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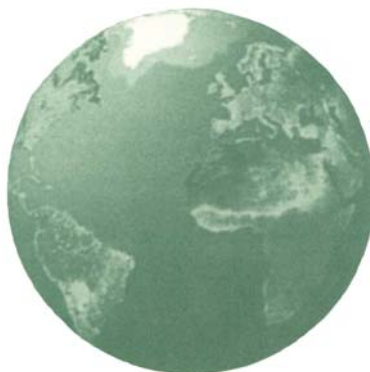
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**COMPETITIVENESS STRATEGIES, RESOURCE  
STRUGGLES AND NATIONAL INTEREST  
IN THE NEW EUROPE**



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## SUMMARY

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Based in principle on a case study of Hungary, this paper raises important questions about the ability of Central and East European states to achieve their competitiveness goals within the framework of EU membership. While more conventional views tend to suggest that the EU policy framework represents a “best strategy” scenario for these countries, this paper fundamentally questions this view. Based on an analysis of both the competitiveness strategies pursued by Hungary prior to EU membership, this paper suggests that Hungary was forced to abandon many of the more successful tools employed prior to and during the accession process.

Whether the EU policy framework is likely to represent a positive trade off depends in many ways on the degree of real flexibility within the EU policy framework and the willingness of the Old Member States to continue funding the goals of economic and social cohesion. Through an analysis of the EU structural and cohesion funds, the current drive for tax harmonization and finally competition and state aid policies in the EU, this paper suggests that ongoing debates within the EU emphasize the competitiveness concerns of the more economically advanced states and illustrate only moderate dedication to the goals of economic and social cohesion.

As a result, this paper raises important questions about the degree to which EU membership genuinely represents an optimal strategy choice for the New Member States. In some ways, EU membership provides an opportunity for the more advanced Old Member States to control the policy strategies employed by the New Member States. In this regard, EU membership imposes important constraints on the ability of the New Member States to pursue independent policy agendas. Just as importantly this paper suggests that a new North/South (or now East/West) divide may be opening in the European Union across which the competitiveness interests of different states are likely to fuel policy debate for some time to come.

## INTRODUCTION<sup>\*</sup>

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The *New Europe* provides a fascinating testing ground for assumptions about the relative efficacy and feasibility of supranational vs. national-level decision-making arrangements. Neo-functional models tend to assume that the supranational level of European Union (EU) decision-making is generally likely to yield more efficient, welfare-enhancing pareto-optimal policy outcomes – to “*upgrade the common interest*”. Intergovernmental models suggest, on the other hand, that policy outcomes are a product of power struggles between states. Due to variation in relative power across states, there are likely to be both winners and losers in the policy-making process and integration outcomes. While all states are typically considered to be “*net winners*”, this does not preclude “*net losses*” for weaker states in individual policy areas. Thus, while in the aggregate supranational-level decision-making may be preferable this does not preclude significant disadvantages in individual policy areas. In par-

ticular, latecomers not present at the inception of individual policies are most likely to be affected by this type of policy mismatch.

This paper analyzes policy developments related to economic competitiveness and development interests and provides an analysis of the dominant forces driving policy output in the New Europe. Given that – in the intergovernmental model at least – the interests of more powerful states are expected to supersede those of other states, it is important to understand both the potential divergence of policy interests in the New Europe and the strain this is likely to place on the supranational decision-making framework. Is policy cohesion possible, given the potential divergence of interests across the New and Old Member States? What kind of solutions will ultimately be proposed for regional development, corporate taxation, national economic competitiveness and what theories of European integration are best suited to explaining these policy outcomes? How sustainable is decision-making in the New Europe and how compatible are the interests of the New and Old Member States in the long term?

Ample signs of the potential for emerging policy conflict precede the creation of the New Europe. Both France and Germany, with the recent addition of Poland, have protested against corporate taxation levels in some of the CEE economies. The Central and East European countries (CEEC’s) were accused of “*fiscal dumping*” – *i.e.* exploiting EU structural and cohesion funds (SCF’s) to make up for low rates of corporate taxation. French Minister of Finance, Nicholas Sarkozy even threatened to lobby for reduced regional development funding should the CEEC’s allow their corporate taxation levels to fall below the European average (something Germany likewise supports). In the context of a meagre allotment of SCF’s for the

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2004–2006<sup>1</sup> period and even lower corporate tax rates in Ireland, this comes as a rude awakening to the New Member States (NMS's). Moreover, this discussion compellingly exposes the importance of interests, states and groups within states to the newcomers in the European club.

This paper argues that the New Europe is likely to experience a considerable divergence of policy interests as a result of the Eastern Enlargement. The more advanced EU member states have a clear interest in reducing overall expenditures on the SCF's and in the creation of a "level playing field" – reducing the role of state subsidies and raising regulatory standards in the CEEC's, putting these on a par with Western levels. Less advanced states on the other hand are far more concerned with overall levels of economic competitiveness, sustainable economic development and the related impact of EU redistributive arrangements. Thus, the NMS's should have a much stronger interest in developing the EU's fiscal tools for promoting economic growth and development (in particular the SCF's). Moreover, the NMS's may have an interest in maintaining many of the policies that the Old Member States (OMS's) would like to see eliminated – e.g. state subsidies and some forms of investment promotion incentives. The new range of median states – i.e. the former beneficiaries of EU SCF's (Spain, Portugal, Greece and Ireland) – fall in a somewhat dubious category. They can lobby hard to be included in future rounds of EU funding or – failing this – join the advanced states in lobbying for reduced expenditure and a level playing field.

EU political bargaining during the enlargement process and even in the New Europe of 25 or 27 member states is strongly weighted in favour of the larger and more advanced EU member states. Moreover, the new *Constitutional*

*Treaty* does not result in any significant changes in this regard.<sup>2</sup> Thus the benefits resulting from the economic and political integration of Central and Eastern Europe (CEE) will likely accrue primarily to the large and more advanced states, thereby potentially increasing the degree of political division in the New Europe. The potential for unanimity voting on multi-annual framework agreements – i.e. those agreements that affect the distribution of SCF's – does make it possible for the NMS's to block agreement on proposals that fail to satisfy their interests. However, they are nonetheless in a weaker position *vis-à-vis* the larger OMS's who can just as effectively block attempts to bargain significant changes to the current policy framework. Moreover, the "enhanced cooperation" clause in the Amsterdam, Nice and the new *Constitutional Treaty* may ultimately remove any potential for the less advanced states to leverage significant concessions from the more advanced states.

The paper proceeds as follows: The *first section* discusses the competitiveness and economic development concerns of the CEEC's in the larger context of the literature on the "developmental state". The *second section* takes a look at some of the strategies pursued by the CEEC's prior to EU membership and assesses some of the potential weaknesses of current economic development in these states. The *third section* takes a look at the current and evolving EU policy framework. The *fourth section* looks at the future interests and concerns of the CEEC's as they relate to the requirements of EU membership, the political bargaining process, and the potential compatibility or conflict of the EU framework with the goals of competitiveness and economic development. The *final section* concludes.

<sup>1</sup> See the discussion of the SCF's in Ellison (2005).

<sup>2</sup> See for example Ellison (2005).

## 1) IN SEARCH OF COMPETITIVENESS

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Economic competitiveness is the subject of much current debate both within and far beyond the borders of Europe. The advent of EU membership for 10 new less developed states has resulted in a renaissance of literature on economic competitiveness in CEE – if indeed one can even argue that interest had declined.<sup>3</sup> Given that EU membership is likely to result in a further intensification of economic competition across the borders of the New Europe, concerns about the future prospects of the CEEC's are at a new pitch. This fact has focused renewed attention on the various policy measures available in the EU that might assist the NMS's in promoting sustainable, long-term economic development. As such, the Lisbon strategy, the EU's SCF's, competition policy and rules regarding the use of state aids define a nexus of highly salient and potentially heated policy debate in the New Europe.

What specific factors drive economic competitiveness and the creation of dynamic economies is still a question of considerable academic and intellectual debate. For many, the answer lies in the complete elimination of barriers to trade and the establishment of free market entry.<sup>4</sup> For others, the key lies in the re-

moval of the state from its involvement in the economy.<sup>5</sup> Others still argue for inflation targeting.<sup>6</sup> For others still, economic competitiveness may be a function of the government's role in market-supporting activities, in particular the development of infrastructure and human capital. This approach likewise places a considerable emphasis on the importance of institutions.<sup>7</sup> The potential role of *external* increasing returns, economies of scale and economic geography introduce a further degree of uncertainty over the consequences of economic integration – in particular for less developed economies and in the context of low European labour mobility.<sup>8</sup>

In recent years, strong intellectual and ideological currents have reinforced and supported the shift away from state involvement in the economy and toward a more neo-liberal agenda. Moreover, the phenomenon of globalization appears to have further strengthened the claim that states have no alternative but to pursue more neo-liberal agendas. There are essentially three core elements of the neo-liberal agenda. The first involves a narrow attack on the state and its interventionist role in economic affairs.<sup>9</sup> The second involves a much broader attack on the fundamentals of the practice of *import substitution industrialization* (ISI)

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<sup>3</sup> Perusing economics journals in Hungary (e.g. *Közgazdasági Szemle, Külgazdaság*, the working papers of the Hungarian Institute for World Economics, etc.) one comes across a large number of articles that address this topic from multiple directions. Indeed this is nothing new. The development of economic competitiveness literature has been something of a cottage industry in CEE ever since the initial stages of transition and has not begun to lose momentum with the advent of EU membership.

<sup>4</sup> See Dollar (1992) and Sachs and Warner (1996).

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<sup>5</sup> See for example Krugman (1987). Both Tupy (2003) and Sachs and Warner (1996) argue, for example, that excessive state regulations lead to slow economic growth and that EU membership will ultimately mean some degree of re-regulation.

<sup>6</sup> See in particular Fischer, Sahay and Végh (1996).

<sup>7</sup> See for example Kolodko (2000?) and Rodrik (2002).

<sup>8</sup> See for example Martin (2003) on economic geography and labour mobility. See Ellison and Hussain (2003) on external increasing returns and uncertainty in the context of European integration. On external increasing returns and economic geography see Krugman (1991).

<sup>9</sup> Paul Krugman (1987) argues that governments are not able to make economic decisions since they are likely to put political interests before economic concerns and they lack the relevant economic expertise.

and promotes in its place *export-led industrialization* or even more broadly what has come to be referred to as the “*Washington Consensus*”. This *Washington Consensus* in particular strongly advocates the role of the market at the expense of the state, exposure to international competition and the free movement of capital and goods.<sup>10</sup> The third core element of the neo-liberal agenda involves the rollback of the welfare state.<sup>11</sup>

For states seeking to become more economically developed, the *Washington Consensus* and the neo-liberal agenda it implies has posed perhaps the most direct threat to national decision-making autonomy and the role of government. Controversial from the start,<sup>12</sup> the *Washington Consensus* prescribes a set of policy measures for states seeking to become more economically developed.<sup>13</sup> In response to the anti-statist and *Washington Consensus* views, a number of authors focus instead on the consequences of the withdrawal of the state from the realm of economic management. Linda

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<sup>10</sup> The *Washington Consensus* is the most prototypical expression of what has come to be viewed as the neo-liberal agenda. For Williamson’s original elaboration of the *Washington Consensus*, see Williamson (1990). While Williamson himself has explicitly contested the use of the term “neo-liberal agenda” (Williamson, 2000), this term seems particularly appropriate in contrast to the range of alternatives proposed as alternatives to the *Washington Consensus*.

<sup>11</sup> Though this facet of the neo-liberal agenda is likewise important, the government’s role in the management of the economy is the principal focus of this paper.

<sup>12</sup> Rodrik (1996) offers one of the more potent criticisms. But this approach continues to inspire strong criticism (see for example Beeson and Islam, 2004; Rodrik, 2002; and Kolodko, 2000?).

<sup>13</sup> In general, the neo-liberal prescription has favoured strong measures of fiscal prudence and reductions in government expenditure, tax reform, competitive exchange rates and secure property rights. The *Washington Consensus* eschews any form of market protectionism or state involvement and promotes instead extensive price, trade and financial liberalization, thorough-going privatization of the economy and deregulation. Finally, the *Washington Consensus* supports the elimination of barriers to the free entry and exit of foreign capital.

Weiss (2003), for example, argues that rather than constraining the behaviour of states, globalization has increased the likelihood of reliance on and potential importance of the state. Rodrik also has consistently criticized the notion that the removal of the state from the role of economic management is a wise strategy. His early analysis of the Latin American and East Asian cases suggested the role of government was crucial to explaining the relative success of the East Asian Tigers (1996),<sup>14</sup> and more recently Rodrik has shifted attention to China and India, suggesting again that the role of the state is crucial in explaining overall economic performance (2002).

While the notion of the “*developmental state*” may have lost credibility in the late 90’s with the emergence of the Asian crisis, many authors still argue that the involvement of the state is crucial for achieving successful and sustainable economic development.<sup>15</sup> Thus much research has begun to (re-)focus attention on the value of institutions and state intervention, in particular in areas such as human capital and infrastructure. And international institutions such as the World Bank have more recently come back on board with much of this agenda.<sup>16</sup>

Authors writing on CEE suggest these countries have done better than countries further East (including Russia) precisely because they chose not to fol-

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<sup>14</sup> Previous analyses have likewise suggested that state involvement played a strong role in explaining the success of the East Asian economies (Amsden, 1989; Wade, 1990).

<sup>15</sup> See in particular Beeson and Islam (2004), Beeson (2003) and Weiss (2003).

<sup>16</sup> See in particular the interview with the World Bank’s Executive Director, Carole Brookins, *Transition Newsletter*, December, 2003–January, 2004: 1–3. To some extent, the World Bank has vacillated on these points. For example, the *World Development Report 1997: The State in a Changing World* likewise pointed to the potential importance of the role of the state, the usefulness of industrial policy, the development of infrastructure, good business–government relations and even subsidies (Beeson, 2003: 12).

low a strictly neo-liberal approach to economic adjustment and renewal (Kolodko, 2000?, 1999; IMEPI-RAN, 2001). In the case of the CEEC's, however, this overall picture is complicated by the fact that these countries stand before two major challenges. On the one hand, they face the challenge of globalization as they move to market economies and greater economic openness. On the other hand, they face the challenge of EU membership, competition with EU member economies and adoption of the EU legislative framework. How these states have responded to these challenges, what factors explain their relative degree of success and how they are likely to be affected by EU membership is the subject of the remainder of this paper. While the turn to the market has certainly involved the state in different ways in the various CEEC's, the advent of EU membership appears more likely to constrain the role of the state in these countries.

The dissenting literature on the Washington Consensus is however somewhat vague on the precise form and shape of institutions that are likely to contribute to economic success. Both Rodrik (writing on China and India) and Kolodko (writing on Poland) suggest that "institutions" broadly defined are the crucially neglected variable in development literature. But at the same time, no precise outline of which institutions are most important for successful economic development is ever specified. In part, this is by design. Both of these authors argue that universally applicable development models do not exist. The virtue of the individual cases they discuss is that the governments in question were attentive to local economic specificities and local institutional and power relations. The only strong commonality across individual cases lies in the authors' insistence upon the importance of the role of the state.

Thus, the next section of this paper will illuminate the institutional and strategic features used by the CEEC's to

promote economic growth and development. As discussed below, these development strategies have important implications for the potential compatibility of CEE interests with the basic features of the EU policy framework discussed in the following section. While this paper focuses predominantly on Hungary, it likewise discusses some data from and related implications for the remaining CEEC's.

## 2) TOOLS OF THE PAST AND TOOLS OF THE FUTURE?

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National-level CEE economic competitiveness strategies exhibit considerable variation. While the Hungarian case exhibits similarities with other countries in the region, it also exhibits many differences. For one, Hungary started quite early both with an extensive project of privatization and a comparatively dynamic program for attracting FDI. The remaining CEEC's did not really initiate similar programs until much later. Moreover, while Hungary was the principal recipient of FDI in CEE throughout most of the period from 1989 until about 1997, the remaining CEEC's only began to catch-up after 1997. As Sass notes, if we look at accumulated per capita stocks of FDI, Hungary still remains the principal investment target in CEE. Second, the relative degree of penetration of foreign capital in Hungary greatly surpasses that of other CEEC's (Hunya, 2004; Sass, 2003: 14).

Throughout the 1990's, the CEEC's were primarily focused on the shift from centrally planned command economies over to market economies and on the privatization of industry. Over this period, there have been a number of important successes. Hungary in particular has been remarkably successful at at-

tracting foreign investment capital. The Hungarian economy is almost entirely privatized. Thus, if any of the NMS's are genuinely prepared to adopt current EU competitiveness and industrial policy strategies, it may be Hungary. As Hunya notes, the degree of foreign penetration of the Hungarian manufacturing sector is extensive. In 2001, some 72.5% of output in the manufacturing sector in Hungary was attributable to foreign owned firms (2004: 15). Apart from 1995, 2001 was one of the biggest years for FDI flows into Hungary (Sass, 2004: 68). As Sass points out, 26,000 firms benefiting from foreign participation account for 80% of trade (2004: 64). As Szanyi notes, in the year 2000, foreign investment enterprises (FIE's) also played a determinant role in net sales revenue (73.7%), value-added production (70%), and in manufacturing were responsible for 47.1% of employment (2003?: 9).

At least one author suggests the corporate taxation policies of the New and Old Member States have begun to diverge. The author notes that from an average 2% difference in statutory corporate tax rates in 1999 across the Old and New Member states emerged and this difference increased to 6% in 2003. Moreover, many countries in CEE envision still further reductions in the level of corporate taxation (UNECE, 2004a: 126, 128). Yet this image papers over the much more generous taxation and investment incentive regimes available to foreign (and domestic) investors alike during large parts of the transition period. If these investment promotion schemes were more consistently included in the numbers above and over a longer time frame (from 1990 to the present), there would be considerably more convergence in the corporate tax rates across the Old and New Member states in the more recent period. To some extent, the reduction of corporate tax rates may actually compensate for the loss of other tools used to promote economic competitiveness.

Economic competitiveness has been promoted in different ways by the Hungarian government. Tax benefits/holidays, monopoly concessions, as well as protective trade barriers<sup>17</sup> have all been introduced in order to encourage investment. A large number of the firms that have taken advantage of these concessions are foreign. This does not mean that no Hungarian firms have benefited from these arrangements. But foreign firms – due to the magnitude of the required investments – have been among the principal beneficiaries. In Hungary, investment incentives were introduced even prior to the 1989 collapse of the East Bloc. As Éltető notes, the XXIV/1988 law on foreign investment permitted foreign firms who invested in a select set of activities<sup>18</sup> to obtain a tax write-off of 100% for the first five years and 60% for the following five years. Tax exemptions of 60% and 40% respectively were possible for investments in other economic activities. In order to receive these tax reductions, the foreign investor share had to be at least 30% of a minimum capital stock totalling more than 25 million Hungarian Forint and at least 50% of the revenues of the firm had to be earned from manufacturing. For smaller foreign investments, firms could deduct 20% of their corporate tax if the foreign investment share was at least 20% of the total capital stock or totalled more than 5 million Hungarian Forint (Éltető, 1998: 9).

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<sup>17</sup> For a discussion of these trade barriers, see Nagy (1994). Nagy argues that it was primarily the interests of large Western producers that were protected in the early European or Association Agreements, while the interests of domestic producers were largely ignored. This suggests that these concessions were largely made in order to attract foreign investment to the region.

<sup>18</sup> These activities were; 'electronics, production of components for vehicles, production of machine tools, machinery components, production of pharmaceuticals, production of food-processing products, agricultural production, tourism, public telecommunication services and environmental protection products or equipment' (Éltető, 1998: 9).



Future modifications of the 1988 law impacted either the minimum capital stock thresholds or the allowable share of the tax write-offs. For example, as Éltető notes, the 1991 Act on Corporate Taxation increased the capital stock threshold for the 60%-40% tax reduction category to 50 million Hungarian Forint. Though these investment incentives were abolished in December 1993, from 1994 on, firms were permitted to apply for individual tax exemptions for foreign investments of “*outstanding size and importance*”. The 1995 amendment to the 1991 corporate tax law made all firms – domestic and foreign<sup>19</sup> – eligible for 5 year tax exemptions of 50% for investments above 1 billion Hungarian Forint leading in the first year to increases in exports of 600 million Hungarian Forint or 25% of previous export values. Five-year tax reductions of 100% were allowed in areas where the rate of unemployment exceeded 15%. Further tax preferences amounting to 6% of the total amount of investment were likewise available for investments in regions where unemployment exceeded 15% or in so-called “entrepreneurial zones”.<sup>20</sup>

The 1996 LXXXI law introduced a number of new investment promotion incentives. For example, a 5 year 100% tax holiday was available for investments in less developed regions. Investments of more than 1 billion Hungarian Forint and leading to turnover valued at more than 25% of the original investment and at least 600 million Forint in the first year were eligible for a 5 year 50% tax reduction. A 5 year 50% tax reduction was available for investments in hotel facilities over 1 billion Hungarian Forint and leading to an increase in turnover of at least 25% and at least 600 million Hungarian Forint. Hotel facilities built in

less developed regions were eligible for a 5 year 100% tax reduction (CompLex, 2005; Antalóczy and Sass, 2003: 12; Szanyi, 2003: 15).

The most liberal Hungarian corporate tax law went into effect on January 1<sup>st</sup>, 1998.<sup>21</sup> As noted above, firms investing more than 10 billion Forint (approx. \$44.5 million) and creating at least 500 new jobs were granted 10 year tax holidays. Firms investing in the less developed regions of Hungary were only required to invest 3 billion Forint (or approx. \$13 million), employ at least 100 new workers and to increase turnover by 5% of the total investment cost (Éltető, 1998: 9–10). According to representatives interviewed at the Hungarian Ministry of Finance, these tax holidays were valid for all of the Hungarian operations of the investing firm (not just the actual facility in which the firm had invested). While both domestic and foreign firms were eligible for these incentives, foreign firms were the principal beneficiaries since few domestic firms had sufficient investment resources.

Further generous investment incentives were promoted with the innovation of so-called “industrial parks”. The innovation of industrial parks in Hungary predates government involvement and fiscal support. Prior to 1996, these parks were predominantly financed through private foreign investments (AHIP, 1999: 97). From approximately 1996 on, however, the Hungarian government – in part as an attempt to promote the development of Small and Medium-sized Enterprises (SME’s) – progressively promoted the establishment of industrial

<sup>19</sup> This is one of the first instances of EU pressure and may have helped diminish complaints that the Hungarian government was only helping promote foreign and not domestic investors.

<sup>20</sup> *Ibid.*: 9-10; *Magyar Közlöny*, 1995, No. 108: 6285–6.

<sup>21</sup> There is some confusion in the literature over the actual date on which this set of investment incentives was introduced. Éltető accurately notes that this law was introduced in 1998 (Éltető, 1998: 9–10). Later work notes the date of 1996 (see for example, Szanyi, 2003: 15; and Antalóczy and Sass, 2003: 12). According to the Hungarian legislative texts, this amendment to the 1996 LXXXI law was introduced with the 1997 CVI law and made retroactive to Dec. 31<sup>st</sup>, 1996 (CompLex, 2005).

parks. From 1996, firms investing in such parks were eligible for a 5 year tax holiday (Éltető, 1998: 11–12). In addition to tax holidays, the government dedicated 400 million Hungarian Forint to their development in 1996 and 800 million Hungarian Forint per year from 1997–1999 (AHIP, 1999: 98).

The Hungarian government likewise made available a number of additional investment funds to which firms could apply for grants, interest-free loans, interest subsidies and even direct state participation. For example, between 1991 and 1994 the *Investment Incentive Fund* distributed approximately 100 billion Hungarian Forint to 98 different “high technology” projects – primarily the automotive industry and suppliers. This investment fund was replaced by two new funds in 1995, the *Economic Development Fund* and the *Allocation Fund* (Éltető, 1998: 10–11). According to Szanyi, the government also offered tax reductions in the first year for investments in R&D activities for up to 20% of the actual costs of the investment (2003: 16).

Hungary also pursued the creation of industrial free trade zones (IFTZ’s). These free trade zones were first introduced in 1982, long prior to the collapse of the East Bloc. As both Sass and Antalóczy note, there were several advantages of setting up IFTZ’s.<sup>22</sup> First, companies could import equipment, machinery and other production inputs without having to pay import duties. Second, they could take advantage of local labour. The only restrictions on firms in IFTZ’s were that they produce for exports. Over some 100 firms had set up industrial free trade zones by January 2002. Firms setting up production in IFTZ’s were likewise eligible for the remaining investment promotion incentives noted above, so that it was quite possible for firms to compound

these two sources of investment promotion. Further, IFTZ’s rapidly grew to produce a formidable share of Hungarian exports. For example, Antalóczy notes that between 1995 and 1998, the IFTZ share of Hungarian exports rose from 10.6% to 36% (1999: 59).

Sass (2003) argues that the role of fiscal incentives was significant in Hungary and played an important role in attracting foreign capital. Other countries in the region – in particular the Czech Republic and Poland – did not begin to attract comparable amounts of FDI until 1997 and beyond, long after the Hungarian market was already substantially saturated and after these latter countries had begun to adopt investment promotion policies similar to those in Hungary. Moreover, Poland, the Czech Republic and Slovakia never established IFTZ’s,<sup>23</sup> and the Czech Republic and Slovakia only began creating industrial parks after 2000 (Sass, 2003: 17). Hungary was likewise the first country in CEE to seriously consider privatizing its “core” strategic industries. According to Mihályi, the other CEECs resisted privatizing sectors such as energy, banking, telecommunications and chemicals until 1994 or 1995 (2001: 72). These factors, as well as many of the legislative decisions granting foreign investors easy and broad access to Hungarian industry helped Hungary to move forward more rapidly and attract more investment capital than other CEECs.

Fiscal aids granted in the form of tax benefits amount, in Hungary, to a significant overall share of state aid. According to the report of the Hungarian State Aid Monitoring Office (2002) – and depending on whether or not state

<sup>22</sup> Sass (2004: 75). See also Antalóczy and Sass (2001) and Antalóczy (1999).

<sup>23</sup> Poland did establish “special economic zones”, but according to Uminski, the regulations associated with them were too cumbersome to successfully attract significant amounts of FDI (2001: 91–2). Nevertheless, Poland requested a transition period for these zones until 2017 that was turned down by the Commission (EP Fact Sheet, 2003).

support for the railroads are excluded from these calculations – state aids in the form of tax benefits amount respectively to either 76.8% or 46.4% of all state aids in the year 2000. This level of state support was quite common for several years. Between 1998 and the year 2000, tax benefits amounted to between 72.9% and 76.8% of state aid.<sup>24</sup> In previous years, the share of tax benefits in overall state aid was smaller (58.7% and 58.2% in 1996 and 1997 respectively), but previously the Hungarian government granted significantly more direct support to the steel sector. In the form of tax concessions, in 1998 the Hungarian government granted 381.4 million Euros in tax benefits, 290.6 million Euros in 1999, and 371.3 million Euros in 2000.<sup>25</sup>

Many of these arrangements met with problems in the area of competition policy and state aids during the negotiation of the EU Accession Treaty.<sup>26</sup> Thus, in December 2003, a government decree was issued, effective January, 2003, that introduced the EU required aid-intensity limits for investment promotion. On the basis of the amended 1996 tax law, firms investing 10 billion Hungarian Forint in developed regions and 3 billion Hungarian Forint in less developed regions are now eligible for a tax deduction up to 35%-50% of the original investment depending on the region in which the investment takes place (not a 0% rate on all Hungarian operations over a 10 year period as was the case under the 1996 law).<sup>27</sup> This deduction

can be carried forward for up to 5 years until the entire 35-50% of the original investment has been deducted. Since this revised strategy qualifies as “regional development”, it has been approved under the framework of EU restrictions on state aids.

At the same time Hungary was required to revise many of the original agreements made with large foreign investors between 1996 and 2002. According to representatives from the Hungarian Ministry of Finance, the agreement between Hungary and the EU essentially allows large investors who started investments prior to January 2000 to recoup up to 75% of the “eligible investment costs”, for investments occurring after January 1<sup>st</sup>, 2000, the amount if 50%. Special agreements were put into effect for the auto industry, reducing these limits even further (European Commission, 2002:19). As industrial free trade zones were deemed incompatible with EU regulations, Hungary and other CEEC’s likewise had to discontinue their use. However, given that the predominant share of trade of these industrial free trade zones took place with other EU member states and given that goods can now move freely without import duties in the single market, the actual impact of this outcome is presumably negligible.

However, the January 2003 changes to the corporate tax law raise concerns. Foreign direct investment – despite Hungary’s remarkable ability to attract foreign capital in the earlier transition years – has declined recently, leaving analysts trying to understand what has happened. Apart from the general decline in foreign direct investment in 2001 and 2002, some blame the decline in Hungary on the inadequacy of the current law. The Hungarian corporate tax rate was further amended in 2004, reducing

<sup>24</sup> See the report of the State Aid Monitoring Office (2002: 17, Table 9).

<sup>25</sup> *Ibid.* (2000: 21 Table A2; 2002: 35 Table A2, 37 Table A4).

<sup>26</sup> Some problems arose even prior to this date. For example, the EU used the Association Agreement as the foundation for objecting that tax reductions based on export performance were a form of export promotion. As a result, Hungary altered the tax law to instead focus on output in 1996 (Éltető, 1998: 9).

<sup>27</sup> Based on an interview with the Hungarian Ministry of Finance, the actual shares are 35% for investments in the Budapest area, 40% in the Pest country area, 45% for investments in West-

ern Hungary, and 50% for investments in the remaining and typically less developed regions of Hungary (this last category is the largest).

it from 18% to 16%.<sup>28</sup> As suggested by representatives from the Ministry of Finance, the Hungarian government would not have adopted the new January 2003 revisions had it not been for the obligations of EU membership and the adoption of the *Acquis*. Whether or not these factors are directly responsible for the Hungarian rate of FDI is more complex. For one, FDI inflows rose again substantially in 2004.<sup>29</sup> For another, the end of privatization in Hungary as well as world business cycle effects have all played a role in the overall decline in FDI inflows.

The above methods are not the only way in which the Hungarian government has attempted to encourage foreign investors to locate in Hungary. Nor is this the only practice threatened by the requirement of adopting EU law. A number of “concessionary” or monopoly agreements were likewise negotiated between the Hungarian government and foreign investors in order to attract sizable investments in Hungarian infrastructure. In the case of Matáv, the Hungarian telecommunications company, the government was able to attract and retain foreign investment by guaranteeing a national monopoly in the telecommunications sector for the first 8 years. Without this arrangement and the attraction of a national monopoly, Matáv might not have been able to put together the capital necessary to rebuild its telecommunications infrastructure.<sup>30</sup> Similar

arrangements were made in the mobile telephone sector with first two and then later three different foreign investors. The monopoly or cartel agreements in these sectors were initiated in 1992, and the mobile phone sector agreement was re-negotiated in 1994 in order to admit one new market player.<sup>31</sup> Both of these concession arrangements had to be terminated as one of the conditions of EU membership.

Similar arrangements were also made in order to promote investment in the construction of Hungarian motorways and in the privatization of Hungarian power plants. Apart from the publicly owned MVM, as noted above, and the Hungarian nuclear power plant (Paks), all remaining power stations in Hungary were privatized with the help of preferential agreements including explicit long-term price and 8% profit guarantees. EU membership has explicitly affected only some of these agreements. In the energy sector, for example, the complete liberalization of access to the energy grid will be introduced as of 2004 (for all non-household energy consumption) and 2007 (for all consumption). It is not immediately clear how this will affect the preferential purchase agreements signed by MVM with various private energy producers, but it is likely this will have a negative impact on MVM’s bottom line.<sup>32</sup> Most of the Hungarian motorway

<sup>28</sup> KPMG Media Release: “Corporate Tax Rates Continue to Fall Worldwide”, March 23, 2004.

<sup>29</sup> Though the figures here include estimates of reinvested profits for 2004, there was a substantial increase in FDI inflows in 2004. The most recent FDI data (including reinvested profits) is available on the website of the Hungarian National Bank ([www.mnb.hu](http://www.mnb.hu)).

<sup>30</sup> The offer of a national monopoly was clearly a tool used to attract foreign investment (see for example Szanyi, 1993). Matáv’s financial position in the early 90’s made it virtually impossible to undertake the investments required to successfully modernize Hungarian telecommunications. In the late 80’s, Matáv published a 10-year plan that estimated the cost of required investments at 380 billion HUF. At the same time, the government’s

annual expenditure on all infrastructure needs at that time amounted to 30 billion HUF (Tóth, 1993: 39–41).

<sup>31</sup> Deutsche Telekom was the principal investor in Matáv, while Pannon and Westel were the principal investors in the mobile phone sector. Vodafone was the third Western company admitted to the Hungarian mobile phone market in 1994.

<sup>32</sup> There have already been significant problems in this regard, since the preferential agreements that Hungary signed have bound the MVM to pay more to electricity producers than the sale price to consumers. Moreover, these preferential purchasing agreements are valid for some 20–25 years from the date of signing (approximately 1997). Thus MVM (and the Hungarian government) will most likely compensate significant losses in the energy sector for years to come (2017–2023) (see Bakos, 2001). Complete liberalization of the energy sector may lower energy

agreements ran their course prior to the final date of enlargement. Thus, as long as Hungary observes EU public procurement regulations, future agreements will not likely be greatly affected by EU membership.

Hungarian strategies have gradually begun to shift away from simple capital attraction schemes to strategies promoting the diffusion of knowledge and technology and the continued clustering of economic and related R&D activity. Thus while some of the more attractive fiscal tax-based mechanisms noted above have been curtailed or reduced in scope, a new generation of programs is gradually being put in place. These programs attempt to respond in important ways to some of the deficiencies of previous capital-seeking strategies and attempt to expand R&D and build upon potential synergies across and between firms and various types of research institutions. The Hungarian government's "*Smart Hungary*" program for example, applied to investments as of December 31<sup>st</sup>, 2002 and offered additional investment promotion incentives to support the development of technology. Firms investing in R&D, for example, were able to deduct up to 200% of those costs from their corporate tax base.<sup>33</sup>

Buzás and Szanyi (2004) point to the potential importance of the more "knowledge-based" focus of a number of government programs geared toward promoting both the development of technology and its diffusion. The authors seem most enthusiastic about the development of "*Cooperation Research Centers*" (CRC's) in 2001 funded by gov-

ernment grants of between 0.2 and 1 million US Dollars and established at different universities in Hungary. One of the goals of these research centres was to include business partners in their activities. CRC's have been established in Budapest (2), Pécs (in cooperation with partners in Budapest and Szeged), Veszprém and Szeged. Further projects have been established since this initial set of five. Furthermore, the cooperative research these centres engage in is also eligible for tax deductions (Buzás and Szanyi, 2004: 22–3).

As Buzás and Szanyi note, other projects the government has initiated appear less successful. For example, the Hungarian government offered grants to entrepreneurs with academic scientific backgrounds to turn their knowledge into business enterprises. But this project has generated a small number of applications. Further efforts have been made to promote the development of Technology Learning Offices (TLO's) in the university setting. However, according to the authors, the lack of available capital has left TLO's at the mercy of investors. Few patents have remained in the hands of the TLO's, making them weak disseminators of technology (Buzás and Szanyi, 2004: 25–6).

Industrial parks constitute a final category discussed by Buzás and Szanyi. While the authors seem less enthusiastic about these parks, their numbers have increased substantially in Hungary. As noted by the Association of Hungarian Industrial Parks (AHIP/IPE), there were 165 industrial parks distributed throughout Hungary by May 2004.<sup>34</sup> However, Buzás and Szanyi remain sanguine about their potential impact on the diffusion of technology. As the authors note, *Infopark* in Budapest – one of the more successful industrial parks – brings together the Ministry of the Economy, the Prime Minister's Office, the Budapest University of

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supply prices, having a more serious impact on the related costs to the Hungarian government (and possibly the Hungarian consumer). Bakos estimates potential losses at 300 billion Hungarian Forint (2001: 1129). However, this estimate does not successfully take into account the costs of liberalization, suggesting that the total loss could be even higher.

<sup>33</sup> See both the program announcement from the Ministry of Economy and Transport (2002), and Ernst & Young (2003: 33-4).

<sup>34</sup> See the website of the Association of Hungarian Industrial Parks (<http://www.datanet.hu/ipe/>).

Technology and the Eötvös Loránd University of Sciences (ELTE), and has attracted the participation of large firms (Matáv, IBM, Hewlett Packard, Nortel and Panasonic). However, *Infopark* has not been successful at attracting further investors or in achieving more centralized forms of information sharing. Insufficient centralization of technology services has led each firm to create its own services. Thus little sharing of technology occurs (2004: 28).

Something of a consensus is emerging about the need to go beyond simple privatization and industrial restructuring in the CEE economies. While this literature typically does not criticize privatization and foreign direct investment (FDI), it does suggest the accumulation of foreign capital alone is not sufficient to achieving sustainable long-term patterns of economic development. As Szanyi points out, previously the principal indicator of economic competitiveness was thought to be the introduction of technologically sophisticated production techniques. Increasing FDI specialization in technology intensive economic branches was seen as an indicator of overall economic competitiveness. As Szanyi notes, current research suggests the actual “*technology and knowledge content*” of the work performed in CEEC’s more strongly emphasizes the assembly of products and less frequently their design and development. Thus increasingly theoretical and empirical work has begun to measure the share of the “*local contribution*” (2003?: 5).

In order to assess the compatibility of the EU policy framework, a clear picture of current deficiencies in the pattern of development is required. Four questions are most relevant to determining the degree to which multinational affiliates or domestic firms are developing sustainable, long-term patterns of economic development. *First*, to what degree do the activities of Hungarian affiliates transcend simple assembly work and involve the accumulation of organiza-

tional and research-related tasks in the hands of affiliates or supplier firms (notion of “embeddedness”). *Second*, to what degree does the presence of foreign multinationals lead to technology spillover to other local firms. *Third*, to what degree has the R&D activity of multinationals been transferred to local firms. And a *fourth* and related question, to what degree are domestic firms incorporated into the production (supplier) networks of larger foreign multinationals operating on domestic soil.<sup>35</sup> This last point is strongly linked to the first and third, since many assume the integration of domestic suppliers into the production networks of locally established foreign multinationals may also facilitate the process of technological spillover.

Response to these points is mixed. The relative degree of “embeddedness” of Hungarian affiliates is thought to be superficial (Szalavetz, 2003). As Szalavetz points out, the degree of integration of Hungarian affiliates into the global production networks of foreign multinational partners is ‘*thin*’, *i.e.* the range of potential responsibilities of Hungarian affiliates is limited by the demands of foreign multinational headquarters. Thus Szalavetz finds that the Hungarian affiliates of foreign multinational networks are caught up in hierarchically fixed vertical production networks leaving them vulnerable to the whims of foreign capital and fluctuations in the international market. Pavlínek comes to similar conclusions adding that vertical integration makes local firms more vulnerable to fluctuations in the international economy and to the strategic decisions of multinational firms (2004: 52).

The rate of technological diffusion is likewise typically given low marks. While direct recipients of FDI have often seen significant changes in their technological capacity (Sass, 2004: 81), the rate at which technology has diffused across

<sup>35</sup> A good overview of the literature on these last two points is provided by Sass (2004).

firm boundaries is more controversial. Some analyses even suggest the principal changes in productivity in the late 90's were more the result of labour shedding than the introduction of new technology (Novák, 1999). The evidence on actual technological spillovers is thin. Novák (2003), for example, finds there has been only a marginal impact on domestic firms and that competition effects and the presence of linkages with foreign multinationals had a stronger impact on technological change. Pavlínek likewise surveys a number of authors who find little or no evidence for technological spillover (2004). Schoors and Van der Tol (2002) are among the few to find significant positive evidence for spillover. The principal barriers to technological spillover appear to be weak linkages with domestic firms and/or attempts by foreign affiliates to control the likelihood of spillover.<sup>36</sup>

With respect to the remaining points, there are important anecdotal examples of the extensive transfer of capital, technology *and* research and innovation potential. General Electric (GE), for example, transferred both production and R&D activities to Hungarian soil. GE's investments in the Hungarian firm Tungsram have ultimately resulted in the transfer of 90% of GE's European production activity and 50% of GE's global R&D activities to Hungary (Berend, 2000: 58). A number of other firms have likewise made significant investments in R&D centres. Pavlínek notes that the motor-building part of Germany's Audi completed a new R&D centre in Győr, Hungary in 2001, while the German truck and bus brake manufacturer Knorr-Bremse built an R&D centre in Budapest in 1999. Other examples can be found for neighbouring countries

(Pavlínek, 2004: 62). The Hungarian Investment and Trade Development Agency (ITDH) points to the R&D activities of some 30 large corporations as an indication of important R&D activity locating in Hungary (Kilian, 2003: 14). And Sass notes that firms such as Nokia, Ericsson, Siemens and Compaq have all transferred parts of their R&D activities to Hungary (2004: 81).

In general, satisfaction with the transfer of R&D activity is low. Pavlínek, for example, points out that there is an international hierarchy of R&D activities. Large multinational firms are likely to keep their primary R&D activities close to their national headquarters and may even transfer R&D activities from affiliates to the multinational headquarters. When R&D activities are transferred to local affiliates, these are likely to be related to either local product development or to small-scale applied research (2004: 59). All in all, Pavlínek is quite sceptical about the likely transfer of extensive R&D activities to CEE. R&D activity has declined dramatically from its previous levels just prior to the transition. Havas, for example, notes that R&D expenditures in Hungary amounted to some 2.3% of GDP in 1988. However, by 1999, this sum had dropped dramatically to approximately 0.68% of GDP. On the other hand, for what is presumably the same period, the OMS's R&D expenditures average around 1.8-2% of GDP (2001: 11-12). While few expect Hungary's R&D expenditure to reach pre-1989 levels,<sup>37</sup> the gap between the OMS's and CEEC's is a cause for concern.

There are examples of increasing links between suppliers and MNC affiliates in Hungary. Sass points to differences in the types of FDI and their relative impact on supplier networks. Privatization FDI, for example, appears to have

<sup>36</sup> On this last point, Lorentzen and Mollgard (2002) find that many investors in CEE imposed "vertical restraint agreements" prohibiting affiliates from using transferred technology for production activities outside the framework of the joint-venture agreement. Such agreements are illegal under EU law.

<sup>37</sup> The EU's *Lisbon Agenda* encourages countries to bring their national-level R&D expenditures up to 3% of GDP by 2010.

led frequently to the maintenance of local supplier networks, while Greenfield FDI (investment in new production facilities) is more frequently associated with weak links between local suppliers and foreign affiliates (Sass, 2004: 79). An interesting comparison in this regard is that between FDI in the car industry in Hungary and the Czech Republic. In Hungary, most investment in the car industry takes the form of Greenfield investments (though prior to WWI there had been a car industry in Hungary, during the socialist era there was no car production in Hungary). Thus, FDI in the car industry in Hungary had no pre-existing network of suppliers to integrate into the regional investment and production network and there was no pre-existing Hungarian auto-manufacturing firm that could have been privatized (Sass, 2004: 80). On the other hand, according to Pavlínek, in the Czech Republic the privatization of Skoda led to the restructuring of Skoda's pre-existing supplier network and thus to a far greater level of local integration. At the same time, Pavlínek points out problems with the degree of "embeddedness" of local suppliers, noting that they perform only minor assembly operations for products primarily produced elsewhere (2004: 54–5).

Even with all the different government programs introduced to promote greater levels of R&D and technological diffusion, there may still be significant barriers restricting the likely impact of such efforts. Taking Szalavetz's approach, local affiliates, for example, have insufficient latitude to deepen their sphere of responsibility *vis-à-vis* their multinational headquarters. Ownership barriers make it difficult for affiliates of large multinational firms to autonomously define their sphere of operation. In this sense, hierarchical relationships with MNC's may represent inflexible vertical barriers that impede the development of horizontal

activities.<sup>38</sup> At the same time, it may be possible for domestic firms to engage in such practices more easily than for fully owned foreign affiliates. Videoton is a good example of a Hungarian firm whose diversified production strategies are not dependent upon any one MNC production goal. This presumably depends on the fact that Videoton is a publicly traded firm, while other greenfield type foreign affiliates are 100% (or very close to 100%) foreign owned.<sup>39</sup>

In this regard, both the degree of incorporation into core-periphery networks and the degree of foreign ownership may ultimately prove to be a liability rather than an asset. The greater the share of fully owned foreign firms and the greater the share of foreign ownership in individual firms, the more difficult it may be to promote deeper embeddedness in multinational production strategies. 100% foreign owned affiliates again may have little authority to engage in the diversification of tasks, whereas publicly traded Hungarian firms are potentially better suited to do so. Thus the degree of foreign ownership may paradoxically hinder the creation of sustainable economic development goals.

Identifying which factors best explain the ability of CEEC's to go beyond *economic growth* to real *economic development* has become a primary focus of current research. The implication is that mere capital deepening – improvements in the capital/labour ratio – fail to cre-

<sup>38</sup> Sass, citing Vince, essentially makes this claim (2004: 80).

<sup>39</sup> Pavlínek notes a similar example in the Czech firm PAL Praha which manufactures small electric engines for a larger foreign firm (Magna). Within the context of a joint venture project, PAL invested in its own R&D center for which it remains fully responsible, thereby retaining considerable managerial autonomy from Magna. Nor does PAL transfer its R&D results to Magna (2004: 62). Such a constellation would presumably not be possible for most MNC affiliates without the degree of managerial autonomy provided by the joint venture relationship between PAL and Magna.



ate the foundations for long-term economic development. While capital deepening may improve productivity and modernize technology, this should not be equated with “know-how” or the capacity to produce new technologies, to innovate and thus to promote long-term economic development. According to this logic, achieving domestically driven economic growth and capital deepening depends on the ability to spearhead technological innovation on its own account and not as a result of exogenous factors. Such an account does not denigrate the value of imported technology and capital deepening – by all accounts, FDI brings with it productivity improvements and thus the potential for economic growth. But complete reliance on exogenous forms of technology and innovation potential risks creating dependency and may fail to create the necessary conditions for long-term sustainable economic development in CEE.

Considerations of this type also raise concerns regarding the relative vulnerability of the CEEC’s to capital mobility. If these countries are dependent upon external sources for the degree of capital deepening and ultimately innovation potential, then the footloose nature of investment capital poses real problems for the future competitiveness and sustainability of CEE economic development. Such concerns are reinforced by current discussion of the declining rate of foreign direct investment in Hungary and in particular whether FDI is likely to move further East or even to Asia (Kalotay, 2003). Though FDI flows rising again in 2004, even with the inclusion of reinvested profits in the calculation of FDI flows (omitted by previous Hungarian FDI flow data), inflows in 2003 were almost half those of inflows in 2001 (Sass, 2004: 68).

There are significant examples of foreign multinationals leaving the terri-

tory to produce further East.<sup>40</sup> As Pavlínek notes, there are even examples of producers trying to minimize their sunk costs in order to retain greater geographic flexibility. Pavlínek points to the example of a supplier firm that owns the machinery and equipment in a plant in the Czech Republic, but not the actual building (2004: 58). The smaller individual NMS’s and the larger individual MNC’s, the more vulnerable are individual states. The Czech Republic, Hungary and Slovakia are increasingly dependent upon the strategic interests of individual firms; Volkswagen accounts for 14% of Czech and 16% of Slovak exports in 1999 (Pavlínek, 2004: 63, 65). *IBM* likewise controls a significant share of Hungarian exports.<sup>41</sup>

The Hungarian National Development Plan, published as part of its application for EU SCF’s for the calendar period 2004–2006, outlines Hungarian concerns about declining levels of foreign direct investment and focuses attention on this shift in investment promotion strategies:

“Hungary’s investment attracting capabilities have recently declined in parallel with an increase in labour costs and more intensive competition from low cost economies. This calls for a shift in investment promotion policy: the objective now is to support the attraction and retention of activities representing a high added

<sup>40</sup> There is a long list of firms that have picked up stakes to invest in other regions: *IBM* (previously the largest exporter and importer in Hungary), *Marc Shoe*, *Mannesmann*, one of their suppliers (*Shinwa*), *Solectron* and *Flextronics* (Szanyi, 2003?: 14; Pavlínek, 2004: 55–6). Hungary is no exception. Similar stories are recounted about production in the Czech Republic: the German firm *Varta Aku*, the Belgian *Massive Production* and the Japanese–German *Takta Petri*, typically as a result of wage considerations (Pavlínek, 2004: 56).

<sup>41</sup> In March 2005, *IBM* announced that it would undertake investments of \$35.5 million in Hungary and between 2003 and 2008 would undertake further investments eventually employing some 17,000 workers ([www.nol.hu](http://www.nol.hu): “*IBM: 6,5 milliárdos beruházás, 700 munkahely*” *IBM: 6.5 billion Forint Investment, 700 jobs*, March 3, 2005).

value and promote their embedding into the Hungarian economy.” (Prime Minister’s Office, 2003: 204)

On the other hand, data published by the United Nations Economic Commission for Europe illustrates that real gross fixed capital formation in Hungary has continuously risen between 1995 and 2002.<sup>42</sup> Thus although FDI inflows in the Hungarian economy have potentially reached a degree of saturation, total investment in the Hungarian economy appears to be on the rise. In this regard, Hungary is even a bit of an outlier, since the Czech Republic, Estonia, Lithuania, and Romania all experienced short-term dips in 1999 (and for Latvia in both 1999 and 2000).<sup>43</sup>

### 3) THE EU POLICY FRAMEWORK AND THE NMS’S

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Whether the supranational EU policy framework is compatible with CEE competitiveness and economic development concerns motivates what follows. Several elements of the EU policy framework target the problem of competitiveness and economic development and are of potential interest to the CEECs. In the context of the Eastern Enlargement, at least three areas are highly salient. The future distribution of SCF’s, the potential harmonization of corporate tax rates and the role of state aids and competition policy are likely to dominate political and intellectual debate in the *New Europe* in the coming years. These three areas exhibit strong potential for diverging interests with respect to economic competitiveness and development.

<sup>42</sup> See the *Economic Survey of Europe*, (2004, No. 1: 191, Appendix Table B.3).

<sup>43</sup> *Ibid.*

Current discussions of EU Structural and Cohesion Fund reform already provide an indication of the potential divergence of interests in the New Europe. The so-called *Sapir Report* (European Commission, 2003) – intended to provide proposals on future reforms of the SCF’s – emerged with the broad recommendation that funding be re-nationalized. This initiative has received some support from the OMS’s.<sup>44</sup> Re-nationalization is likely to be more strongly supported by “*net contributors*” to the EU budget (in particular Germany, the Netherlands, Sweden, Austria and the UK). On the other hand, the NMS’s have strong incentives to insist on maintaining or even increasing the amplitude of the EU’s SCF’s. In this policy area, some effort has already been put into studying both the interests of Old and New Member states and the potential leeway for raising the amount of money available for these funds.<sup>45</sup>

The willingness of Western, net-contributor or more advanced states to dedicate significant resources to policies of Economic and Social Cohesion is questionable. The amounts set aside in the Commission’s proposal for the financial perspective 2007-2013<sup>46</sup> provide only minor increases over previous amounts (see *Table 1* below). Between 2006 and 2007, spending will increase by 10% when Bulgaria and Romania join, but by much smaller amounts in following years. Seen in per-capita terms, the amounts set aside for SCF spending remain almost constant between 2006 and 2007, rising from 0.26 to 0.27 Euros per person. Inflation is likely to wipe out the small increments between 2007 and 2013. These spending amounts are startling in the context of the Commission’s *Third*

<sup>44</sup> See for example Tarschys (2003).

<sup>45</sup> See for example the report published by the Hungarian Institute for World Economics (Szemler, 2004).

<sup>46</sup> See “Building our Common Future: Financial and Political Outlook for the Enlarged Union 2007–2013”, (COM(2004) 101 final).

Table 1  
Proposed EU Expenditures on SCF's 2006–2013

	Total Appropriations	Percent Increase	Estimated Population	Per Capita Appropriations
2006	120,688,000		459,069,367	0.26
2007	133,560,000	10.7%	489,194,290	0.27
2008	138,700,000	3.8%	490,157,736	0.28
2009	143,140,000	3.2%	491,125,055	0.29
2010	146,670,000	2.5%	492,096,247	0.30
2011	150,200,000	2.4%	493,071,313	0.30
2012	154,315,000	2.7%	494,050,251	0.31
2013	158,450,000	2.7%	495,033,061	0.32

Source: Own calculations based on Appropriations data from "Building Our Common Future" (COM(2004) 101 final: p. 29) and population data from Eurostat Online NewCronos data ([http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/&product=EU\\_general\\_statistics&depth=1&language=en](http://europa.eu.int/comm/eurostat/newcronos/reference/display.do?screen=welcomeref&open=/&product=EU_general_statistics&depth=1&language=en))

#### *Report on Economic and Social Cohesion.*

This report notes a doubling in the EU population living below 75% of the EU average per capita GDP in 2007.<sup>47</sup> Despite no mention of re-nationalization in the report, dedicated spending amounts may represent a trend in that direction. The CEEC's will be required to pick up a far greater share of the economic restructuring and membership tab than former cohesion countries.

Debates over corporate taxation exhibit a similarly strong insistence on national interests. Wrangling over the future of EU tax harmonization was initiated by Germany's Chancellor Gerhard Schröder in March of 2004, two months prior to the official enlargement date. Though many states profess a strong interest in corporate taxation policy, Germany (with the support of France and other countries) led the charge against the comparatively low corporate tax rates offered in the CEEC's. Schröder even complained of "fiscal dumping", noting that these countries have average corporate tax rates below 20%, while the West European average hovers around 31-32%. Several states including Germany and Sweden noted that low corporate tax rates in CEE are being financed by

<sup>47</sup> European Commission (2004a: ix-x).

EU funding.<sup>48</sup> Together, France and Germany – occasionally joined by Poland – launched an attempt to introduce a minimum rate of corporate taxation in Europe.<sup>49</sup> On September 6<sup>th</sup>, 2004, France's Finance Minister Nicholas Sarkozy explicitly attempted to link SCF spending to compliance with a future EU-regulated minimum level of corporate taxation.<sup>50</sup> Poland as well as the broader range of CEEC's were opposed to this effort.<sup>51</sup>

Corporate taxation issues predate the membership agreement (see *e.g.* Radaelli, 2001). Estonia's "liberal" corporate tax regime was criticized by Romano Prodi as a potential "problem" as early as March, 2002. France, Italy and Spain were concerned that Estonia's corporate tax regime constituted an "unfair" competitive advantage.<sup>52</sup> As the above noted example of Hungary suggests, similar problems arose with other countries. Prior to the enlargement it was difficult to make any headway on harmonization. In response to the Enlargement, several countries in Western Europe began to lower their corporate tax rates. In particular, effective January 1<sup>st</sup>, 2005, Austria lowered its corporate tax rate from 34% to 24%.<sup>53</sup> Germany likewise lowered its fed-

<sup>48</sup> See for example: <http://www.eubusiness.com>, "New EU States Use Low Tax Rates as Investment Bait" (4/25/2004).

<sup>49</sup> See for example: <http://www.eubusiness.com>, "Warsaw, Berlin and Paris Call for Harmonisation of EU Taxes" (7/22/2004).

<sup>50</sup> See *e.g.* Reuters.com: "Paris Idea to Link EU Funds, Tax Gets Cold Reception" (9/6/2004).

<sup>51</sup> See for example: <http://www.eubusiness.com>, "Poland Joins Outcry against French Proposal on EU Funds" (9/9/2004).

<sup>52</sup> See for example: <http://www.eubusiness.com>, "Commission Questions Estonia's Liberal Corporate Tax Regime" (3/8/2002).

<sup>53</sup> See the website of the Federal Chancellery of Austria (<http://www.austria.gv.at/>).

eral corporate tax rate from 40% for retained earnings, and 30% for distributed earnings to a flat rate of 25% in January, 2001.<sup>54</sup> Moreover, Germany is currently considering a further reduction to 19%. However, given high local corporate tax rates, the effective corporate tax rate will remain much higher: 38.7% at the current rate and 32.7% at the suggested rate.<sup>55</sup>

The enlargement may ultimately be successful in bringing corporate tax harmonization to the bargaining table. However, British and Irish resistance is significant. The UK, in particular, is responsible for retaining the right to a national veto on taxation issues in the new *Constitutional Treaty*.<sup>56</sup> Moreover, the UK – as made clear by Gordon Brown, British Chancellor of the Exchequer – appears steadfastly opposed to any move in the direction of tax harmonization.<sup>57</sup> Ireland – currently sporting the lowest corporate tax rate in Europe – likewise has every reason to continue to oppose harmonization. Given that most of the CEEC's are opposed to such a move and given that such decisions – now or in the future under *Constitutional Treaty* – will require unanimity, corporate tax rates are not likely to be harmonized any time soon. This does not preclude the

possibility that some of the OMS's most concerned about the consequences of corporate tax competition in the New Europe might attempt to link this issue to others (in particular the SCF's) and either pressure the NMS's into compliance or lobby for the gradual phasing out of the SCF's.

Whether harmonization is justified on the basis of variation in rates of corporate taxation across countries is more problematic.<sup>58</sup> These difficulties aside, based on statutory rates of corporate taxation, there is little evidence that the EU genuinely needs to engage in harmonization. *Table 2* below provides some preliminary data on corporate tax rates across countries and on regional averages of corporate taxation across the New and Old Europe and the CEEC's. Significant differences in unweighted average rates are apparent between the

Table 2  
Average Corporate Tax Rates in Europe

	Unweighted Averages (2003-2004)	Unweighted Averages (Future?)	Weighted Averages (2003-2004)	Weighted Averages (Future?)
EU15	29.4%	29.4%	30.1%	30.1%
CEEC10	21.5%	18.9%	21.4%	20.5%
EU27	25.9%	24.7%	28.3%	28.1%

*Sources:* Based on own calculations from Eurostat website population data. Corporate taxation data was taken from the 2003 Devereux, Griffith and Klemm dataset (for OMS's), and from Ernst and Young (2003). Corporate tax rates for Germany were modified based on data from the German government's information website (<http://www.germany-info.org/relaunch/business/taxes-german-tax-rates.html>)

<sup>54</sup> See the information website of the German government: <http://www.germany-info.org/-relaunch/business/taxes/german-tax-rates.html>.

<sup>55</sup> See *The Economist*: "Taxing Times", March 21, 2005.

<sup>56</sup> Approved by the European Council in June 2004, the *Constitutional Treaty* must further be ratified by each of the Member States, a process that could take up to two years from the original date of passage.

<sup>57</sup> See for example: <http://www.eubusiness.com>, "Chancellor Schroeder Slams 'Fiscal Dumping' by New EU States" (4/29/2004), and "EU Embroiled in Taxing Debate Over 'Fiscal Dumping'" (9/11/2004).

<sup>58</sup> Determining actual levels of corporate taxation across countries is complicated. Statutory rates are readily available, but these rates differ from those firms actually pay for several reasons. Countries have very different rules and taxation rates based on anything from how firms are allowed to calculate and deduct the depreciation of physical capital, to the rate at which *retained* and *distributed* earnings are taxed, to the role of various deductions available for region-specific investments and other investment incentive programs. So-called "effective" rates of corporate taxation thus differ from "statutory" rates. Attempts have been made to measure these different rates of corporate taxation. See for example the work of Carey and Tchilinguirian (2000).

OMS's and the CEEC's (29.4% and either 21.5% or 18.9% respectively based on current and projected rates). The un-weighted average across the New Europe is not as low, but exhibits a potentially significant drop from the previous average rate of corporate taxation (29.4% and either 25.9% or 24.7% respectively based on current and projected rates of corporate taxation).

A strong case can be made for using *weighted* average corporate tax rates based on relative population sizes. Even though some countries have quite low rates of corporate taxation, the relative size of the employable population (and to a lesser extent the relative purchasing power)<sup>59</sup> provides an upper limit on the potential to take advantage of this variation. The differences in the *weighted* averages across the Old Europe and the CEEC's remain large (30.1% and 21.4% respectively). But the differences across the Old and the New Europe are far less substantial (30.1% and 28.3% or 28.1% respectively based on current and projected rates of corporate taxation). In this second case, the change in the average rate of corporate taxation across the Old and New Europe is at most 2%. Moreover, the CEEC's have raised their effective rates in recent years due to the requirements of EU competition policy. Given these calculations it is difficult to comprehend the zeal with which the OMS's have pursued this issue.

Data on the FDI behaviour of the OMS's, Japan and the US (see *Table 3*) suggests that capital has not been moving at any great pace toward CEE. While a few countries exhibit a shift in their regional FDI strategies – pronounced for Austria but far more moderate for Germany – the remaining Western states typically only exhibit a mild shift in their investment behaviour

toward CEE. The majority of OMS's have CEE investment shares well below 5% of their investment shares in the former “European core” (here defined as the set of more advanced OMS's, excluding the cohesion countries Greece, Ireland, Portugal and Spain).

In 1999, France's CEE FDI, for example, only amounts to 4.1% of its European core investments. On the other hand, Germany's CEE investment share represents a good 10.3% of its European core investments in the same year. Oddly, Austria, though so far not a party to the complaints of France, Germany and Sweden, has witnessed very high rates of investment in CEE. Though these investments may have reached their highpoint in 1997 (72.6% of their investments in the European core), they still amounted to 62.1% of investments in the European core in 1999. Greece as well remains an outlier with CEE investments almost equalling investments in the European core in 1998. But these investments drop off precipitously by the year 2000. Moreover, in recent years a reversal of these trends may be emerging. As noted above, although Hungarian FDI rose again substantially in 2004, Hungary and other CEEC's have begun to experience declining rates of FDI. Finally, even with investment promotion incentives and low rates of corporate taxation, FDI outflows from CEE have risen steadily over the years. This last point is difficult to explain in the context of Western concerns.<sup>60</sup>

On the other hand, looking at data on the shift in Old Member States, Japanese and US FDI behaviour in the former cohesion countries (Greece, Ireland, Portugal and Spain) (See *Table 4*), much of the investment in CEE may well occur at the expense of the former cohesion

<sup>59</sup> Since a significant share of foreign investment is for the purpose of exports, no attempt is made in this analysis to control for relative purchasing power.

<sup>60</sup> According to data from the website of the Hungarian National Bank, for example, total stocks of outward FDI have risen from 216.9 million Euros in 1995 to 2,566 million Euros in 2003.

Table 3  
Share of CEEC FDI Relative to FDI in the European Core

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Austria	6.2%	16.5%	26.4%	43.5%	55.3%	72.5%	63.9%	65.5%	72.6%	59.8%	62.1%	
Belgium/Luxembourg	0.1%	-0.1%	2.8%	0.6%	11.5%	0.2%	2.9%	9.2%	8.1%	6.9%	4.6%	1.0%
Denmark			0.5%			2.2%				6.9%		
Finland				0.0%	0.0%	1.7%	0.9%	1.7%	1.5%	1.2%	3.5%	
France	-0.3%	0.0%	0.2%	0.5%	0.6%	0.7%	1.8%	2.3%	3.3%	3.0%	4.1%	
Germany	0.1%	0.3%	1.0%	2.3%	3.8%	5.0%	6.2%	7.6%	9.1%	11.5%	10.3%	
Greece										98.5%	77.0%	47.1%
Ireland												
Italy	0.0%	0.0%	0.2%	0.3%	1.1%	1.3%	0.0%	0.0%	0.0%	0.0%	0.0%	
Netherlands	0.0%	0.0%	0.0%	0.0%	1.1%	1.6%	2.1%	4.1%	4.7%	5.6%	6.1%	
Portugal							0.3%	0.4%	1.4%	2.8%	24.0%	13.5%
Spain	0.0%	0.1%	0.2%	0.7%	0.5%	4.5%	3.2%	3.9%	1.3%	1.5%	1.4%	8.2%
Sweden		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.1%	1.9%	2.2%	2.9%	3.8%
UK	0.0%	0.0%	0.1%	0.4%	0.2%	0.7%	0.6%	0.8%	1.7%	2.3%	1.8%	
Norway	0.0%	0.0%	0.0%	0.2%	0.2%	0.5%	0.6%	1.1%	1.2%	1.4%		
Switzerland					0.8%	1.0%	2.1%	2.1%	2.1%	2.9%	3.4%	
Japan	0.0%	0.0%	0.0%	0.4%	0.4%	0.5%		0.0%	0.0%	0.0%	0.0%	0.0%
USA	0.0%	0.1%	0.1%	0.2%	0.7%	1.0%	1.1%	1.1%	0.9%	1.0%	0.9%	0.9%

Source: Calculated on the basis of data from the OECD International Direct Investment Statistics (2001).

Table 4  
Share of CEEC FDI Relative to FDI in the Old Cohesion Countries

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Austria	192.0%	376.4%	424.2%	909.3%	666.1%	785.3%	906.5%	909.0%	858.0%	954.0%	1016.5%	
Belgium/Luxembourg	1.6%	-1.0%	91.6%	2.9%	86.6%	-0.8%	18.3%	20.2%	171.2%	24.1%	96.8%	26.3%
Denmark			4.3%			17.2%				84.6%		
Finland				0.0%	0.0%	23.5%	23.2%	39.3%	36.0%	44.5%	208.9%	
France	-1.8%	-0.1%	0.8%	2.5%	4.3%	4.8%	10.8%	13.9%	16.5%	19.8%	37.1%	
Germany	0.6%	1.5%	3.8%	9.4%	16.8%	23.1%	31.4%	41.6%	51.3%	67.6%	74.0%	
Greece										16031.6%	7653.0%	5168.8%
Ireland												
Italy	0.0%	0.0%	1.3%	2.5%	12.0%	12.9%	0.0%	0.0%	0.0%	0.0%	0.0%	
Netherlands	0.0%	0.0%	0.0%	0.0%	9.2%	13.5%	15.8%	28.0%	31.6%	33.3%	37.4%	
Portugal							0.2%	0.2%	0.9%	2.1%	6.5%	5.2%
Spain	0.0%	0.4%	0.5%	1.3%	3.3%	7.9%	43.2%	4.8%	3.3%	5.5%	753.1%	60.5%
Sweden				0.0%	0.0%	0.0%	0.0%	9.7%	19.4%	21.6%	31.0%	38.1%
UK	0.0%	0.0%	0.4%	1.5%	1.3%	4.2%	3.9%	5.2%	13.2%	15.7%	15.0%	
Norway	0.0%	0.0%	0.4%	9.0%	17.2%	18.3%	15.9%	18.6%	23.1%	29.8%		
Switzerland					9.7%	12.3%	22.2%	19.0%	17.0%	27.3%	21.6%	
Japan	0.0%	0.0%	0.0%	6.5%	7.4%	7.4%		0.0%	0.0%	0.0%	0.0%	0.0%
USA	0.0%	0.8%	1.4%	2.5%	9.5%	13.1%	14.7%	14.5%	13.0%	10.8%	10.1%	9.6%
	192.0%	376.4%	424.2%	909.3%	666.1%	785.3%	906.5%	909.0%	858.0%	954.0%	1016.5%	

Source: Calculated on the basis of data from the OECD International Direct Investment Statistics (2001).

countries. The relative share of investment in CEE has risen rapidly for Austria, Finland, France, Germany, Greece, the Netherlands, Portugal, Sweden, the UK, Norway, Switzerland and the US. Though this pattern is not typically accompanied by a decline in the absolute FDI figures in the former cohesion countries, in the absence of the fall of the East Bloc a share of CEE investment might well have gone to the former cohesion countries. This provides strong motivation both for Spain's participation in this agenda and the insistence of the former cohesion countries on their continued receipt of EU structural and cohesion funding, suggesting that these countries are likely to continue lobbying intensively.

The European Commission has thus far resisted attempts to move toward corporate tax harmonization and has rejected the Sarkozy proposals. For one, Günter Verheugen, new competition minister in 2004 noted that barring low tax states from receiving SCF's in the manner suggested by Sarkozy is virtually impossible given existing rules for their distribution.<sup>61</sup> During the hearings for new Commissioners before the European Parliament during the fall of 2004, Verheugen argued that tax competition "could be useful" and that the presence of lower tax rates in some states does "not necessarily lead to delocalization".<sup>62</sup>

The third policy area likely to dominate future discussion in the New Europe is competition policy and the role of state aids. This policy area is linked to the issue of rates of corporate taxation. As noted above, several of the NMS's were required to substantially modify generous tax holidays and other

investment promotion schemes.<sup>63</sup> Ultimately, the EU viewed these methods of promoting FDI as state aids and Hungary and other countries were required to dismantle or modify them.

Current EU approaches to state aid and the promotion of competitiveness have been influenced both by anti-statist and state interventionist traditions.<sup>64</sup> On the anti-statist side, EU policy has gradually begun to favour greater competition in areas previously considered the preeminent domain of the state (e.g. telecommunications, railways, energy). Free-market entry and open and competitive public procurement policies pervade current practice in the regulation of the provision of services.<sup>65</sup> And while privatization is not specifically a requirement of EU law, the EU does protect and promote both free competition with public sector utilities (such as state-owned telecommunications and postal services), and EU competition policy requires that public firms not make use of state resources in order to compete with private sector firms (Martin, 1999: 5). Likewise, the neo-liberal logic appears to pervade the shift away from providing government support to individual economic sectors, in particular, coal, steel, textiles and the clothing sector. The European Coal and Steel Community, for example, was formally abandoned in 2002.

On the state interventionist side, EU state aid and industrial policy has begun a gradual shift toward more neutral forms of state intervention. EU state aid policy emphasizes "*horizontal*" state aid measures and eschews sectoral or what I refer to as "*vertical*" state aids. *Horizon-*

<sup>61</sup> See [www.euractiv.com](http://www.euractiv.com) (10/4/2004), "Verheugen calls Sarkozy's Corporate Tax Ideas 'Unrealistic'".

<sup>62</sup> *Ibid.* See also Verheugen's statements before the EP Committee on Industry, Research and Energy (EP New Report, 9/30/2004).

<sup>63</sup> The EU even used the early "European" or "Association Agreements" as a means to try and reduce the level of state subsidies in CEE.

<sup>64</sup> Behrens and Smyrl (1999) note that EU policy is driven by competing and contradictory paradigms.

<sup>65</sup> Since the late 80's, the EU has pursued directives on open public procurement and the requirement of open EU-wide bidding on the provision of public services.



*tal* state aids are focused on broadly applicable principles of economic development (human capital development, infrastructure, R&D) and are thus potentially useful to a broad range of economic sectors. *Sectoral* or *vertical* state aids ultimately help to prop up declining economic sectors and/or firms (e.g. the steel, clothing and textile sectors in Western Europe).<sup>66</sup> Moreover, across the EU as a whole, some 51% of EU member state aid still goes to the manufacturing sector, suggesting that states themselves are unwilling to completely relinquish more vertically oriented interventionist traditions (European Commission, 2004b: 13).

The EU, however, has not dispensed with more *vertical* forms of government intervention. The EU continues to permit extensive government intervention in at least two sectors: agriculture and railways. Although the shift to horizontal measures has typically not affected agricultural policy in the EU, a general though excessively gradual trend towards the elimination of direct agricultural supports has emerged with particular the June 2003 reform of the EU's Common Agricultural Policy. This reform introduces a gradual shift from direct farm payments to support for rural development. The railway sector remains the second sector in which the EU continues to allow extensive public intervention. Moreover, while aid to the railway sector is typically detailed in the European Commission's *State Aid Scoreboards*, it is still considered a separate category not subject to state aid restrictions.

For another, regional policy goals remain a significant portion of the EU budget. Whether this policy area should

be considered vertical or horizontal in character is problematic. Within the framework of the EU's regulations on state aid, states are permitted to engage in national projects of regional development. And the Commission's *State Aid Scoreboard* classifies *regional* aid as "*horizontal*", suggesting such aid is in line with the shift to more broadly-based objectives. However, regional state aid can still end up in the hands of firms and investors. Moreover, whereas at the national level aid can be distributed using broad neutral criteria that do not favour individual firms, given the scale of regional and local development strategies, projects are more likely to target individual firms.<sup>67</sup> In 2002, some 31.5% of EU horizontal aid was defined as "*regional*" state aid (European Commission, 2004b: 20). Presumably SCF's should be classified in a similar category.

The EU's most recent attempt at promoting economic competitiveness – the so-called *Lisbon Agenda* – places a strong emphasis on horizontal measures and the promotion of broadly-based EU and national-level research and development goals. In particular, as noted also in the EU's various *State Aid Scoreboards* (see e.g. European Commission, 2004b, 2004c), the *Lisbon Agenda* explicitly represents a formal attempt to broaden the scope of state intervention by recommending that states shift "public expenditure towards growth-enhancing investment in physical and human capital and knowledge subject to overall budget constraints" (European Commission, 2004c: 21).

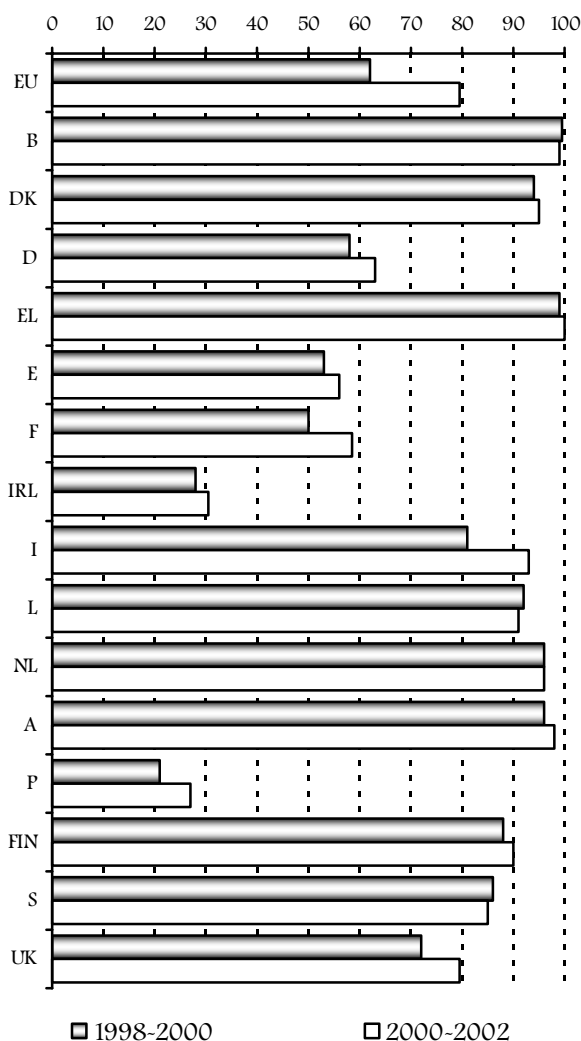
Whether *horizontal* measures are well suited to solving the economic development and restructuring problems of

<sup>66</sup> For an excellent overview of these different state aid measures, see Martin (1999). The European Commission first announced the shift toward horizontal measures in 1994 with the publication of its report on "An Industrial Competitiveness Policy for the EU" (COM(94) 319 final). This initiative has gained considerable momentum with the Lisbon Agenda announced at the 2000 Lisbon Summit.

<sup>67</sup> While there are general limitations on the so-called "intensity" of aid – i.e. the total amount of benefit individual recipients are eligible to receive relative to the investment made (e.g. tax exemptions can only refund up to some precise percentage of the original investment) – there are no real limitations on which firms can receive aid.

the CEEC's, or whether more *vertical* policy approaches are necessary in order to achieve improvements in economic competitiveness should perhaps be at the core of debates in the New Europe. The EU's *State Aid Scoreboard* provides an interesting perspective on potential future policy divergence across the more and less developed economies of Europe. A small group of countries stand out as having made the smallest transition toward *horizontal* state aid initiatives over the period 1998–2002 (See *Figure 1*). The four countries with the highest share of *vertical* state aid are Portugal, Ireland, Spain and France – ranging from some 26–58%. In contrast, at least eight

Figure 1  
Share of State Aid Spent  
on Horizontal Objectives, 1998–2002



Source: Reproduced from European Commission (2004b: 21).

EU member states distribute more than 90% of state aid through *horizontal* state aid measures, while 2 further states (Sweden and the UK) distribute significantly large shares of *horizontal* state aid. Only two of the more advanced EU member states – France and Germany – still distribute significantly large shares of aid through *vertical* measures. While Greece appears to be an outlier and distributes surprisingly few resources through *vertical* measures, 74% of Greek state aid is for regional development, the highest share of any single EU member state (European Commission, 2004b: 14, 20).<sup>68</sup>

In CEE there is a far greater emphasis on *vertical* state aid measures. As noted above, in Hungary *horizontal* measures accounted only for 8.2% and 9.3% of state aids in 1999 and 2000 respectively.<sup>69</sup> The autumn 2004 update of the *State Aid Scoreboard* includes data on state aid expenditure in CEE over the period 2000–2003. According to this report, the findings for Hungary are generally consistent with findings for the broad range of CEEC's. On average, the NMS's spent some 78% of state aids on *vertical* measures. Estonia is the only significant outlier, with 100% of state aid spent on *horizontal* measures. As with Greece, some of this aid is for regional development (33%, the largest single category in Estonia). A significant share of state aid in Estonia is nonetheless spent on more typically *horizontal* measures. However, Estonia's investment promotion strategy (described in more detail below) is not classified as "state aid" and thus is not picked up by these statistics. Apart from Estonia, all of the CEEC's still have significant vertical state

<sup>68</sup> Luxembourg is next in line with 61% of state aid going to regional development, then Belgium with 52%. (*ibid*: 20).

<sup>69</sup> All data on Hungarian state aids is derived from the *Annual Survey of Hungary on State Aid Falling Under Article 62 of the Europe Agreement 1996-2000*, State Aid Monitoring Office (2002: 17, 35, 37).

aid expenditures (European Commission, 2004c: 21).

The typical form of aid for individual countries is tax exemptions. Apart from Cyprus (80.9%) and Malta (36.6%), Hungary (61.5%), Latvia (57.1%), Poland (34.5%) and Slovakia (72.4%) provide the dominant share of state aid through tax exemptions. Estonia, Lithuania and Slovenia, on the other hand, provide most of their state aid through direct grants. While the Czech Republic has provided most of its aid through guarantees, this is primarily explained by government bailouts in the Czech banking sector (European Commission, 2004c: 25).

#### 4) OF SQUARE PEGS, ROUND HOLES AND BARGAINING HURDLES

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Returning to the previous distinction between *economic growth* and *economic development*, the most pressing question is whether the EU policy framework is suitable to sustainable long-term economic development in CEE. This remains an open question. As noted above, most of the previous measures employed to promote investment in Hungary, for example, were classified as state aids during the accession negotiations. As a result, these measures have now either been eliminated or modified into regional measures compatible with the EU policy framework. While on the one hand it is often seen as advantageous for the CEEC's to adopt EU policy approaches, this needs more thorough debate, both in the context of competitiveness strategies and more generally. The following discussion analyzes the impact of EU membership and adopting the EU policy framework on the potential for CEEC's to pursue the objectives of economic growth

and long-term, sustained economic development.

While Hungary (Slovenia, the Czech Republic, Estonia and perhaps even Poland and Slovakia) may be well along the road to sustained economic recovery, many of the other countries in CEE have been less fortunate in their attempts to attract foreign direct investment and/or have introduced less extensive investment promotion schemes. When FDI stocks are measured as a share of GDP, in order of magnitude, Estonia, the Czech Republic, Hungary and Slovakia appear to be the winners in the process of attracting foreign investment (Hunya, 2004: 96). Measured in per capita terms, FDI stocks are greatest in Hungary, the Czech Republic, Slovakia and Poland (Sass does not provide data on Estonia) (Sass, 2003: 14). Investment promotion incentives appear to play a strong role. As noted in the *State Aid Scoreboard*, over the period 2000–2003 86% of the total state aid in CEE was spent by 3 countries; Poland, the Czech Republic and Hungary (European Commission, 2004c: 5). Likewise, as noted above and in order of magnitude, Slovakia (72.4%), Hungary (61.5%), Latvia (57.1%) and Poland (34.5%) granted the largest shares of state aid through tax exemptions (the category that covers investment promotion schemes qualifying as state aid under the EU regulatory framework). While Estonia first appears as an outlier, the investment promotion schemes adopted were not classified as state aid. Even though countries such as the Czech Republic, Poland or Slovakia have had a much smaller window of opportunity to pursue such schemes, they appear to have been able to use them to their advantage.

At least some elements of the evolving EU policy framework are likely to be marginally compatible with the interests of the more advanced CEEC's. The current shift in emphasis in Hungary from the simple attraction of foreign direct investment to more diverse forms of in-

vestment promotion – in particular the *Smart Hungary* program’s promotion of R&D activities or the promotion of *Cooperation Research Centers* – are programs broadly compatible with horizontal EU policy objectives. In this regard, Hungary, along with Estonia and Slovenia, has clearly begun to shift more of its state aid to horizontal measures (European Commission, 2004c: 21).

However, several potential problems emerge with the compatibility of the EU policy framework. The *Lisbon Agenda’s* promotion of broad-based horizontal policy initiatives is primarily based on raising national-level expenditures and/or *re-directing* EU-level expenditures.<sup>70</sup> In this regard, the *Lisbon Agenda* is potentially part of a redistributive re-nationalization plan. Most of the *Lisbon Agenda* – perceived as the new potential engine of economic growth and development within the EU – is focused primarily on state-level expenditures. In order to promote the *knowledge-based economy*, states are urged to increase their overall R&D expenditures to 3% of GDP by 2010. Two thirds of this expenditure is expected to come from the private sector.<sup>71</sup> Discussion of EU spending on the *Lisbon Agenda* is further firmly rooted in the context of movement away from vertical forms of state aid.<sup>72</sup> As such, this policy approach provides a venue for arguing against the logic of current forms of EU-level funding. Moreover, the required levels of domestic R&D expenditure are likely to be diffi-

cult for the CEEC’s to achieve given current budgetary pressures.

Whether or not the EU’s regional development policy and state aid framework ultimately provides enough flexibility to continue promoting sufficient levels of investment is likewise questionable. The regional *aid-intensity* maps agreed with the European Commission set precise limits on the share of nationally funded state aid. In Hungary, investment promotion incentives can now refund between 35% and 50% of the original investment. Comparable *aid-intensity* levels apply for the other CEEC’s.<sup>73</sup> However, the previous aid intensities granted to individual investing firms in the pre-accession phase often exceeded these levels. Mutti and Grubert (2004) argue that multinational corporations producing for export rather than domestic markets are more and more sensitive to host country taxation. To the extent this is true, this modification of CEE investment promotion schemes may significantly impact on regional FDI flows.

Two further observations likewise serve to illustrate problems concerning reliance on the EU’s regional development tool. For one, the allowable aid-intensities for tax exemptions or grants are much lower in regions that have attracted the highest levels of FDI. Shifting investment and economic development to those regions that have thus far attracted less of it is potentially positive. But this may not augur well in conjunction with seemingly natural economic tendencies to “cluster” investment in regions with previously existing concentrations of economic activity (Martin, 2003). In this respect, investors

<sup>70</sup> Rather than attempt to find new ways of shifting EU expenditure to such broad categories, the Council of Ministers’ response to the Lisbon Agenda instead recommended that the Commission focus its efforts on re-directing expenditures and that states try to find the resources for such expenditures within existing budgetary limitations (“Final Report on the European Action for Growth”, Council of the EU, November 26, 2003: 7–9).

<sup>71</sup> See for example “Investing in Research: An Action Plan for Europe”, COM(2003) 226 final/2.

<sup>72</sup> *Ibid.*: 19.

<sup>73</sup> Most of Hungary qualifies for the maximum aid intensity of 50%, but the metropolitan area of Budapest only qualifies for an aid intensity of 35%, while the larger Pest County surrounding Budapest qualifies for 40%. Two Western counties in Hungary qualify for 45%. For more information, see the EU’s aid intensity maps for the NMS’s at the website of the Directorate General for Competition: [http://europa.eu.int/comm/competition/state\\_aid/regional/2004/](http://europa.eu.int/comm/competition/state_aid/regional/2004/).

may simply choose to go elsewhere, making it difficult to capitalize on the last decade of economic restructuring and foreign investment flows. Moreover, investors may be more likely to avoid less developed regions to the extent that infrastructure and human capital remains underdeveloped. In this regard, the lack of significant SCF's to support the building of infrastructure and human capital potential in underdeveloped regions may further hamstring the success of regional development measures.

This is potentially most problematic where countries would like to continue to target specific industries (such as the automotive and electrical engineering sectors) or types of economic activity (in particular R&D) in order to further refine the process of economic development. Thus, for example, Hungary's attempts to focus on the sustainable and embedded development of the automotive and electrical engineering sectors might potentially be one of the early casualties of integration in the EU policy framework.<sup>74</sup> Despite the fact that the *Lisbon Agenda* promotes the use of "private sector" resources, capital scarcity and the difficulties of CEE domestic firms in raising capital expenditures and resources greatly limits this potential. In this regard, CEE governments find themselves compelled to fill the gap between the lack of private sector resources and their development interests, but are likewise constrained by the combination of EU restrictions on aid intensity and EMU convergence criteria.

The remaining CEEC's – Latvia, Lithuania, Bulgaria and Romania – have had virtually no opportunity to introduce significant investment promotion mechanisms. Far less successful at attracting significant amounts of FDI – in particular due to their inability to introduce

successful market reforms or promote political stability – the slow process of transition has produced a lag that may be more difficult to overcome once inside the EU. As EU members, these countries may have a more difficult time initiating similar investment promotion schemes and attracting comparable amounts of FDI. In this regard, all of the above observations raise significant questions about the CEE ability to integrate seamlessly into the EU policy framework.

A number of potential criticisms can or have been levied at these investment promotion strategies. For one, the crafting of investment promotion schemes varies considerably across countries. Variation in their form and shape may provide insight into their advantages and disadvantages. In the Hungarian context, while the investment promotion incentives were strongly geared toward attracting *large initial* investments, there were no strong incentives offered to encourage large firms to *continue* investing. Once firms made an initial investment they could benefit from the tax concession for 10 years without undertaking further investments. In this regard, Estonia's strategy provides a relevant comparison. Though Estonia's overall rate of corporate taxation remains high in the CEEC context (currently 26% on the distribution of dividends), Estonia adopted a 0% corporate tax rate for re-invested profits. While this policy was criticized in the EU, it does not contravene existing EU policy and has not been declared incompatible with the EU *acquis* (Radaelli, 2001).<sup>75</sup> More importantly however, it

<sup>74</sup> One response to this in Hungary may be to fund projects from national level expenditure, but at relatively low levels, so that expenditures do not contravene EU state-aid restrictions (Interview with Magdolna Sass, March 24<sup>th</sup>, 2005).

<sup>75</sup> Current Estonian corporate taxation only concerns the distribution of dividends to investors, gifts and non-business related expenses (see Estonian Ministry of Finance: <http://www.fin.ee/index.php?id=3830>). The tax rate on distributed corporate profits is 26%. However, Estonia also abolished its tax on reinvested corporate profits in January, 2000 (Hunya, 2004: 106). Finally, Estonia received a transition period that allows affiliates in Estonia to distribute profits to their parent companies at

has the potential advantage of encouraging continued investments.

Real tradeoffs likewise exist between government subsidized investment promotion schemes and the ability of governments to fund other policy areas. The budget for social welfare expenditure in particular may have been constrained by such policies. Greskovits and Bohle (2003) note that Slovakia progressively lowered its corporate tax rate from 40% to 29% in the year 2000, and then to 19% in 2004.<sup>76</sup> As these authors make clear, the Slovakian government estimated that the changes in 2004 would lead to a drop in government revenues of some 480 million Euros. In the long run, these authors link the 2004 food riots in Eastern Slovakia to parallel reductions in unemployment benefits (2003: 23–5).

Other costs of investment promotion are far more difficult to calculate. On the one hand, tax exemptions for large investments are not directly paid for out of the government budget and therefore do not necessarily reduce the existing budget. On the other hand, tax exemptions represent potential losses in terms of government revenues. However, two caveats deserve attention. First, without such tax exemptions, the rate of foreign investment in Hungary and other countries might not have been as high. In order to calculate any loss in government revenues, this point must be considered. Second, attempting to attract *large* investments may well have the impact of creating significant *sunk costs* which foreign investors are then unlikely to uproot once tax incentive schemes have run their course. In this regard,

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a 0% tax rate until December 31, 2008 (European Commission, 2002: 35).

<sup>76</sup> Income and value-added tax rates (VAT) were also adjusted to one single flat rate of 19%. While this represented an increase in the VAT, it represented a significant reduction of income taxes. In order to compensate for the potential loss in government revenues, the VAT, excise duties and energy prices were raised (Greskovits and Bohle, 2003: 23–4).

the important number of large-scale investments made in the Hungarian economy may provide a more solid future tax base, despite the potential for such firms to continue taking advantage of future tax schemes.

Two further observations suggest that investment promotion schemes may have had significant payoffs for the average citizen in CEE. For one, though the evolution of income inequality across CEE is uneven,<sup>77</sup> Hungary and the Czech Republic in both 1989 and 2001 remain well below the average level of income inequality in the OECD in the mid-1990's. Poland, Estonia and the other CEEC's (Slovakia was not included in this measure) had however all risen above the OECD average by 2001 (UNECE, 2004b: 165–6).<sup>78</sup> For another, the evolution of real wages is generally favourable for countries that pursued investment promotion schemes. Only four of the CEEC's were able to obtain wage levels at or above their 1989 level by 2001: the Czech Republic, Estonia, Hungary and Poland (though Slovakia lags on this measure, the big changes in government policy with respect to investment promotion occur in 2000 and most importantly in 2004) (UNECE, 2004b: 167). These two measures suggest that governments were not only likely to secure future revenues, but citizens directly benefited as well.

Another objection concerns the degree of tax competition between the CEEC's. While this may be a very real problem, this analysis may misconceive the real axis of competition over invest-

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<sup>77</sup> Hellman likewise pointed out a correlation between lower levels of income inequality in CEE (despite overall rises in income inequality) in countries that had pursued more extensive reforms (1998: 224–5).

<sup>78</sup> A word of caution is necessary here. As both Hellman and the UNECE study point out, the former CIS states (apart from Belarus) all have much higher levels of income inequality. Only Estonia, the most "liberalized" of the CEEC's, begins to rise above some of the lowest levels in the former CIS states (UNECE, 2004b: 166).

ment resources in Europe. To some extent, the CEECs are competing for investment with the more advanced European economies. While the CEE economies have very real advantages *vis-à-vis* investment locations such as Germany – a significant supply of skilled and comparatively cheap labour – they lack a number of other advantages present in the more advanced regions of Europe – highly developed infrastructures, a larger pool of highly-skilled labour, and long established centres focused on research, development and product innovation. As suggested by the data on FDI flows in Table 3 above, the advantages of CEE have not been great enough to significantly reverse regional investment flows away from the European core.

Finally, the problem of *capture* deserves attention.<sup>79</sup> Clearly it is not always in the interest of governments to subsidize firms. There were, however, significant differences in the strategies pursued by Hungary and some of the other CEECs. Hungary's approach was strongly focused on moving firms out of the sphere of state ownership. This strategy of large scale privatization was pursued earlier in Hungary than in the other CEE economies.<sup>80</sup> Thus, as pointed out by Antalóczy and Sass, significant concessions granted to foreign investors first assisted the state in the process of priva-

tization (including even monopoly control and/or protected markets). Later, Hungarian FDI strategies focused on promoting continued investment in Greenfield projects (Antalóczy and Sass, 2001: 44). In general, Hungarian investment promotion schemes employed what I call “neutral (performance) criteria” and were typically not directed at individual firms (though the early policies clearly favoured foreign investors). These criteria were neutral in that any firm was eligible to receive tax exemptions from the government and they were often “performance-based” in cases where export or output criteria were added to the criteria for receiving tax exemptions.

In contrast, some countries held on to large state enterprises and provided direct subsidies for longer periods of time than were presumably advisable. Poland, for example, pursued a conscious strategy of ‘*commercializing*’ of state-owned firms. While this strategy did not rule out the potential for future privatization, neither did it guarantee that all state-owned firms would ultimately be transferred over to private ownership or offered for sale to foreign investors (Kolodko and Nuti, 1997: 26). The slow restructuring of the Polish steel sector cost the government considerable sums of money and weighed heavily on the state budget.<sup>81</sup> According to *Protocol No. 8 of the Accession Treaty*, Poland had already spent some 62.360 million PLN (approx. \$15.6 million) in restructuring aid between 1997 and 2001.<sup>82</sup> Moreover, this figure may well underestimate the amount of real indirect government subsidies provided to PHS. Most

<sup>79</sup> The notion of “capture” is an important concept in the literature on state intervention. Hellman in particular provides an interesting discussion of the very real problems of capture in CEE economies, arguing that those countries that were more successful at introducing and then pursuing more thoroughgoing market reforms – largely due to greater democratic reforms – were also more successful at avoiding the costs of capture (1998). Vachudova further builds upon this concept of the potential for capture and the importance of democratic reforms (2005).

<sup>80</sup> Though rapid privatization to foreign owners was in part inspired by the Hungarian level of foreign debt in the early years of transition, there was an added benefit of selling Hungarian firms to foreign investors. This strategy facilitated avoiding accusations of corruption (Mihályi, 2001: 63–66). For a more comparative analysis of Central and East European privatization strategies, see Rojec (2004).

<sup>81</sup> Accounting for approximately 70% of Polish steel production, Polskie Huty Stali (PHS) was privatized in 2004. The agreement with LNM Holding included payments of \$850 million to cover PHS debts and \$600 million in guaranteed investments (*PAP News Wire*, 3/5/2004). The privatization agreement was spurred forward by demands from the European Commission that the Polish government stop providing state aid to the steel sector.

<sup>82</sup> *Official Journal* (9/23/2003: 948).

government subsidies to the Polish steel, coal-mining and railway sectors took the form of tax reductions and other debt write-offs. Moreover, record keeping on these subsidies often appears to conceal the major recipients (Sowa, 2003). *Protocol No. 8* limited further restructuring expenditures to 3.078 billion PLN (approx. \$770 million USD) in 2002 and 2003, and no further aid was to be granted from that point on.<sup>83</sup> Many of the CEEC's provide numerous examples of the excessive costs of state ownership.

At the same time, though many see the impact of EU pressure as positive,<sup>84</sup> it is difficult to ignore the negative role of Western interests in this case. In the late 1990's, the Polish government gave in to EU attempts to limit production and reduce employment in the Polish steel sector thereby successfully dampening the impact of some of the more competitive Polish steel firms on the EU marketplace and labour structure. The Polish government ultimately signed an agreement that traded EU funding for the restructuring Polish steel industry in return for Polish government control over the allocation of production quotas to Polish steel producers (Keat, 2000). As Keat argues, this agreement failed to reward firms in the Polish steel industry that had privatized and invested in new technologies, effectively reducing their ability to compete in the EU marketplace. Moreover, by distributing market shares, production quotas presumably impacted the ability of the Polish government to privatize the steel sector.

Despite the greater degree of early privatization, Hungarian state-owned firms likewise represent a significant

drain on the budget and a number of firms remain in state ownership.<sup>85</sup> The reintroduction of the holdings of the Hungarian National Development Bank (MFB) – one of the two agencies in Hungary responsible for managing the assets of state firms along with the Hungarian Privatization and Holding Company (APV Rt.) – back into the budget of the Hungarian national government in 2002 was one of the principal factors explaining the significant rise in the government's budget deficit to 9.3% of GDP that year.<sup>86</sup> The rising government deficit was presumably also affected by the inability of the government to use privatization revenues from the APV Rt. after January 2003. Previously, these funds were used to pay down the government debt and were not subject to parliamentary approval. Since January 2003, however, privatization revenues

<sup>83</sup> *Official Journal* (9/23/2003: 948). A Polish government audit of the effects of state aid found that 9 out of 12 cases of aid to the Polish steel sector were "inefficient and ineffective" (Sowa, 2003: 28).

<sup>84</sup> Moravcsik and Vachudova, for example, refer to "blocked bailouts of uncompetitive firms" as one of the positive benefits of EU pressure (2003: 47).

<sup>85</sup> The APV Rt. still administrates some 99 or more state-owned firms. One example, MALÉV airlines – currently almost 100% owned by the Hungarian government – has for many years been a loss-making state enterprise (though previously partially privatized and part-owned by Alitalia). China's Hainan Airlines considered making a bid for MALÉV in the summer 2004, but the deal was later dropped. In early 2004, MALÉV had an accumulated debt of 36.4 billion Forint (or about 181 million US Dollars) and was running a deficit in the first half of 2004 of 3.9 billion Forint (about 19.5 million US Dollars). See for example: <http://english.budapest.hu>, "MALEV Hopes to Break Even" (9/16/2004). Though most of the Hungarian electricity sector is now fully privatized, MVM, the Hungarian Power Companies Ltd., is a second example. Owner/operator of the national electricity transmission grid in Hungary, MVM continues to be almost 100% owned by the Hungarian state. According to MVM's 2002 Annual Report (the last report available in 2004), MVM reported a total loss of 30.784 billion Forint (approximately \$112 million USD) for fiscal year 2002. Additional examples include the Budapest public transport system (BKV), the Hungarian railway (MÁV) and the Hungarian regional bus system (VOLÁN).

<sup>86</sup> I am indebted here to an observation from Kálmán Dezséri. See also the IMF's individual country annual "Reports on the Observance of Standards and Codes", in particular the May 2003 report on Hungary (<http://www.imf.org/external/np/rosc/rosc.asp>).



can only be used for specific purposes and subject to parliamentary approval.<sup>87</sup>

In the long term, there may be few alternatives to the eventual privatization of state holdings in large firms. However, future privatization and/or investment promotion strategies are subject to EU aid-intensity criteria which limit the latitude of CEE governments. Aid-intensity levels and restrictions on state aid for the rescue and restructuring of firms are strictly circumscribed by EU regulations. On the other hand, the slow rate of privatization in some countries – in particular the Czech Republic – may ultimately have had a positive impact on overall rates of unemployment, thereby mitigating the more dramatic impact of the transition process. In Poland too, fears of the social impact of closing the state-owned steel sector kept the government from pursuing this path. In this regard, the share of the actively employed labour force in Hungary is somewhat lower than that for Poland or the Czech Republic.<sup>88</sup>

In the long run, the above observations point to serious potential limitations to the EU policy framework. Structured at it is on the basis of states and inter-governmental bargaining – in particular where overall EU expenditure levels are concerned – the EU policy-making framework poses real barriers to the redistribution of resources across states. As noted at the outset, even the new *Constitutional Treaty* preserves the right of individual states to veto policies related both to taxation policy and to EU spending (the EU's multi-annual Framework Perspectives).

With the older and larger EU member states far more concerned about their own growth and employment, they are likely to favour policies that benefit domestic constituencies. Under such circumstances it is difficult to imagine strong support for a renewed redistributive agenda in the EU framework – at least one favouring the less developed economies of CEE. This is likely for at least two possible reasons. On the one hand, as net payers, the more advanced EU member states gain very little direct benefit from the EU's SCF's. And second, policies such as the *Lisbon Agenda* promote policy objectives from which the more advanced EU member states are likely to benefit. Thus these states are likely to focus attention on these agendas at the expense of alternative policy goals.

As the EU grows larger and larger, this problem is likely to grow more severe. Some 10-12 more states are likely to pursue EU membership in the not too distant future.<sup>89</sup> Not the least among these, Turkey is scheduled to begin membership negotiations in October, 2005 and is a large state that could certainly rival the voting power of current large states. In this regard, the future potential expansion of the EU is likely to result in an ever reduced emphasis on cross-border redistributive funding. Gaining support for funding in CEE has already proved complicated enough. The potential for extending such expenditures indefinitely to more and more states may ultimately drain the Old EU's remaining tolerance for cross-border redistributive measures.<sup>90</sup> At the same time however, this fact is unlikely to dampen the interest of the less developed

<sup>87</sup> *Ibid.* However, since most Hungarian firms have already been privatized, there have been few revenues from privatization since about 1997.

<sup>88</sup> In 2002, the share of the actively employed labour force was 74%, while it was 87.8% in the Czech Republic and 85.8% in Poland. See the *Economic Survey of Europe*, (2004, No. 1: 193, Appendix Table B.5). I am indebted to an observation from Magdolna Sass.

<sup>89</sup> Croatia was also scheduled to begin membership negotiations in March, 2005 and Turkey is scheduled to begin negotiations in October 2005. Bosnia-Herzegovina, Yugoslavia, Macedonia and Albania may have a chance at future membership. Additional states likely to remain EU "neighbours" include Russia, Ukraine, Moldova and Belarus.

<sup>90</sup> I am indebted here to a conversation with Alina Mungiu-Pippidi.

economies in attempting to promote such policies and/or their alternatives.

## CONCLUSION

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A number of important conclusions can be drawn that address multiple areas in the study of European integration, comparative politics and international political economy. For one, a first set of conclusions relate to the theoretical literature on globalization and neo-liberal approaches to economic transition. Susan Strange (1992) once noted that globalization drives states to compete over scarce resources – in particular capital. Whether open borders or the level of economic development drive states to compete in this way, one or both of these factors appears to have had a significant impact on CEE strategies of investment promotion. States went to considerable lengths to attract capital, even to the extent of fully subsidizing – however indirectly – the cost of large investments over time. Second, the neo-liberal view that states simply need to open their borders to foreign capital in order to attract investment – while not rejected by the CEE experience – is not strongly supported by it either. As just noted, states went to considerable lengths to attract foreign capital to their territories. Even Hungary, which enjoyed a clear first-mover advantage<sup>91</sup> in the region – presumably in part due to its early establishment of a stable legal framework for foreign investors – did not consider this sufficient and ultimately went much further.

Third, many have suggested that the insertion of the CEECs into global production networks will provide the foundation for long-term sustainable eco-

nomical growth.<sup>92</sup> However, this evolution appears problematic for CEE economies for at least two basic reasons. For one, as suggested above, extensive insertion into the global production networks of multinational firms may impede the potential for sustainable, long-term economic development. This outcome can be explained on the basis of three factors. A high degree of insertion into global production networks (i) may limit the relative autonomy of domestic affiliates in developing independent strategies to promote greater embeddedness, (ii) may have the undesirable impact of crowding out domestic potential for the creation of technology and innovative capacity, and (iii) may make firms and countries more vulnerable to fluctuations in the international marketplace and the strategic considerations of multinational headquarters.

For another, at least without more concerted efforts to refine and more deeply embed the existing structure of economic activity in CEE, these strategies may result in some crowding out of the innovation potential of the region. The more severe implication is that such strategies will lead to path dependence. This analysis thus places the emphasis for future policy considerations on strategies that will counteract the above mentioned concerns. These observations are not intended as a suggestion that countries should resist the privatization of industry or large inflows of foreign capital. The Hungarian case seems to suggest it would be a mistake for countries to avoid FDI as a solution to promoting economic growth. This appears to be one but not the only important element in promoting the potential for longer-term economic development.

A second set of conclusions relates to the potential advantages of supranational *vs.* national-level decision-making. The supranational level of decision-making may well prove inferior to the national-level. Countries marked by sig-

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<sup>91</sup> Sass (2004).

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<sup>92</sup> See for example Eichengreen and Kohl (1998).

nificant differences in the level of economic development may have significant difficulties coordinating compatible policy goals. At least for the CEEC's, their relative room for manoeuvre has been considerably reduced by the advent of EU membership. The EU accession process has been used to limit and constrain the behaviour of the CEEC's in multiple ways. From restrictions on the use of tax holidays and state aids to restrictions on monopoly concessions, the EU accession process has gradually circumscribed and limited the range of competitiveness and investment promotion strategies available to the CEEC's.

Despite the common assumption that the supranational or EU level of decision-making is somehow superior where the CEEC's are concerned – presumably due to their Soviet legacy – it is too easily ignored or forgotten that at least some of the steps Hungary made in the direction of promoting greater economic competitiveness and investment were initiated even prior to the fall of the East Bloc.<sup>93</sup> The investment promotion strategies that emerged in later years built on the early experience of the mid to late 80's. Moreover, while many tend to assume that the EU accession has improved the practice of economic management in CEE, in the Hungarian case at least, EU membership has offered a framework in which Western member states can better hope to control the fiscal and regulatory policies of the NMS's. Moreover, the ability to do this presumably has a profound impact on shifting the regional burden of economic integration and adjustment.

A third conclusion relates to a commonly made assumption that the

drive for EU membership explains the potential economic success of many CEEC's. This paper suggests the opposite. In this case, EU membership is a constraining variable that limits the potential range of strategic choices rather than one of the principal factors explaining the relative degree of economic success. As Mihályi notes, Western experts strongly criticized the Hungarian strategy (2001: 64). In the context of developmental models of the state, this paper provides strong support for state-led models of development and for the view that developmental approaches are likely to differ strongly across the more and less developed economies of Europe (and elsewhere). Moreover, this point has profound implications for the shape of future tensions in the EU decision-making process.

A fourth conclusion relates to the debate over whether neo-functional or intergovernmental models are best suited to understanding what drives the process of European integration. From the above, interests appear to drive the behaviour of states in the context of European integration. EU member states have used the accession process not only as a means of constraining CEE practices, but also as a means of strengthening their grip on the EU's redistributive resources (Ellison, 2005). Thus, while the EU framework is one in which the CEEC's may hope to have some influence on the decision-making process and legislative output, it is likewise a framework in which the EU can more successfully control the behaviour of the CEEC's.

This does not mean that the CEEC's will receive no benefits from EU membership. They should ultimately be among the principal recipients of structural and cohesion funding for at least the next decade and perhaps longer. At the same time, one should not ignore competing pressures for the continued re-nationalization of EU spending *vs.* strong CEE interests in redistribution. And while the *Lisbon Agenda's* focus on the knowl-

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<sup>93</sup> Mihályi, for example, places the seeds of the Hungarian approach to transition in the early 80's and places the principal authorship of Hungarian strategies of industrial development with Hungarian thinkers. While two of the individuals he mentions are Hungarians living in the US and the UK, a good number of the individuals involved had remained in Hungary (2001: 64-5).

edge economy may potentially benefit the CEECs – in particular countries like Hungary who are further along the path of economic restructuring – the CEECs generally have limited resources to dedicate to such a program. Moreover, even in Hungary, several big projects still remain (such as the railways, infrastructure, the electric utilities and the environment) that are likely to require significant expenditures for years to come. Moreover, EU co-financing requirements, in the context of severe budgetary restrictions and the EMU represent very serious obstacles. Thus the compatibility of interests in the New Europe seems open to debate. The economic policy interests of New and Old Member States in particular are likely to diverge in important ways. In this regard, redistributive and resource struggles are destined to remain strongly intertwined in future debates and policy-making struggles in the New Europe.

Two potential weaknesses of this paper are worth addressing. This paper may over-emphasize the actual role of the investment promotion schemes pursued by different CEECs. The counterfactual that such investment would not have flowed to CEE without these incentives is hard to disprove. However, the degree and shape of foreign investment might well have been very different. Though Hungary was early engaged in extensive privatization and allowed significant foreign investments, it still felt compelled even without regional inter-state tax competition at this early stage to offer significant promotional incentives to investors. Moreover, FDI did not flow in similar amounts to other countries of the region until they began introducing similar strategies. These two points remain difficult to explain without pointing to the importance of the role of government and strategies of the developmental state.

The second failing of this paper is the fact that – by emphasizing the case of Hungary – it selects on the dependent variable. While some analysis of other

countries is provided above, ultimately more work needs to be done on the remaining CEECs. As already suggested by the above analysis, there is a considerable amount of variation in the development strategies different CEECs have pursued. The outcome of these strategies in terms of long-term sustainable economic development and its distributional impact on citizens is likewise quite varied. Some important elements of variation – such as Slovenia's resistance to foreign capital or Estonia's more neo-liberal approach – have not been discussed. Further exploring the depths of these differences, their outcomes and the factors that explain them should ultimately provide a richer understanding of future CEE development prospects.

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