expectations as interest costs began to fall which, in turn, reduced the cost of government

borrowing and improved the prospects of fiscal sustainability. As a result, in the final year or so prior to the 1998/9 launch date, the immediate costs implied (in terms of 'interim' benefits foregone) by any backsliding would have been enormous. This can help explain the extraordinary nature of the political consensus in Italy during this period behind the reforms needed to meet the Maastricht conditions - a consensus not seen before (or since). Italy had used its commitment to meet the pre-set conditions in a truly spectacular way to gain credibility for its reform process; and the interim credibility gains of lower borrowing costs made it relatively easy in the final stages both to clear the hurdle of Maastricht conditionality and to enforce political discipline.

It is still too early to assess the evidence for such a non-linear increase in credibility in CEECs in the final years before accession. However, systematic evidence is already available which is at least consistent with the self-reinforcing increases in interim credibility benefits which the argument of this paper would predict should flow from a commitment to accession. In their study of FDI flows to CEECs, Bevan and Estrin (2000) use an econometric model to analyse the main determinants - including the 'influence of prospective EU membership'. Their model shows that EU announcements at Essen (which boosted the credibility of the whole accession process) had a significant impact on the level of FDI flows to the Visegrad countries (the subset of CEECs closest to the EU). Most interestingly, those countries invited to open negotiations first in 1997 following Agenda 2000 enjoyed a 'significant boost to their growth rate of FDI' relative to other CEECs (Bevan & Estrin, 2000). These findings suggest that when the commitment made by countries to the goal of accession is itself rendered more credible by serious efforts by the EU to make the process workable, and when signals are given about the relative success of countries in meeting the EU's conditionality, the result is a strong and differentiated impact on credibility (and hence FDI flows).

Anecdotal evidence is also strong for the positive disciplining impact of the commitment to EU accession by CEECs. Many applicant countries (e.g., the Baltic states) have surprised observers by their speedy implementation of the reforms needed to meet EU conditionality. Governments may have come and gone, and the popularity of market reformers has often waned; but there have been few cases of a serious break with the trajectory of reform dictated by EU conditionality<sup>9</sup>.

### **3.3: Conditions for success of 'soft' commitment devices**

The mechanisms by which 'soft' commitment devices can in theory and in practice increase credibility should now be clear. Pending further systematic empirical measurement of the actual impact, there is also scope for making general predictions about how successful commitment by CEECs to the goal of accession may actually be in bestowing interim benefits of borrowed credibility on the transition process, by considering how far the general conditions required for a commitment device to work effectively (as discussed in the context of monetary policy literature in section 2.2) apply. Comparison can again be made with the Italian commitment to euro entry.

The first general requirement, if a commitment device is to be successful, is that the goal and rules committed to must be sufficiently consistent and coherent in policy terms with other strategic goals of the regimes in question. So, the conditionality imposed on CEECs by their commitment to accede to the EU - the pre-set rules governing the accession process - must be sufficiently consistent and coherent with the other transition

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<sup>9</sup> Innes (2002) discusses how membership of the EU has been seen as a public necessity in CEECs, with the 'standards for membership ... presented as a *fait accompli*, as policies around which there was little room for [political party] competition'. Innes argues that, as a result, political parties in CEECs have largely differentiated themselves by their 'operating style' rather than any deep ideological cleavage of the sort that would unsettle markets.



goals of these countries for the total policy mix to be sensible. If there were serious doubts about the compatibility of the accession and transition objectives, then the commitment to accession by CEECs would not itself be credible. It is interesting to note that, where there are strong doubts about the ability of countries to combine both objectives in a reasonable time-frame - e.g. Bulgaria and Romania - the commitment to accede enjoys and bestows little credibility<sup>10</sup>.

A relevant factor here is the quality and provenance of the rules or criteria that countries are committing themselves to meeting. One important respect in which the Copenhagen criteria differ from the Maastricht criteria as applied to Italy or Greece is that the CEECs had no *ex ante* role in drafting the Copenhagen criteria (or the detailed rule-book - the *acquis communautaire* - they must adopt prior to accession) whereas all EU-15 member states had a say in the formulation of the Maastricht criteria. The Bank of Italy, indeed, had every reason to like the Maastricht criteria, since the criteria enshrined its own objectives and would set the scene for what amounted to nothing less than a temporary central bank coup in Italy. (The Bank of Italy even provided the prime minister for a time in the 1990s as part of the crusade to meet the criteria!) By contrast, it is much less clear that the Romanian authorities (or their third-party advisers like the World Bank) would have designed the *acquis communautaire* as their chosen reform template; the conditionality implied by the Copenhagen criteria may in important respects be ill suited for use as a *de facto* development plan and transition guidance particularly for those CEECs seen as laggards in the accession process.

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<sup>10</sup> These lower credibility benefits are manifested in relatively low FDI flows to Bulgaria and Romania; according to Grabbe (2001) these countries 'have received only 10% of total inflows into central Europe despite having a third of the region's population'.

Moreover, it is not enough for CEECs to be able in theory to meet the EU conditions in ways that are broadly consistent with transition objectives. In functioning democracies, a second condition for commitment to accession to act as a successful credibility-enhancing commitment device is that there must be strong public support for the goal of accession. Despite the fact that a perceived lack of EU generosity on trade and enlargement terms has helped engender a recent rise in euro-scepticism in some countries, this condition is largely met in the case of CEECs (Grabbe & Hughes, 1998). There is widespread support in CEECs for accession as part of the geopolitical project of overcoming the Yalta divide and reintegrating Europe (Mayhew, 1998). This popular support appears as strong as that seen for EMU in the case of Italy's successful push to adopt the euro. It is important to note the role and limitations of this public support, however. First, it enables the initial commitment to accession to be made credibly in democratic countries. Secondly, it acts as a reservoir of democratic goodwill which can be drawn on to offset discontent with the reforms needed to make a successful application. One of the ways in which formal commitment to accession raises the short-term costs of deviation from the path of reform is that it makes explicit via EU commission reports etc the damage done to the pursuit of the popular long-term goal (EU accession) by any shirking of necessary reforms. The short-term political costs of implementing necessary reform may still be high (if the electorate wills the end - EU accession - but not the means) but the short-term political costs of explicitly jeopardising the popular accession goal (and falling foul of Commission benchmarking) may be even more lethal as Meciar found to his cost in the 1998 Slovak elections<sup>11</sup>. Of course, popular support for the long-term goal is a finite commodity and continual application of inherently unpopular policies in the name of

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<sup>11</sup> As Schimmelfennig et al (2002) note, public disquiet concerning damage done to Slovakian accession prospects by the failure of Meciar's government to convince the Commission it had met the democracy/minority rights criterion helped lead to a change of government and policy in 1998.

pursuing this goal may gradually weaken support for accession to the EU. So far, however, while support for any particular politicians advocating reforms needed for accession is often ephemeral, popular support for EU accession as a goal remains high.

By contrast, there is significant room for concern about the level of public support for enlargement on the EU side of the equation, and this represents the principal threat to the credibility-enhancing properties of the CEEC commitment to accession. Until 1993 there was not even a formal commitment to the principle of Eastern enlargement on the part of the EU. Even now, it is not certain that EU member states will all ratify enlargement even if the CEECs are judged to meet the Copenhagen criteria in full. Average public support in the EU-15 for enlargement to include twelve new members dipped at the end of 2000 to just 34% (Eurobarometer, no 55, 2000); and the initial Irish rejection of the Nice Treaty in 2001 underlines the dangers of a lack of popular support in EU countries for enlargement. The interim credibility benefits brought by CEEC commitment to the goal of accession would all be put in jeopardy if any EU-15 country looked set to block enlargement. In this important sense the final decision to admit CEECs into the EU is not analogous to the technical judgement in Spring 1998 as to whether Italy had met the Maastricht criteria in accordance with a pre-ratified Treaty.

The final condition for the effectiveness of the commitment device is that the guardians of the rules, to which so much discretion relating to the shape of the CEEC reform program has been delegated, (i.e., the EU Commission) must themselves be credible. The Commission's credibility in this area is generally considered high; but some commentators have pointed to the need to probe the consistency and objectivity of the advice contained in its regular reports, by asking how far the Commission is competent to judge compliance with the conditions and how far it is able to overcome the inherent tensions in being at one and the same time 'gate-

keeper' of the EU and adviser to applicant states (see Grabbe, 2002). It may also be relevant to analyse how far the Commission and the sector-specific councils which must decide the details of accession terms are susceptible to 'agency capture', i.e., to being 'captured' by the EU-15 sectoral interests they represent (Mayhew, 1998).

The brief review in this section suggests that the commitment of CEECs to accession goes a long way to meeting the conditions required for it to operate as successful commitment device; there appears to be good reason to expect the commitment to lead to interim credibility benefits and to an increasing reluctance to jeopardise them by straying from the path of reform. However, the conditions of policy consistency (and even popular support) are met in a less clear-cut fashion particularly for some CEECs than they were in the case of Italy's successful use of an analogous 'soft' commitment device in the 1990s. All this is consistent with Bevan and Estrin's findings of a strongly differentiated increase in FDI in favour of 'front-runners'.

#### **4. THE COSTS OF GAINING CREDIBILITY BY COMMITMENT**

The interim credibility benefits of commitment to the goal of accession need to be set against possible costs implied by the inflexibility of EU conditionality. This is because of the paradox that commitment to accession boosts the credibility and success of the reform process partly by virtue of the very non-negotiability of EU entry rules which in other respects may entail clashes between accession and transition objectives. In examining this paradox, this section draws together the conclusions of section 3 with reservations expressed about commitment devices in monetary policy literature, and with concerns in transition literature about the negative impact of EU conditionality.

Many central bankers and economists intuitively dislike or are theoretically sceptical of 'free lunches'. Perhaps it does not accord with a dominant Puritanism among central bankers to believe that it is possible to avoid painstakingly building up reputation-based credibility by submitting to some *deus ex machina* commitment technology which gives you the benefits in any case. Blinder in his survey of central bankers and macro-economists found that many fewer thought credibility could be effectively established by 'tying hands' than by earning a reputation by consistently 'living up to their word' (Blinder, 1999). And yet the example of the Italian progress to euro entry suggests that commitment technology can be a very effective way of earning credibility measured in terms of the risk premium on debt. Indeed merely the 'soft' commitment implied by a stated intention to tie hands irrevocably appears to have been enough to engineer a convergence in credibility that few market participants would have expected in the absence of that commitment.

In reality, however, the lunch may not be as free in all such cases as the Italian example implies. To understand why, it is useful to note one other finding of Blinder's survey. He found that both central bankers and economists, when asked about the benefits of credibility, gave a high weighting to the greater 'strategic flexibility' it gives central bankers to depart from their normal procedures (or rules) without losing credibility (Blinder, 1999). These findings point to the crucial difference between **reputation-based** credibility, which allows for careful use of discretion or strategic flexibility, and the **borrowed** credibility which arises from submission to an externally controlled commitment device because of the very absence of discretion implied. This distinction may help to explain the lower rating given by central bankers in Blinder's survey to the borrowed credibility implied by commitment technology. Borrowed credibility does not give extra discretion to policy makers; indeed it is bought precisely at the cost of giving up control of the policy mix and submitting to pre-set or externally determined rules or conditions. The

commitment device lends credibility to policy makers because it ties their hands, and gives them no room for manoeuvre, thereby insulating them from time-inconsistency of preferences and strengthening their resolve not to meet the demands of rent-seeking special interest groups. This is why credibility can only attach to a commitment device or rule-based system if the conditions and rules implied are broadly consistent with the other strategic goals of policy makers. For it is only then that the lack of any flexibility of policy approach is relatively costless.

These points can again be applied to the Italian and CEEC examples. Italy's strategic goals in the 1990s were dominated by the need to make the country's huge burden of outstanding fiscal debt sustainable; and both the requirement to meet the Maastricht criteria as part of Italy's commitment to euro entry and the lower interest costs that came with the consequent increased credibility were essential to meeting this paramount goal. It would have been potentially fatal to the efficacy of the commitment device had Italy been in a position to negotiate significant changes to the criteria or a significant softening of their interpretation, since that would have weakened policy makers' ability to withstand political pressures to soften necessary domestic reforms; but it would not in any case have been desirable economically to water down the objectives implied by the Maastricht criteria given Italy's predicament. Moreover, while the 'hard' commitment device represented by irrevocable membership (after entry to the euro) may imply some costs in terms of reduced autonomy for Italy (e.g., the inability to devalue the nominal exchange rate), it seems highly unlikely that these costs will outweigh the enormous fiscal savings and lower interest costs for business implied by euro membership. For these reasons, it can be argued that the 'hands tying' route to credibility gains was close to a free lunch for Italy because there were next to no losses from reduced policy discretion to set against the huge credibility gains arising from the commitment device. The rules

and policy mix implied by commitment to adopt the euro were fully consistent with the overriding imperative of fiscal salvation.

Are the CEECs in the same happy position? In their case there is more reason to question the full compatibility of accession and transition objectives and therefore to highlight the costs of a loss of policy discretion. There are real doubts about whether the *acquis communautaire* - the club rules of the EU (Grabbe 2002) which applicants must adopt - are in all cases a fitting legislative template for the institutional and market reforms of transition countries. While many elements of the *acquis* - relating for example to competition law - may represent exactly the sort of 'social and organisational capital' (Stiglitz, 1999) they need, it is legitimate to question the inherent appropriateness for transition economies of some implied regulations (e.g., environmental regulations or water quality norms usually considered a luxury that can only be afforded by rich countries). Other concerns focus on the deleterious impact a headlong rush to adopt EU legislation may have on the ability of CEECs to sequence reforms correctly (Mayhew, 1998); and there is a general worry that efforts to integrate EU structures may distract attention and money from more pressing development goals in the CEECs (e.g., education or health). When looking at the political as opposed to the economic impact of conditionality doubts intensify. Innes (2002) argues that the 'hands tying' impact of conditionality has stunted the evolution of a vibrant system of political party competition in CEECs thereby weakening civil society and undercutting political stability; the requirement to meet the exigencies of EU conditionality constrains policy choice in key areas of voter concern so much that it leaves political parties unable to differentiate themselves in clear substantive ways and renders their policy identities and constituencies unstable (Innes, 2002).

All these arguments lead some commentators to conclude that the needs of CEECs would be better met if the EU was willing to negotiate long

transition periods for accession countries and be much more flexible on the conditionality it imposes on would-be entrants, tailoring it to their particular development needs and leaving more scope for policy choice. There is widespread agreement that the net balance of costs and benefits of accession on current EU conditions is positive for CEECs (e.g., Baldwin et al, 1997); but many still argue that the net benefits could be much greater - or certainly entail fewer interim costs - if the conditionality was softened and greater account taken of the needs of transition.

By contrast, the findings of this paper suggest that if such flexibility in the conditionality could be negotiated by CEECs on any significant scale it might imply costs in terms of a reduction of the interim credibility benefits afforded by their commitment to accession. For the right to negotiate away terms disliked by CEEC governments would untie their hands, leaving them open to special interest group lobbying and susceptible to time-inconsistency of preferences. As a result, such a right might damage credibility and raise the risk premium, since it would imply much less certainty about the trajectory of reform. The scale of the potential costs may be impossible to estimate *a priori*. However, the scale of the risk premium benefits predicted by Baldwin et al as a consequence of accession - a 17% rise in the real incomes of the seven CEECs they analysed (Baldwin et al, 1997) - suggest that **interim** credibility benefits could also be very significant; and if even a small amount of these were put at risk by a weakening of the conditionality, there could be a substantial reduction in the speed with which CEECs start to enjoy self-reinforcing increases in credibility. This might well delay recovery in economic growth until nearer the time of accession, even if it did not call into question the ability to meet remaining conditions. In other words, CEECs are faced with an inescapable paradox that commitment to accession helps boost the credibility and success of the reform process by virtue of the very non-negotiability of EU entry rules which is in other respects seen to entail costs because of possible clashes between accession and transition



objectives. Those arguing for more negotiability need to compare the interim benefits of credibility that might be foregone by a more flexible approach to conditionality with the short and long-term gains that would accrue to the policy mix as a result of negotiating more palatable entry conditions.

In assessing the cost-benefit ratio of inflexible EU conditionality, it may be helpful to consider together three general recommendations in relation to the transition process made by Stiglitz. He advocates as paramount, first, the requirement for adequate 'social and organisational capital'; secondly, the need for careful sequencing of reform; and, thirdly, the need for sufficient demand and capital to mop up labour released as a result of stabilisation policies and the phasing out of subsidies to firms (Stiglitz, 1999). It is essentially in relation to the first and second of these recommendations that a number of authors (e.g. Mayhew, 1998; Grabbe, 2002; Innes, 2002) have assessed the appropriateness or otherwise of EU conditionality and the *acquis communautaire* as a template for reform. Their analysis, as we have seen, suggests that some of the implications of the conditionality for the reform of civil society and the correct sequencing of reforms in transition countries are ambiguous in the absence of greater flexibility in its application. By contrast, the findings of this paper, together with the findings of Baldwin et al (1997) and Bevan & Estrin (2000), relate to the third of Stiglitz's requirements. They suggest that there is a significant impact on the risk premium, and therefore on the availability of FDI and cheap capital, from governments' hands being tied to meeting the requirements of non-negotiable EU conditionality. In other words, the inflexibility of EU conditionality implies benefits in relation to Stiglitz's third recommendation which need to be offset against any costs in relation to his first and second recommendation.

After accession (or euro entry) countries can, of course, escape the reputation consequences of an inglorious past and tap into the club's

credibility regardless of their trajectory prior to accession; but this credibility is also bought at a cost of countries permanently sacrificing their ability to decide their own policy mix to suit their particular interests. This trade-off may well be acceptable to all CEECs - given the credibility benefits and the fact that at least after entry they will have some say in the setting of the club's collective rules. By contrast, the analytical framework of this paper does suggest why it may not be attractive for countries like Switzerland (or Norway) to make the same trade-off by entering the EU. They already enjoy strong reputation-based (or oil-based) credibility which gives them significant strategic room for manoeuvre at low cost in risk premium terms; and they have other strategic goals that are largely incompatible with the rules of the EU (e.g., in the areas of banking, agriculture and road transit).

## 5. CONCLUSION

This paper explores the commitment device as a policy tool and analyses its credibility-enhancing properties. In particular, it examines the dynamics of how CEEC commitment to accession delivers considerable interim (i.e., pre-accession) credibility benefits - by tying governments' hands in policy terms to the requirement to meet pre-set EU conditionality and submitting them to benchmarking in Commission reports and other sanctions. These disciplining effects insulate CEEC governments from time-inconsistency of preferences and strengthen their resolve to resist the demands of rent-seeking special interest groups. Markets particularly like to see evidence of a clear trajectory of transition reform, and the value to markets of settled expectations is reflected in a lower risk premium charged on investment.

These interim credibility benefits are important in themselves in raising investment and FDI and altering political and economic actors' expectations favourably; but they also imply another even more significant

political economy advantage, namely that they further raise the **current** (or short-term) cost of reneging on the commitment to stick to the policy path leading to accession. When a CEEC government is deciding whether to push through a difficult reform necessary for accession, it has to weigh the short-term costs of persevering not only against the potential loss or postponement of **long-term** benefits but also against the likely **current** loss of 'interim' credibility benefits. In this way, the interim credibility benefits flowing from a credible commitment device help overcome the problem that politicians generally apply a high 'political discount rate' to future benefits.

The paper also discusses conditions for the success of these 'soft' commitment devices - the need for tolerable consistency of the resulting policy mix, popular support for the goal committed to, and the credibility of the arbiter of the external rules or conditions.

Finally, it explores the paradox that because commitment to accession lends the reform process credibility by virtue of tying CEEC governments' hands, it does so at the cost of leaving them little flexibility to align the requirements of EU entry and of political and economic transition. Indeed, if the CEECs could negotiate much flexibility in the conditionality, it might damage their credibility in markets and raise the risk premium, since it would imply greater uncertainty about the trajectory of reform.

The paper considers a significant amount of empirical evidence to support its conclusions – in particular the findings of Bevan & Estrin's (2000) paper and the analogous impact of Italian commitment to enter EMU. However, there are several potentially fruitful areas of analysis which could test the conclusions further. One would be to analyse time-series data for the risk premium of each accession candidate and assess their correlation with the events and variables related to commitment to and progress towards accession; such time series could - after the first

accessions - test the hypothesis presented here of self-reinforcing increases in credibility, by examining how non-linear is the improvement in credibility in the run-up to actual accession (i.e., how far it conforms to the predicted S-curve pattern).

Another approach would be a political science examination (e.g., via interviews of policy makers) of specific case studies of the evolution of reform policy and political decision-making in various CEECs. This could look at how important the 'hands tying' effect of EU conditionality has been in determining political outcomes and policy choices. It could also examine how much, in particular circumstances, the need to maximise the interim benefits of credibility (in terms of FDI etc) has actually influenced decision-makers.

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