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Andrea Szalavetz

Some Neglected Effects of EU Enlargement

Rationalization and Specialization

1014 Budapest, Országház u. 30.
Tel.: (36-1) 224-6760 • Fax: (36-1) 224-6761 • E-mail: vki@vki.hu

SUMMARY

This paper develops and presents five propositions about the consequences of EU enlargement.

1. Although the most advanced transforming countries have achieved remarkable success in their modernization efforts by adopting a passive policy approach, their preparations for EU accession necessitate a more active, 'developmental' involvement by the state.
2. Accession will not generate an automatic increase in modernization inducing and trade-augmenting FDI. The net inflow of FDI may be joined by an outflow, so that some acceding countries could face a wave of divestment in some industries.
3. Competition between locations will resume, challenging the position of some affiliates that were purchased for market-seeking reasons during the privatization of the transition decade. Enlargement will bring about a reallocation of FDI stocks, as multinationals (MNCs) possessing subsidiaries of a market-seeking type in more than one candidate country rationalize their production. Rationalization may also affect subsidiaries established with resource-seeking investment motives.
4. Subsequent FDI in acceding countries will reinforce past specialization patterns, in terms of the shares of market-seeking and resource-seeking FDI received by specific industries. Candidate countries specialised in industries, which are typically recipients of market-seeking FDI, will increase their specialization in these industries. On the other hand, in candidate countries where industries with resource-seeking FDI have a leading share in total industrial value added, the share of these industries will increase even more.
5. Enlargement will accelerate changes in the investment motives of MNCs. Affiliates initially established with market- or resource-seeking motives will increasingly improve their position within the MNC, so that the investment motive turns to efficiency- and/or strategic asset-seeking. This trend already started in the transition decade and will gain momentum after accession.

INTRODUCTION

The transforming countries, in the 'long transition decade', have achieved remarkable success with minimal state intervention. By adopting a passive policy approach, they have allowed themselves to be driven forward by the modernizing effects of foreign direct investment (FDI). However, the challenges that follow EU accession will compel them to adopt an approach of more active state involvement. Local economic policy decision-makers will need to work out how to redefine the position of their countries in the world economy.

This paper develops and presents five propositions about the consequences of EU enlargement.

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4. Subsequent FDI in acceding countries will reinforce past specialization patterns, in terms of the shares of market-seeking and resource-seeking FDI received by specific industries.[1] Candidate countries specialised in industries, which are typically recipients of market-seeking FDI, will increase their specialization in these industries. On the other hand, in candidate countries where industries with resource-seeking FDI have a leading share in total industrial value added, the share of these industries will increase even more.
5. Enlargement will accelerate changes in the investment motives of MNCs. Affiliates initially established with market- or resource-seeking motives will increasingly improve their position within the MNC, so that the investment motive turns to efficiency[2]- and/or strategic asset-seeking.[3] This trend already started in the transition decade and will gain momentum after accession.

DOES PREPARING FOR EU ACCESSION CALL FOR A MORE ACTIVE STATE?

Arguing for more state activism in governing and promoting modernization and sustainable competitiveness may seem outmoded in an era marked by increasing erosion of state capacity, due to the globaliza-

[1] The motive behind resource-seeking location decisions is to acquire specific resources, such as raw materials or labour, at the lowest real cost.

[2] The motive behind efficiency-seeking investment is to configure assets globally in a way that maximizes efficiency within the group and exploits economies of scale. The value chain within firms then becomes globally distributed, with higher specialization in specific locations.

[3] Strategic asset-seeking investment is intended to acquire dynamic, mainly intangible resources and create factors such as knowledge, innovation capabilities, or management or organizational skills.

tion of markets, firms and technologies and to a shift in political action to sub-national and supranational levels. Papers from a wide range of disciplines – political science, economics, sociology and political geography – document the 'hollowing out' of nation-states due to the twin processes of globalization and localization. (Grande, 2000; Jessop, 1999; MacKinnon and Phelps, 2001). Such arguments may seem especially obsolete in the EU candidate countries. The trend described by Jessop (1999, p. 393) as disappearance of 'the taken-for-granted primacy of state apparatuses' and the emergence of 'varied forms and levels of partnership between official and non-governmental organizations in managing economic and social relations' is especially conspicuous in the EU. So the degree of policy freedom in the candidate countries will diminish after accession.

Nevertheless, European political practice abounds in examples of state activism. Sizeable governmental intervention to promote national competitiveness is found in three fields. The first is regional development, which involves national government as well as local, regional and supranational actors. Though the form of involvement by the national government has changed: interventionist states have turned into enabling ones, the significance of national governments as promoters of regional cohesion and competitiveness should not be underestimated. The second, with extensive public support and investment, is technology and innovation. Although the declared objectives and procedures of state-level intervention have undergone comprehensive transformation in both fields – away from direct public financing of industry-specific programmes towards general priorities and generating externalities – substantial amounts from the state budget are still devoted to government-promoted development. The third is investment promotion. Advanced economies tackle in global competition among localities by offering generous investment incentives.

Although the resources devoted by transforming countries to 'government-push' development are much smaller than those offered by the advanced economies, more political activism is necessary for two reasons.

The first relates to the new supranational institutional context to which the acceding countries will belong. One essential function of nation-states here is coordination and management of relationships on the regional, national and European planes. National governments have to devise a new approach appropriate to the post-accession challenges and begin to reformulate their development goals. They have to stabilize their institutional relations and their procedures of development financing, to provide a clear definition of responsibilities that complies with the European regulations. At the same time, national governments need to increase the amount of public funds they devote to development. EU aid is usually provided on co-financing basis, so that access will depend (among other factors) on the ability of the new members to meet their co-financing obligations.

The other reason concerns more traditional action to promote competitiveness. Alongside a multitude of unexpected challenges, accession to the European Union will mark the end of the once-and-for-all modernization effects of systemic transformation and opening up that have been driving countries forward even without much systematic policy effort.

These challenges and some other policy actions required are detailed in the following chapters.

Rationalization and a Wave of Divestment?

The trade-creating effects of EU accession and the intensification of inward FDI are oft-proclaimed benefits for acceding countries, but neither of these prospects is as straightforward as it seems.

Consider the gravity model of trade,[4] developed to assess the long-term trade potential between two countries or groups of countries. This draws the analogy of the gravity law in physics to suggest that the volume of trade between any two countries is influenced by their respective sizes and the economic distance between them. Trade flows between Eastern European countries and the West in the late 1980s were still far below their gravity norm (Faini and Portes, 1995; Winters and Wang, 1994; Black, 1997; Brenton and Di Mauro, 1999). Bilateral trade between the EU and the CEE (Central and East European) countries increased very rapidly after the Europe Agreements of 1992. The most advanced transforming economies quickly approached the hypothetical level suggested by the gravity model (some have got even beyond this level). The upsurge has been due not only to the dismantling of EU-CEE trade barriers, but also and mainly to large trade-augmenting flows of FDI facilitating the rapid reorientation of trade.

At the present level of economic interpenetration, fully-fledged membership cannot automatically generate significant further increases in bilateral trade or trade-enhancing FDI. What is more, rationalization measures may bring closures of some existing foreign affiliates in acceding countries.

Reallocation of the FDI stock will affect mainly investments carried out with market-seeking motives. Although foreign-owned subsidiaries of large MNCs can be considered reasonably well prepared to meet the challenges of intensifying competition, plant closures can be expected, as the owners of affiliates reappraise their organization and recalculate factor costs following the EU accession of the host country. They will have to decide whether the technological and managerial capabilities in their affiliates are sufficiently developed for an *EU company*. They will compare productivity and profitability levels, size, income-generating capability and technological level in their production facilities in the new member-countries and in core EU countries. These differences go much beyond simple productivity disparities. Large gaps between the respective values of the indicators can be observed in various areas, and not necessarily in terms of profitability. Although the activity of affiliates in candidate countries is often highly profitable, there are significant differences between the operational properties of EU-based and extra-EU affiliates in terms of capital and labour intensiveness, unit size, market orientation, technological level, and so on.

These differences are rooted in the business history of the units concerned. In transforming countries, most essential actors in the fast-moving consumer-goods (FMCG) sector[5] – a typical recipient of market-seeking FDI – have been bought by foreign investors. Privatization offered a unique opportunity to MNCs competing in the saturated markets of developed countries to gain huge new markets. They therefore established local subsidiaries with overlapping activities and product mixes in several transforming countries. The businesses acquired were restructured only up to a specific level, to make them capable of meeting local and regional market expectations. Technology was upgraded and the finances were restructured to ensure that the new acquisition produced to the requisite quality. Besides producing a wide range of products themselves, local subsidiaries manage the local distribution of their parent company's complementary products not produced locally. Domestic market orientation is dominant but not exclusive, since some of these companies also make regional and some EU sales.

The high share of domestic sales, wide range of products, relatively low level of

[4] The model, devised by Tinbergen (1962) was given sound theoretical underpinning by Anderson (1979) and Bergstrand (1985).

[5] This covers products of the food-processing and household-care industries, personal hygiene products, tobacco and spirits.

technology intensity and high level of labour intensity comply neither with the drive within the European integration process to exploit economies of scale, through enlargement and homogenization of markets (Fagerberg, 2000) nor with the trends in the industries concerned. What are these trends? The optimal size (for output) and specialization level of FMCG companies keep increasing in the advanced economies. Companies have to comply with ever stricter safety, environmental and hygiene standards. Compliance necessitated huge investment, which causes efficiency requirements to increase as well. The need for an optimum use of resources involves rationalization. FMCG companies in advanced countries have therefore been undergoing painful rationalization for several years. The survivors are large and highly efficient companies, with a relatively narrow product line and consequently strong global orientation.

As a consequence, the capital and technology intensity of the present EU companies in these industries is markedly higher and the labour intensity markedly lower than a decade ago. Since the affiliates in the acceding countries in these industries fall far short of the optimum size, technology level, labour intensiveness and productivity, accession will certainly be followed by rationalization and more conspicuous and less tolerable redundancies.

The surviving production facilities among the competing locations in the new EU member-countries will undergo a second wave of restructuring. They will expand their activities, but also undergo significant changes in technological and organizational terms. Production technology will be upgraded, so that they come to resemble the affiliates in the core EU countries in the length of their production run, their product range and their capital and labour intensity. They will gain wider product mandates[6] in terms of markets served and cover further functional areas besides simple production, for the much narrow range of products in which they will specialize. So the second wave of restructuring will be marked by sizeable trade-augmenting investment. Consequently the originally market-seeking motives that characterized these affiliates when they were established will give way to an efficiency-seeking motive. The changes in investment motive will reflect changes in the subsidiaries' position and function within their owners' multinational organization.

Changes in specialization patterns?

Which affiliates will shut down and which develop, so that their features become comparable with EU companies? Which transforming countries are better positioned in the forthcoming competition among locations? At present, the distribution of market, resource and efficiency-seeking investment is uneven across transforming countries. There are several methodological procedures for classifying countries according to their specialization patterns, including observations about the RCA indices of sectors in terms of the Pavitt (1984) taxonomy,[7] quantification exercises of vertical intra-firm trade (Landesmann and Burgstaller, 1997) and of the share of 'production-fragmentation' exports in manufacturing exports (Kaminski and Ng, 2001). Irrespective of the methodology, papers usually classify Poland as a country specialized in traditional sectors, with a large share of industries with market-seeking FDI. The Czech Republic, Hungary and Slovenia are

[6] See Birkinshaw and Hood (1998) on the evolution of subsidiaries.

[7] The Pavitt taxonomy analyses the technological content of trade, classifying industries as traditional and resource-intensive; scale-intensive; high-tech; and specialized suppliers. See Guerrieri (1999) for a recent overview of the literature.

mentioned as countries specialized in resource-intensive and technology-based scale-intensive sectors, with a large share of resource-seeking FDI. Accession to the EU will redraw the specialization patterns of the acceding countries. One expected trend will be a crystallization of past specialization patterns – viewed as a distribution of shares of industries with market-seeking or resource-seeking FDI.

In the past decade, the distribution of GDP shares across industries in transforming countries was determined by external forces (FDI and production relocation) rather than endogenous development. There is reason to believe that this trend will continue. Following accession, external forces are bound to reinforce the past distribution pattern of industries with market-seeking and resource-seeking FDI. At the same time, they will transform the original market or resource-seeking patterns into efficiency-seeking ones. There are four strands in theoretical research to support this hypothesis.

The first concerns the implications of country size.[8] Transforming countries with a large domestic market and a relatively high share of FDI stock in sectors where market-seeking investment is dominant may benefit from further investment in these sectors (carried out to upgrade existing affiliates). Krugman (1980) finds that if countries are identical in all respects except size, the country with the relatively larger domestic market will be the net exporter of goods (the home country effect). This effect will produce a similar outcome in transforming economies. Due to higher domestic demand for the products in countries with a large domestic market, production runs are longer and technology more developed compared with those of affiliates in small countries, already as a result of their initial restructuring in the early 1990s. Other factors being equal, therefore, the winners in the rationalization, among affiliates with overlapping activity and product mixes, will be the ones located in larger countries. They will receive the investment aimed at making them similar to core EU plants in technological and functional terms. Their host countries' specialization in these industries will increase. At the same time, the original investment motivation of the owners will undergo substantial transformation. Industries originally characterized by local market-seeking type of FDI will become net exporters after accession, which will group them into the category of industries with efficiency-seeking investment.

The location decisions of MNCs are also influenced by other factors besides market size and factor endowment. These include institutional tightness and proactive behaviour by the authorities: investment promotion efforts and investment after-care programmes. Equally or even more important are the managerial capabilities of local affiliates and their ability to expand their charter,[9] i.e. assume corporate functions other than production. (The independent market-acquiring capability and R and D potential will be considered.)

The wave of rationalization described hits market-seeking investments, i.e. companies originally established to serve the domestic market that have proved unable to turn into efficiency-seeking investments.[10]

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[8] Amiti (1998) provides a good overview of the literature.

[9] Birkinshaw and Hood (1988) define charter as the business – or elements of business – in which the subsidiary participates and for which it is recognized to have responsibility within the MNC. It is defined in terms of markets served, products manufactured, technologies held, functions covered, or any combination of these.

[10] Switches from being a market-seeking subsidiary into being an efficiency seeking one or – if examined from the point of view of the investors – from a multi-domestic strategy to a global one could be observed in FMCG and other industries. In the 1990s, similar switches also occurred in some transforming countries in the power-generation equipment industry. Lower than expected domestic demand made the owners of privatized companies in this industry reshape the strategic function of their local subsidiaries. Instead of manufacturing complex equipment and

The opposite side of the coin is the defensive increase[11] in the specialization of small, outward-oriented economies on industries with resource-seeking investment, due to plant closures in industry segments with market-seeking FDI.

Resource-seeking investment may also undergo a wave of rationalization caused by factor-cost changes. Relocation to extra-EU countries can be expected in industries characterized by low local value added. According to the most pessimistic scenario, countries with a high share of resource-seeking investment, whose economic actors have proved unable to move up the ladder of technological learning and increase the local value added during the decade of transition, may become the big losers by EU accession. They may prove unable to retain their market-seeking investors and be hit by a relocation wave in industries featuring low domestic value added, where resource-seekers face a reduction in factor-cost differentials. The possibility of this scenario does not depend purely on country size. There is a rapidly increasing literature describing how changes in the organization of production and product development are altering the terms of competition and creating significant global opportunities for small countries (Bara and Csaba, 2000). It depends rather on capability of competence accumulation.

The second analytical approach is to enquire into the consequences of regional integration for FDI (Dunning, 1997; Pearce and Papanastassiou, 1997). According to this line of research, the removal of trade barriers may turn local market-oriented production affiliates into export-oriented ones. In a process of region-wide rationalization, affiliates focused on the host market will have to narrow their product range. Scale-related production will become more concentrated and intra-EU trade increase. This approach predicts changes in the functions of import-substituting affiliates, due to the removal of tariffs and other trade restrictions. In the transition economies, import substitution was not the intention that led to the inefficient affiliates focused on the host market. Rather it was the privatization opportunities in local FMCG industries, which caused MNCs to adopt multi-domestic strategies. For different reasons, there will be a similar outcome: the original market-seeking motive will turn into an efficiency-seeking one.

The third line of argument investigates the path dependence of international trade specialization patterns. There have been a number of papers showing that trade specialization in advanced economies is remarkably stable over time.[12] Some transforming economies, on the other hand, have experienced considerable changes in their export specialization patterns (see Landesmann, 1996; Freudenberg and Lemoine, 1999; Havlik, 2000, Soós, 2000). Since these changes can be traced back to the effects of systemic transformation and to the process of opening up to the world trading system and integration into it, further changes of a similar magnitude are unlikely. The incorporation of these economies into global economic activity suggests that elements of their new specialization pattern will be quite persistent in the medium term, which will make possible only incremental changes. This applies especially to the typical recipients of resource and efficiency-seeking FDI. Many of these industries, particularly the technology-intensive ones, are subject to intensive globalization tendencies (OECD, 1996) and display a strong geographical concentration, because they are scale intensive. These

systems for the domestic markets, the owners incorporated these subsidiaries into their global networks as component manufacturers (Szalavetz, 1998).

[11] Measured by relative shares in statistical analyses. If some market-seeking companies exit the market, the proportion of resource-seeking companies increases, through the reduction of the denominator.

[12] For an overview, see Dalum et al. (1996) and Gagnon and Rose (1995).

features support the notion that acceding countries where industries attracting resource-intensive FDI predominate will continue this specialization pattern. If existing representatives of these industries can keep up with their owners' competence-accumulation requirements, they can achieve incremental changes in their specialization pattern and make these industries turn into efficiency-seeking ones.

The fourth body of literature focuses on the determinants of subsidiary evolution. Authors view the charter of affiliates as the outcome of a dynamic process subject to further changes.[13] Changes are driven either by headquarters initiatives or by subsidiaries themselves (Birkinshaw, 1998; Westney, 1999; Martinez and Jarillo, 1989). Related literature examines technological learning, with emphasis on the evolution of firms' capabilities of absorbing technology, up to the level of independent technology generation (Pavitt and Bell, 1992; Hobday, 1994).

The evolution of the capabilities and charter of affiliates provokes changes in their organizational position. Szalavetz (2000) defined a local subsidiary's position within the hierarchy of its MNC as the set of the owner's expectations, which becomes increasingly complex as the subsidiary's capabilities improve. Once the accumulation of technological and other functional capabilities attains a quality threshold, this provokes changes in the owners' investment motives. Changes in the owners' investment motives during the transformation decade were driven either by mistaken investor predictions about the evolution of domestic demand[14] or by a recognition that the acquired assets were more valuable than initially expected. In the former case, insufficient domestic demand ended the initial market-seeking type of investment motive and replaced it with a resource-seeking or efficiency-seeking one, i.e. a global strategy instead of the initial multi-domestic strategy. The discovery of valuable intangible assets in acquired companies made several resource or market-seekers locate part of their strategic R and D in transforming countries.[15] In shifting away from their initial motives, they have thereby become strategic asset seekers, while their local affiliates have developed into specialized suppliers. These tendencies will be intensified by EU accession.

CONCLUSIONS AND RECOMMENDATIONS

The object of the paper has been to show that EU accession in itself will not lead to intensification of the beneficial tendencies that have so far contributed to modernization in the candidate countries. Accession requires reconsideration and reformulation of the passive policy stance being taken by candidate countries, since it provokes rationalization and concentration moves on a micro level and a progressive sharing of responsibilities on the national and European levels of public policy.

In trying to remain afloat amid the turbulence accompanying accession, economic and regional policy-makers are recommended to offer creative investment after-care programmes to local market oriented subsidiaries and maximize efforts to make these the great survivors of rationalization. They are also recommended to sup-

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[13] As Engelhoff (1999) remarks, 'Traditional models [of MNC organizational design] tend to be models of equilibrium [focusing on the role of structure and traditional mechanisms of co-ordination] while the newer models are largely models of change' (p. 15).

[14] Demand expectations proved exaggerated in Hungary in some engineering sectors subject to public procurement tenders. The same applies to investors in Slovenia who had originally calculated with the Yugoslav market, which collapsed soon after their investment was made.

[15] Instances in Hungary include GE, Knorr Bremse, Ericsson and Nokia.

port competence accumulation at local affiliates (in conjunction local management), to achieve an increase in local value added and an improvement in the status of existing affiliates within the global organizations of their parent corporations. This will allow local affiliates to shift from 'primary comparative advantages' based on low labour costs and to turn the initial resource-seeking motives of investors into efficiency-seeking or strategic asset-seeking motives.

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