Competitiveness Strategies, Resource Struggles and National Interest In the New Europe

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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-functionalist models tend to assume that the supranational level of 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 weaker states from being net losers 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 particular, latecomers not present at the inception of individual policy areas are most likely to be affected by this type of policy mismatch.

This paper will analyze policy developments related to economic competitiveness and development interests in this general context and provide an analysis of the dominant forces that are likely to influence 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 analyze and understand the potential divergence of policy interests in the New Europe, as well as the strain this is likely to place on the supranational decision-making framework. Is policy cohesion possible, given the relative divergence of policy 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 Central and East European economies. Central and East European countries were accused of "fiscal dumping"—i.e. exploiting EU structural and cohesion funds 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 Central and East European countries allow their corporate taxation levels to fall below the European average (something Germany likewise supports). In the context of a meager allotment of structural and cohesion funds for the 2004-2006[1] period and even lower corporate tax rates in Ireland, this comes as a rude awakening to the New Member States. 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 structural and cohesion funds and in the creation of a "level playing field"—reducing the role of state subsidies and raising regulatory standards in the countries of Central and Eastern Europe, 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 redistributional arrangements. Thus, the New Member States should have a much stronger interest in developing the EU's fiscal tools for promoting economic growth and development (in particular the Structural and Cohesion Funds). Moreover, the New Member States may have an interest in maintaining many of the policies that the Old Member States 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 structural and cohesion funds (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 favor of the larger and more advanced EU Member states. Moreover, the new Constitution does not result in any significant changes in this regard.[2] Thus the benefits resulting from the economic and political integration of Central and Eastern Europe 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 structural and cohesion funds—does make it possible for the New Member States to block agreement on proposals that fail to satisfy their interests. However, they are nonetheless in a weaker position vis-à-vis the larger Old Member states who can just as effectively block attempts to bargain significant changes to the current policy framework. Moreover, the "*enhanced cooperation*" clause in the Amsterdam and Nice Treaties and the new Constitution 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 Central and East European states 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 Central and East European states prior to EU membership and the third section assesses some of the potential weaknesses of current economic development in these states. The fourth section takes a look at the current and

[1] See the discussion of the structural and cohesion funds in Ellison (2005).
[2] See for example the discussion of political bargaining in Ellison (2005).

evolving EU policy framework. The fifth section looks at the future interests and concerns of the Central and East European states 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.

In Search of Competitiveness

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 Central and Eastern Europe—if indeed one can argue that interest in the subject ever declined.[3] 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 Central and East European states are at a new pitch. This fact has focused renewed attention on the various policy measures available in the EU that might assist these New Member states in promoting sustainable, long-term economic development. As such, the Lisbon strategy, the EU's structural and cohesion funds, competition policy and rules regarding the use of state aids define a nexus of policy issues and concerns that are all highly salient and potentially heated topics of debate in the New Europe.

What specific factors really drive economic competitiveness or the creation of dynamic economies is still a question of considerable academic and intellectual debate. For many, the answer to economic competitiveness lies in the complete elimination of barriers to trade and the establishment of free market entry.[4] For others, the key to economic competitiveness lies in the removal of the state from its involvement in the economy.[5] Others still have targeted inflation as the principal demon to be brought under control.[6] Yet again for others, economic competitiveness may well be a function of the degree to which governments are actually engaged 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.[7] The potential role of *external* increasing returns, economies of scale and economic geography likewise introduce a significant degree of uncertainty into the potential consequences of economic

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[3] Perusing through recent editions of economics journals in Hungary (e.g. Közgazdasági Szemle, Külgazdasági Szemle, 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 Central and Eastern Europe ever since the initial stages of transition and has not begun to lose momentum with the advent of EU membership.
[4] See Dollar (1992) and Sachs and Warner (1996).
[5] 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.
[6] See in particular Fischer, Sahay and Végh (1996)
[7] See for example Kolodko (2000?) and Rodrik (2002).

integration—in particular for less developed economies and in the context of low European labor mobility.[8]

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 two core elements of the neo-liberal agenda. The first involves a narrow attack on the state and its interventionist role in economic affairs. The second involves a much broader attack on the fundamentals of the practice of *import substitution industrialization* (ISI) and promotes in its place what has come to be referred to as the *"Washington Consensus"*. This literature strongly advocates the role of the market at the expense of the state, economic openness and exposure to international competition.

The now classic argument against government intervention has perhaps been most strongly articulated by Paul Krugman (1987). Krugman argues that governments are not able to make appropriate economic decisions and thus are best kept out of the economic arena. Private sector investments are preferable to public sector subsidies because private sector actors are subject to stricter budget constraints and are presumed to be more knowledgeable about the market. Moreover, Krugman emphasizes that politicians do not make strictly economic decisions, but rather make "political" decisions that may fail to recognize market constraints. Finally, Krugman points to the persistent problem of "capture" by private interests. Governments that attempt to prop up individual firms may find it politically and economically difficult to extricate themselves from their involvement in the market and thus are particularly susceptible to the rent-seeking activities of the business sector.[9]

The "Washington Consensus" is perhaps the most prototypical expression of what has come to be viewed as the neo-liberal agenda.[10] Controversial from the start, the Washington Consensus is a loose panoply of prescribed policy measures for states seeking to become more economically developed.[11] In general, the neo-liberal prescription has favored strong measures of fiscal prudence and the overall reduction of government expenditure, tax reform, competitive exchange rates, and secure property rights. The Washington Consensus eschews any form of market protectionism or state

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[8] See for example Martin (2003) on the issues of economic geography and labor mobility. See Ellison and Hussain (2003) on the issue of external increasing returns and uncertainty in the context of European integration. On the general concept of external increasing returns and economic geography see Krugman (1991).

[9] Hellman in particular provides an interesting discussion of the very real problems of capture in Central and East European economies, arguing that those countries that were more successful at introducing and then pursuing more thoroughgoing market reforms were also more successful at avoiding the costs of capture (1998).

[10] For Williamson's original expression 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 frequently proposed as alternatives to the Washington Consensus.

[11] One of the more potent criticisms is that offered by Rodrik (1996). But this policy approach continues to inspire strong criticism (see for example Beeson and Islam, 2004; Rodrik, 2002; and Kolodko, 2000?).

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.

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 from the role of economic management. Linda Weiss (2003) for example, argues that rather than constraining the behavior of states, globalization has in fact 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 realm of economic management is a wise strategy. His early analysis of the Latin American and East Asian cases suggested that the role of government was in fact crucial to explaining the relative success of the East Asian Tigers (1996),[12] and more recently Rodrik has shifted his attention to the relative success of 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 some 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.[13] 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.[14]

Shifting our attention to Central and Eastern Europe, several authors have suggested that the Central and East European countries have done better than countries further East (including Russia) precisely because they chose not to follow a strictly neo-liberal approach to economic adjustment and renewal (Kolodko, 2000?, 1999; IMEPI-RAN, 2001). In the case of the Central and East European states however, this overall picture is somewhat complicated by the fact that these countries stand before two major challenges. On the one hand, these states face the challenge of globalization as they move to market economies and greater economic openness. On the other hand, they likewise face the challenge of EU membership, competition with EU Member economies and adoption of the EU legislative framework. How these states have thus far dealt with these challenges, what factors best 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 countries of Central and Eastern Europe, the advent of EU membership appears more likely to constrain the role of the state in these countries.

[12] In this regard, Rodrik builds upon a strong history of analysis of the East Asian case suggesting that state involvement played a strong role (see in particular Amsden, 1989 and Wade, 1990).

[13] See in particular Beeson and Islam (2004), Beeson (2003) and Weiss (2003).

[14] 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).

The dissenting literature on the Washington Consensus is disconcertingly vague on the precise form and shape of institutions that are likely to contribute to relative economic success. Both Rodrik (writing on China and India) and Kolodko (writing on Poland) suggest that institutions are the crucially neglected variable in development literature. But at the same time, they fail to specify much more precisely than this which institutions are the most important ones for successful economic development. This is—in part at least—by design. Both of these authors suggest that universal models that can be applied in all cases do not really exist. Each of the countries they discuss has in fact pursued a model of development that is in some way attentive to local specificities and local institutional and power relations. The only strong commonality across developmental models these authors discuss lies in their insistence upon the importance of the role of the institutions of the state.

In this regard, this paper will focus attention upon one specific role of the state in Central and East European countries in promoting economic growth and development in Central and Eastern Europe. In particular, this paper will look at the role of investment promotion strategies and their ability to explain successful economic development—in particular in Hungary, upon which most of the following analysis is based. As will be discussed in further sections of the paper, this development strategy has important implications for the potential compatibility of Central and East European interests with the existing EU policy framework for economic development.

Tools of the Past and Tools of the Future?

The economic competitiveness strategies of the Central and East European countries have been quite varied. While the Hungarian case exhibits similarities with other countries in the region, it also exhibits many differences. For one, Hungary started quite early with a comparatively dynamic program for attracting FDI. The remaining Central and East European countries did not really initiate similar programs until much later. Moreover, while Hungary was the principal recipient of FDI in Central and Eastern Europe throughout most of the period from 1989 until about 1997, the remaining Central and East European countries only began to catch-up after 1997. In fact, as Sass notes, if we look at accumulated per capita stocks of FDI rather than flows, Hungary still remains the principal investment target in Central and Eastern Europe. Second, the relative degree of penetration of foreign capital in Hungary greatly surpasses that of other Central and East European countries (Hunya, 2004; Sass, 2003: 14).

Throughout the 1990's, the Central and East European countries 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 attracting foreign investment capital. The Hungarian economy is in fact almost entirely privatized, with little room left for further foreign investment in existing firms.[15] In fact,

[15] Few state firms remain to be privatized. MALEV airlines is still 100% owned by the state—though there have been flirtations with various foreign investors (including Alitalia, Delta and Hainan Airlines). MVM, the firm that owns and manages the Hungarian electrical grid is likewise still 100% owned by the state. To date, some 99 or more firms remain to be sold by the *Hungarian Privatization and State Holding Company*

if any of the New Member states 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 has suggested that 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 taxation rates in 1999 across the Old and New Member states, this difference increased to 6% in 2003. Moreover, many countries in Central and Eastern Europe envision still further reductions in the level of corporate taxation (UNECE, 2004a: 126, 128). Hungary, for example, further reduced its corporate income tax from 18% to 16% in 2004. Yet this image in fact 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 rates of corporate taxation across the Old and New Member States in the more recent period.

The general issue of economic competitiveness has been dealt with in different ways by the Hungarian government. Tax benefits/holidays, monopoly concessions, as well as protective trade barriers[16] 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 Éltetö notes, The XXIV/1988 law on Foreign Investment permitted foreign firms who invested in a select set of activities[17] 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 totaling more

(APVrt). But most large state firms have been sold to foreign investors (for more up-to-date information, see the website of the APVrt: www.apvrt.hu).

[16] While I do not discuss these trade barriers in this paper, they have been discussed at greater length by Nagy (1994). The most interesting point Nagy makes in this context is 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.

[17] 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' (Éltetö, 1998: 9).

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 totaled more than 5 million Hungarian Forint (Éltetö, 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 Éltetö 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) 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. 5 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".[18]

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 worth at least 5% of the original investment value in the first year were eligible for a 5 year 50% tax reduction. A 10 year 100% 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% or 600 million Hungarian Forint (Antalóczy and Sass, 2003: 12; see also Szanyi, 2003: 15).

The most liberal Hungarian corporate tax law went into effect on January 1st, 1998.[19] 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 (Éltetö, 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 in fact predates

[18] Ibid: 9-10; Magyarközlöny, 1995, No. 108: 6285-6.

[19] There is some confusion in the literature over the actual date on which this set of investment incentives was introduced. Only Éltetö accurately notes this law was introduced in 1998 (Éltetö, 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 (CompLex, 2005).

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 parks. From 1996, Firms investing in such parks were eligible for a 5 year tax holiday (Éltetö, 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 a new fund in 1995, the *Economic Development Fund* and also the *Allocation Fund* (Éltetö, 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 in fact first introduced in 1982, long prior to the collapse of the East Bloc. As Sass and Antalóczy both note, there were several advantages of setting up IFTZ's.[20] First, companies could import equipment, machinery and other production inputs without having to pay import duties. Second, they could take advantage of local labor. The only restrictions on firms in IFTZ's were that they produce for export. Over some 100 firms set up industrial free trade zones by January 2002.

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,[21] and the Czech Republic and Slovakia only began creating industrial parks after 2000 (Sass, 2003: 17). Hungary was likewise the first country in Central and Eastern Europe to seriously consider privatizing its "core" strategic industries. According to Mihalyi, the other countries of Central and Eastern Europe 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 noted above that gave foreign investors easy and broad access to Hungarian industry helped Hungary to move forward more rapidly and attract more investment capital than other countries of Central and Eastern Europe.

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[20] Sass (2004: 75). See also Antalóczy and Sass (2001) and Antalóczy (1999).

[21] Poland did establish "special economic zones", but the regulations associated with these were too cumbersome to successfully attract significant amounts of FDI (Uminski, 2001: 91-2). Nevertheless, Poland requested a transition period for these special economic zones until 2017 but was turned down by the Commission (EP Fact Sheet, 2003).

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 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 in fact quite common for several years. Between 1998 and the year 2000, tax benefits amounted to between 72.9% and 76.8% of state aid.[22] 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 at that time the Hungarian government was granting 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.[23]

Many of these arrangements met with problems in the area of competition policy and state aids during the negotiation of the EU Accession Treaty.[24] Thus, for example, the Hungarian tax law passed in 2001 (and that entered into force in January, 2003) in response to complaints from Brussels allows a far more restricted practice of favoring large investments. 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 worth 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 as was the case under the 1996 law).[25] 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 discontinue 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 European Union essentially allows large investors who signed contracts prior to 2002 to recoup up to the full amount of their original investments in tax write-offs (rather than allowing firms to retain 0% tax holidays until the full 10 year contract period runs out). As industrial free trade zones were deemed incompatible with EU regulations, Hungary and the other Central and East European countries 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 firms, and given that goods can now move freely and without import duties within the European Single Market, the actual impact of this outcome is presumably negligible.

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[22] See the report of the State Aid Monitoring Office (2002: 17, Table 9).

[23] Ibid. (2000: 21 Table A2; 2002: 35 Table A2, 37 Table A4)

[24] In fact, some problems arose even prior to this date. For example, the EU used the Association Agreement Hungary had signed with EU as the basis for objecting that Hungary's attempts to base tax reductions on export performance were a form of indirect export promotion. As a result, Hungary changed this legislation in 1996 to promote production and not explicitly exports (Éltetö, 1998: 9).

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

However, the January 2003 revisions to the corporate tax law raise concerns. Foreign direct investment—despite Hungary's quite 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. And the Hungarian corporate tax rate was amended in 2004, reducing the corporate tax rate from 18% to 16%.[26] 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 increased again in 2004.[27] For another, the end of privatization in Hungary and 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 that has been 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 necessary capital needed to rebuild its telecommunications infrastructure.[28] 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.[29] 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 that included explicit long-term price and 8% profit guarantees.

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[26] KPMG Media Release: "Corporate Tax Rates Continue to Fall Worldwide", March 23, 2004.

[27] 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).

[28] 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 the Hungarian telecommunications sector. In the late 80's, Matáv published a 10-year plan that estimated the cost of the 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).

[29] Deutsche Telekom has been the principal investor in Matáv, while Pannon and Westel have been the principal investors in the mobile phone sector. Vodafone was the third Western company admitted to the Hungarian mobile phone market in 1994.

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 that MVM has signed with various private energy producers, but it is likely that this will have a negative impact on the MVM's bottom line.[30] Most of the Hungarian motorway agreements ran their course prior to the final date of enlargement. Thus, as long as Hungary observes EU public procurement regulations, it is not likely that future agreements will be greatly affected by the fact of EU membership.

Hungarian strategies have gradually begun to shift away from simple capital attraction schemes to strategies intended to promote the diffusion of knowledge and technology. 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 Dec. 31st, 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.[31]

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 that have been funded with government grants of between 0.2 and 1 million US Dollars and have been established at different universities in Hungary. One of the goals of these research centers was to include business partners in the activities of the Centers. 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 projects. Furthermore, the cooperative research these centers 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 to be less successful. For example the Hungarian government offered grants to entrepreneurs with academic scientific backgrounds to turn their knowledge into business

[30] There have already been significant problems in this regard, since the preferential agreements that Hungary signed have bound the MVM to pay more to producers for electricity than it is always able to sell it for 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 be compensating significant losses in the energy sector for many years to come (2017-2023) (see Bakos, 2001). What makes matters worse, complete liberalization of the Energy sector may even lower energy supply prices, thus having a potentially more serious impact on the related costs to the Hungarian government (and possibly the Hungarian consumer). Bakos estimates these potential losses at 300 billion Hungarian Forint (2001: 1129). However, this estimate cannot adequately account for the costs of complete liberalization.

[31] See both the program announcement from the Ministry of Economy and Transport (2002), and Ernst & Young (2003: 33-4).

enterprises. But this particular project has generated a rather 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 and inventors. Few patents have remained in the hands of the TLO's, making them weak potential 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 since they were first promoted by the government in 1996. As noted by the Association of Hungarian Industrial Parks (AHIP/IPE), there were 165 industrial parks distributed throughout Hungary by May 2004.[32] Thus industrial parks have seen quite substantial growth in Hungary. However, Buzás and Szanyi remain sanguine about their potential impact on the diffusion of technology. As the authors note, the *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 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, this industrial park 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).

What Has Been Achieved?

To some degree, a consensus is emerging about the need to go beyond simple privatization and industrial restructuring in Hungary and other countries. While this literature typically does not criticize the phenomenon of privatization through foreign direct investment (FDI), it does suggest that the accumulation of foreign capital alone is not sufficient to achieve long-term economic development. As Szanyi for example points out, previously the principal indicator of economic competitiveness was thought to be the introduction of technologically sophisticated production techniques. Thus increasing FDI specialization in technology intensive economic branches was seen as an indicator of overall economic competitiveness in the CEEC's. As Szanyi notes, current research suggests the actual "*technology and knowledge content*" of the work performed in Central and East European countries 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).

Four questions in particular seem most relevant to determining the degree to which multinational affiliates or domestic firms are developing sustainable long-term patterns of economic growth. First, to what degree do the activities of Hungarian affiliates transcend simple assembly work and involve the accumulation of organizational 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

[32] See the website of the Association of Hungarian Industrial Parks (http://www.datanet.hu/ipe/).

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.[33] 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.

The 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 the foreign multinational partners is quite '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 that leave them vulnerable to the whims of foreign capital and fluctuations in the international market. Pavlínek comes to a similar conclusion, noting that the vertical integration of local plants into international production networks makes them 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 somewhat low marks. While firms that are the direct recipients of FDI have often seen significant changes in their technological capacity (Sass, 2004: 81), the rate at which technology has diffused across such boundaries is somewhat more controversial. Some analyses even suggest that the principal changes in productivity in the late 90's were more the result of labor shedding than the introduction of new technology (Novák, 1999). The evidence on actual technological spillovers is thin. Novák (2003), for example, finds that there has been only a marginal impact on domestic firms and that competition effects and the presence of linkages with foreign multinationals had stronger effects 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 authors to find significant positive evidence for spillover. The principal barriers to technological spillover appear to be weak linkages with domestic firms and/or attempts on the part of foreign affiliates to control the likelihood of spillover.[34]

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

[33] A good overview of the literature on these last two points is provided by Sass (2004).

[34] On this last point, Lorentzen and Mollgard (2002) find that in fact many investors in Central and Eastern Europe in fact imposed "vertical restraint agreements" that prohibited affiliates from using transferred technology for production activities outside the framework of the existing joint-venture agreement. However, such agreements are illegal under EU law, and thus were presumably rescinded with the advent of EU membership.

likewise made significant investments in R&D centers. Pavlínek notes that the motor building part of Germany's Audi completed a new R&D center in Györ, Hungary in 2001, while the German truck and bus brake manufacturer Knorr-Bremse built an R&D center in Budapest in 1999. Other examples can be found for neighboring 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 important firms such as Nokia, Ericsson, Siemens and Compaq have all transferred parts of their R&D activities to Hungary (2004: 81).

In general however, satisfaction with the degree of transfer of R&D activity is quite 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 skeptical about the likely transfer of extensive R&D activities to Central and Eastern Europe. In fact, 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 Old EU Member states 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 anytime soon,[35] the gap between the Old EU Member states and Central and East European countries is a cause for concern.

There are examples of increasing links between suppliers and MNC affiliates in Hungary. Sass points out that there are important differences in the different types of FDI and their relative impact on supplier networks. Privatization FDI, for example, appears to have led frequently to the maintenance of local supplier networks, while Greenfield FDI (investment in completely new production facilities) appears to be more frequently associated with very 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. However, at the same time, Pavlínek points out problems with the degree of "embeddedness" of local suppliers, noting that often these

[35] The EU's Lisbon Agenda encourages countries to bring their national-level R&D expenditures up to 3% of GDP by 2010.

local suppliers also perform only minor assembly operations for products that are largely 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 it is not clear that local affiliates, for example, have sufficient latitude to deepen their sphere of responsibility toward 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.[36] 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 that has diversified its production strategies in multiple directions and is not dependent upon any one multinational 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).[37]

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.

Thus the basic concern of most theorists is what factors best explain the ability of Central and East European countries to go beyond *economic growth* to real *economic development*. The distinction is not facile. The implication is that mere capital deepening—improvements in the capital/labor ratio—are not sufficient to create the foundations for long-term economic development. While this may improve productivity and technological capability, this should not be equated with the potential to produce new technologies, innovation and thus long-term economic development. According to this logic, the ability to achieve 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

[36] Sass, citing Vince, essentially makes this claim (2004: 80).

[37] Pavlínek appears to note a similar example in the Czech firm PAL Praha which manufactures small electric engines for a larger foreign firm (Magna). As a joint venture project, PAL retains considerable managerial autonomy from Magna and has invested in its own R&D center for which PAL remains fully responsible. 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.

dependency and may fail to create the necessary conditions for long-term sustainable economic development in Central and Eastern Europe.

Considerations of this type also raise concerns regarding the relative vulnerability of Central and East European countries to capital mobility. If these countries are in fact 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 Central and East European 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 to other countries further East or even to Asia (Kalotay, 2003). Even with the inclusion of reinvested profits in the calculation of FDI flows (something that previous estimates of Hungarian FDI flows tended to omit), FDI inflows in 2003 were almost half those of inflows in 2001 (Sass, 2004: 68). However, as noted above, FDI inflows rose substantially in 2004.

At the same time, there are significant examples of foreign multinationals leaving the territory to produce further East. IBM (previously the largest exporter and importer in Hungary) and Marc Shoe (Szanyi, 2003?: 14), Mannesmann, one of their suppliers (Shinwa), Solectron and Flextronics moved part or all of their production either to China or to Romania (in the case of Solectron) (Pavlínek, 2004: 55-6). Nor is Hungary an exception. Similar stories are recounted about production in the Czech Republic. Pavlínek notes the examples of the German firm Varta Aku, the Belgian firm Massive Production, and the Japanese-German firm Takta Petri, four firms that moved from the Czech Republic to either China or to unspecified locations, typically as a result of wage considerations (ibid., 56). 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). Moreover, the smaller individual New Member states are, the more vulnerable they are to the interests of individual large multinational investors and firms. According to Pavlínek, the Czech Republic and Slovakia, for example, are increasingly dependent upon the strategic interests of Volkswagen, which was responsible for 14% of Czech and 16% of Slovak exports in 1999 (2004: 63, 65). IBM—as noted above—is another case in point, though more recently IBM announced a significant expansion of its remaining activities in Hungary.[38]

The Hungarian National Development Plan 2004-2006, published as part of its application for EU structural and cohesion funds for the same calendar period (2004-2006) outlines Hungarian concerns about declining levels of foreign direct investment and focuses attention on the general shift in investment promotion strategies noted above:

> Hungary's investment attracting capabilities have recently declined in parallel with an increase in labour costs and more intensive competition

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[38] In March 2005, IBM announced that it would undertake investments of $35.5 million in Hungary and between 2003 and 2008 would undertake further considerable investments eventually employing some 17,000 workers (www.nol.hu: "IBM: 6.5 milliárdos beruházás, 700 munkahely" IBM: 6.5 billion Forint Investment, 700 jobs, March 3, 2005).

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 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 (the latest year for which there were available data).[39] Thus although FDI inflows in the Hungarian economy may have reached a degree of saturation, overall investment in the Hungarian economy appears to be consistently on the rise. In this regard, Hungary is even a bit of an outlier, since the Czech Republic, Estonia, Lithuania, and Romania all experienced significant short-term dips in 1999 (and for Latvia in both 1999 and 2000).[40]

The EU Policy Framework and the New Member States

The central question that follows from the discussion in the previous section is whether the EU policy framework is compatible with the competitiveness and economic development concerns of the Central and East European states. The potential for policy divergence is perhaps best grasped from a quick reading of the European Commission's Third Report on Economic and Social Cohesion. Published in February 2004, three months prior to the final date of the Accession, the report outlines the significant differences in the level of economic development between the Western and Eastern parts of the New Europe:

> Average GDP per head in these 10 countries is under half the average in the present EU and only 56% of those of working age are in jobs as against 64% in the EU15…
> Some 92% of the people in the new Member States live in regions with GDP per head below 75% of the EU25 average and over two-thirds in regions where it is under half the average…
> If Bulgaria and Romania, where GDP per head is under 30% of the EU25 average, were to join the Union, the population living in regions with GDP per head below 75% of the EU average would more than double from the present number (from around 73 million to over 153 million). The gap between their average GDP per head and the EU average would also double (from around 30% below average to over 60% below)…
> [As a result, EU] socio-economic disparities will double and the average GDP of the Union will decrease by 12.5%...
> The effect of enlargement is to add just under 5% to EU GDP (measured in Euros) but almost 20% to the Union's population.[41]

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[39] See the Economic Survey of Europe, (2004, No. 1: 191, Appendix Table B.3).
[40] Ibid.
[41] Passages selected from the Executive Summary of the Third Report on Economic and Social Cohesion (European Commission, 2004a).

Across the New Europe, the quite dramatic widening of differences in the level of economic development may well drive a parallel widening of policy interests across the various New and Old Member States.

Several elements of the EU policy framework are specifically directed at the problem of competitiveness and economic development and are of potential interest to the countries of Central and Eastern Europe. In the context of the Eastern Enlargement, at least three areas are highly salient. Debates over the future distribution of Structural and Cohesion Funds, over the potential harmonization of corporate taxation rates, and over the role of state aids and competition policy more generally are likely to dominate political and intellectual debate in the coming years. These three areas in particular most strongly exhibit the potential for the divergence of interests with respect to economic competitiveness and development interests. The remainder of this section will address each of these policy areas in turn.

Current discussions of potential reforms of the EU's Structural and Cohesion Funds already provide an indication of the potential for the divergence of interests in the New Europe. The so-called *Sapir Report* (European Commission, 2003)—intended to provide proposals on future reforms of the Structural and Cohesion Funds—emerged with the broad recommendation that these funds be re-nationalized. This initiative has received some support from Old Member States of the European Union.[42] It should come as no surprise that re-nationalization is likely to be supported by those states that are "*net contributors*" to the EU budget (in particular Germany, the Netherlands, Sweden, Austria and the UK). On the other hand, the New Member states have strong incentives to insist on maintaining or even increasing the amplitude of the EU's Structural and Cohesion Funds. In fact, some effort has already been put into studying both the interests of Old and New Member states in this policy and the potential leeway for raising the amount of money available for these funds.[43]

The willingness of the EU to dedicate significant funds to policies of Economic and Social Cohesion is questionable. The amounts set aside in the Commission's proposal for the financial perspective 2007-2013[44] provide only minor increases over previous amounts (see Table I below). Between 2006 and 2007, spending increases by 10% for the year in which Bulgaria and Romania are scheduled to join, but by much smaller amounts in following years. Seen in per-capita terms, the amounts set aside for Structural and Cohesion fund spending remain almost constant, 0.26 Euros per person in 2006 and 0.27 Euros per person in 2007. From 2007 to 2013 per capita expenditures slowly rise to 0.32 Euros per person, but inflation is likely to wipe out these gains. Seen in the context of the above noted doubling in the EU population living below 75% of the EU average, these sums are somewhat startling. Despite no mention of re-nationalization, there does appear to be a trend in this direction. Central and East European countries will be required to pick up a far greater share of the tab for economic restructuring than the former cohesion countries.

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[42] See for example Tarschys (2003).

[43] See for example the report published by the Hungarian Institute for World Economics (Szemlér, 2004).

[44] See "Building our Common Future: Financial and Political Outlook for the Enlarged Union 2007-2013", (COM(2004) 101 final).

[Table I about here: Proposed EU Expenditures on Structural and Cohesion Funds, 2006-2013]

Debates over rates of corporate taxation in Europe exhibit 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, only two months prior to the official date of entry into the EU. 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 Central and East European countries. Schröder went so far as to complain 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 have complained that low corporate tax rates in Central and Eastern Europe are being financed by EU funding.[45] Together, France and Germany—later joined by Poland despite previous resistance to this effort—launched an attempt to introduce a minimum rate of corporate taxation in Europe.[46] Though this effort has so far been resisted by the Commission, Britain, Ireland and several of the Central and East European states,[47] on Sept. 6th, 2004, France's Finance Minister Nicholas Sarkozy explicitly attempted to link Structural and Cohesion Fund support to compliance with a future EU regulated minimum level of corporate taxation.[48] Poland however was strongly opposed to this effort.[49]

Discussion of the potential harmonization of corporate tax rates predates the accession. EU membership negotiations first began uncovering problems in this area. Estonia's "liberal" corporate tax regime was criticized by Romano Prodi as a potential "problem" for the EU as early as March, 2002. In particular, France, Italy and Spain were concerned that Estonia's corporate tax regime constituted an "'unfair' competitive advantage".[50] As the above noted example of Hungary suggests, similar problems arose with other countries. At least prior to the enlargement, it was difficult to make any headway on harmonization. In response to the Enlargement, several countries in Western Europe have already begun to lower their average rates of corporate taxation. In particular, effective on January 1st, 2005, Austria lowered its corporate tax rate from 34% to 24%.[51] Germany likewise lowered its federal corporate tax rate from 40% for "retained" earnings, and 30% for "distributed" earnings to a flat rate of 25% in January,

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45 See for example: http://www.eubusiness.com, "New EU States Use Low Tax Rates as Investment Bait" (4/25/2004).
46 See for example: http://www.eubusiness.com, "Warsaw, Berlin and Paris Call for Harmonisation of EU Taxes" (7/22/2004).
47 See for example: http://www.eubusiness.com, "EU Embroiled in Taxing Debate Over 'Fiscal Dumping'" (9/11/2004).
48 See e.g. Reuters.com: "Paris Idea to Link EU Funds, Tax Gets Cold Reception" (9/06/2004).
49 See for example: http://www.eubusiness.com, "Poland Joins Outcry Against French Proposal on EU Funds" (9/9/2004).
50 See for example: http://www.eubusiness.com, "Commission Questions Estonia's Liberal Corporate Tax Regime" (3/8/2002).
51 See the website of the Federal Chancellary of Austria (http://www.austria.gv.at/).

2001.[52] Moreover, Germany is currently considering a further reduction to 19%. However, given high local corporate tax rates in Germany, the effective rate of corporate taxation will remain much higher 38.7% at the current rate and 32.7% at the suggested rate.[53]

While there has in fact been a long-standing debate about corporate tax harmonization in the European Union (see e.g. Radaelli, 2001), the enlargement may ultimately be more successful in bringing this issue to the 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 approved by the European Council in June 2004.[54] Moreover, the UK—as has been made clear on separate occasions by Gordon Brown, British Chancellor of the Exchequer—appears steadfastly opposed to any move in the direction of tax harmonization.[55] Ireland—currently the EU Member state with the lowest rate of corporate taxation—likewise has every reason to continue to oppose the harmonization of corporate tax rates. Given that most of the Central and East European countries are opposed to such a move, and given that such decisions—now or in the future under the new European Constitution—will require unanimity in the Council of Ministers, it is unlikely corporate tax rates will be harmonized any time soon. This does not remove the possibility, however, that some of the Old Member states who are most concerned about the consequences of corporate tax competition in the New Europe might attempt to link this issue to others (such as the Structural and Cohesion Funds) and pressure the New Member states into compliance.

Whether harmonization is justified on the basis of variation in rates of corporate taxation across countries is more problematic. Determining actual levels of corporate taxation across countries is no simple matter. While statutory rates are typically easily accessible, 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 corporate earnings are taxed, to the role of various deductions available for region-specific investments. The consequence is that so-called "effective" rates of corporate taxation differ, sometimes substantially, from "statutory" rates of corporate taxation.[56]

These difficulties aside, based on statutory rates of corporate taxation, there is little evidence that the EU genuinely needs to engage in the harmonization of corporate tax rates. Table II below provides some preliminary data on rates of corporate taxation across countries and likewise provides calculations of the regional averages of corporate taxation across the New and Old Europe and the countries of Central and Eastern Europe. There are significant differences between the *unweighted* average rates of corporate

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[52] See the information website of the German government: http://www.germany-info.org/relaunch/-business/taxes/german_tax_rates.html.

[53] See the Economist: "Taxing Times", March 21, 2005.

[54] 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.

[55] 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).

[56] Attempts have been made to measure these different rates of corporate taxation. See for example the work of Carey and Tchilinguirian (2000).

taxation for the Old Member states and the CEEC's (29.4% and either 21.5% or 18.9% respectively based on current and projected rates of corporate taxation). The unweighted average across the New Europe is not as low, but there is nonetheless an important 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).

[Table II about here: Average Corporate Tax Rates in Europe]

A strong case can be made for using *weighted* averages of corporate taxation based on relative population sizes rather than *unweighted* averages. The principal reason is that even though some countries may have quite low rates of corporate taxation, the relative size of the employable population provides a significant upper limit on the potential for European capital to take advantage of this variation in tax rates. 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 Central and East European countries have raised rather than lowered their rates in more recent years due to the requirement of compatibility with EU law. Given these calculations it is difficult to understand the degree of conviction with which some of the Old Member states are pursuing this issue.

Taking a glance at data on the FDI behavior of the Old Members states, Japan and the US (See Table III), these countries have not been moving their investments at any great pace toward Central and Eastern Europe. While a few countries do exhibit a considerable shift in their regional FDI strategies, above all Austria and to a far more moderate degree Germany, for the most part the Western states only exhibit a relatively mild shift in their investment behavior toward Central and Eastern Europe. The majority of Old EU member states have investment rates in Central and Eastern Europe that remain well below 5% of their investment rates in the former "European core" (the "European core" is defined as the set of more advanced Old EU Member states, excluding the cohesion countries Greece, Ireland, Portugal and Spain).

[Table III about here: Share of CEEC FDI Relative to FDI in the European Core]

France's Central and East European FDI, for example, only represents 4.1% of its European core investments in 1999. On the other hand, Germany's Central and East European investment share represents a good 10.3% of its European core investments in 1999. Oddly enough, Austria, though so far not a party to the complaints of France, Germany and Sweden, has seen excessive rates of investment in Central and Eastern Europe. Though these investments seem to have hit their highpoint in 1997 (at 72.6% of their investments in the European core), in 1999, they still represented 62.1% of investments in the European core. Greece as well remains an outlier with its Central and

East European investments almost equaling its investments in the European core in 1998, but dropping off quite precipitously by the year 2000. In recent years, a reversal of the previous trend may be emerging. As noted above, Hungary and other CEEC's have begun to experience declining rates of FDI, although Hungarian FDI rose again substantially in 2004. Finally, even with investment promotion incentives and low rates of corporate taxation, the total stock of FDI outflow from CEE have risen steadily over the years.[57]

On the other hand, looking at data on the shift in Old Member state, Japanese and the US FDI behavior in the former cohesion countries (Greece, Ireland, Portugal and Spain) (See Table IV), it becomes clear that much of the investment in Central and Eastern Europe may well occur at the expense of the former cohesion countries. The relative share of investment in Central and Eastern Europe has risen rapidly for Austria, Finland, France, Germany, Greece, the Netherlands, Portugal, Sweden, the UK, Norway, Switzerland and the US. Though this shift in investment patterns 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 the investment in Central and Eastern Europe might have gone to the former cohesion countries. This fact may well explain both Spain's participation in this agenda, as well as the insistence of the former cohesion countries on their continued receipt of EU structural and cohesion funding.

[Table IV about here: Share of CEEC FDI Relative to FDI in the Old Cohesion Countries]

The European Commission has thus far resisted attempts to move toward the harmonization of corporate tax rates and has rejected the Sarkozy proposals. For one, Günter Verheugen, the new competition minister in 2004 (and previously Enlargement Commissioner) noted that rules for the distribution of structural and cohesion funds are already clear, suggesting it would be impossible to go back and rewrite them in order to bar low tax states from receiving them in the manner suggested by Sarkozy.[58] During the hearings for new Commissioners before the European Parliament during the fall of 2004, Verheugen in fact argued that tax competition "could be useful" and that the presence of lower tax rates in some states did "not necessarily lead to delocalization".[59]

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 in fact linked to the issue of rates of corporate taxation. During the accession negotiations, several of the New Member states were required to substantially modify generous tax holidays and other investment promotion schemes.[60] Ultimately, these methods of promoting FDI were seen

[57] 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.

[58] See www.euractiv.com (10/4/2004), "Verheugen calls Sarkozy's Corporate Tax Ideas 'Unrealistic'".

[59] Ibid. See also Verheugen's statements before the EP Committee on Industry, Research and Energy (EP New Report, 9/30/2004).

[60] In fact, the EU even used the early "European" or "Association Agreements" as a means to try and reduce the level of state subsidies in Central and Eastern Europe.

as state aids by the European Union and Hungary and other countries were required to dismantle or modify them. In fact, one of the conditions of EU membership set down at the 1993 Copenhagen Summit required that the economies of Central and Eastern Europe be capable of withstanding competition in the European Single Market. At least one of the key meanings of this phrase was that Central and East European firms should be able to survive economic competition without state support.

Current EU approaches to economic competitiveness have been influenced both by the anti-statist and state interventionist traditions noted at the outset of this paper. On the anti-statist side, EU policy has gradually begun to favor greater and greater competition in economic domains previously considered the preeminent domain of the state (e.g. telecommunications, railways, energy). Free-market entry and open and competitive public procurement policies have clearly begun to pervade current practice in the provision of services.[61] 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 (ECSC), for example was formally abandoned in 2002.

On the statist interventionist side, EU policy has begun a gradual shift toward more neutral forms of state intervention. EU competition and industrial policy has begun to reflect this shift in emphasis. EU industrial policy in particular emphasizes "*horizontal*" state aid measures and eschews sectoral or what I refer to as *vertical* state aids. *Horizontal* state aids are aids focused on broadly applicable principles of economic development (human capital development, infrastructure, R&D) and potentially useful to a broad range of economic sectors. The only form of quasi-direct aid to individual firms that remains in this context is support for small and medium-sized enterprises (SME's) and to some extent regional aid. *Sectoral* or *vertical* state aids are aids that ultimately help to prop up declining economic sectors and/or firms (e.g. the steel, clothing and textile sectors in Western Europe).[62]

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, there is at least a general though excessively gradual trend towards the elimination of direct agricultural supports. In particular the June 2003 reform of the EU's Common Agricultural Policy imposes a gradual shift from the current system of direct payments to support for rural development. The railway sector remains the second sector in which the EU continues to allow

[61] 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.

[62] For a 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 European Union", COM(94) 319 final. This initiative has gained considerable momentum with the Lisbon Agenda announced at the 2000 Lisbon Summit.

extensive public intervention. Moreover, while aid to the railway sector is typically detailed in the European Commission's *State Aid Scoreboards*, this type of aid is still considered as a separate category not subject to general EU restrictions of the use of state aid.

For another, the EU's Regional Development policies remain a significant portion of the overall EU budget. Whether this policy area should be considered vertical or horizontal in character is more problematic. Within the framework of the EU's regulations on state aid, states are permitted to engage in national projects of regional development. 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 much of regional state aid ends up in the hands of individual firms and investors. Moreover, whereas at the national level aid can be distributed using broad neutral criteria that do not favor individual firms, given the scale of regional and local development strategies, projects often target individual firms.[63] In 2002, some 31.5% of EU horizontal aid was defined as "regional" state aid (European Commission, 2004b: 20). 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 (ibid: 13). Presumably one can classify the structural and cohesion funds 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 states shift "public expenditure towards growth-enhancing investment in physical and human capital and knowledge subject to overall budget constraints" (European Commission, 2004c: 21).

The requirements of EU membership comprise an important set of constraints on New Member states. EU competition policy in particular imposes specific guidelines on state intervention. For the countries of Central and Eastern Europe, the big question is to what degree such policies are likely to assist them in their pursuit of further economic development and restructuring, and to what degree previous policy strategies may have created more favorable conditions for economic development and restructuring. As noted above, prior to the formal conclusion of the Enlargement, the Central and East European countries pursued a wide range of economic development and restructuring policies. In the course of the negotiations on EU accession, many of these policies were found to be incompatible with the EU's "*acquis communautaires*". Those countries that pursued incompatible policies were required to change those policies as a part of the formal bargain of EU membership.

[63] While there are general limitations on the so-called "intensity" of aid—i.e. the total amount of a benefit that individual recipients are eligible to receive relative to the investment made (e.g. tax exemptions can only refund up to approximately 65% of the original investment)—there are no real limitations on which firms can receive aid.

Whether these policy changes were in the interest of the countries of Central and Eastern Europe is in part a matter of ideological perspective, in part a matter of intellectual and academic debate. Saddled with the legacy of strong state involvement in the economy through the former system of centralized planning, state ownership and over-investment in heavy industry, these states were confronted with considerable burden of economic adjustment. The move to the market economy has included the liberalization of market relations and abandoning much of heavy industry. Large state firms have in part been privatized and subjected to the constraints of exchange under the free market. However, there have been problems with the privatization of large state firms and special measures have frequently been necessary to encourage foreign investment and promote industrial restructuring, or to protect employment. A number of economic sectors have been particularly hard hit by the constraints of market adjustment and pose particular problems for competitiveness and the use of state aid. The steel sector has been problematic in several countries (in particular Poland and the Czech Republic), while the transportation sector (in particular the railways), energy and telecommunications, banking and the pharmaceutical sectors have posed significant problems for the majority of accession countries.[64]

Whether "horizontal" measures are well suited to solving the economic development and restructuring problems of the Central and East European countries, or whether more "vertical" or "sector-oriented" 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 from 1998-2002 (See Figure I). The four countries with the highest share of non-horizontal state aid are Portugal, Ireland, Spain and France—ranging from some 26-58%. In contrast, at least eight EU Member states distribute more than 90% of state aid to so-called "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 non-horizontal measures. While Greece appears to be an outlier and distributes surprisingly few resources through vertical measures, 74% of Greek state aid is in fact for regional development, the highest share of any single EU Member state (European Commission, 2004b: 14, 20).[65]

[Figure I about here: Share of State Aid Spent on Horizontal Objectives, 1998-2002]

In Central and Eastern Europe there is a far greater emphasis on vertical measures of state aid. In Hungary for example—as already suggested in the above discussion of fiscal supports—horizontal measures accounted for only 8.2% and 9.3% of state aids

[64] See e.g. Burson-Marsteller (2004).

[65] Luxembourg is next in line with 61% of state aid going to regional development, then Belgium with 52%. (ibid: 20).

(excluding non-industrial aid) in 1999 and 2000 respectively.[66] Thus the vast majority of state aids in Hungary are in fact spent on vertical measures. The predominant share of state aid (excluding railway expenditure) falls in the category of investment promotion and tax incentives: 290.6 million Euros in 1999 and 371.3 million Euros in 2000. Moreover, as suggested above, there has been an increasing dependence on support derived from tax benefits and a parallel move away from direct grants of aid in Hungary over the period 1996-2000. Thus actual state *expenditures* on state aid are quite small, though the potential losses to state revenues may be more significant (this last point is discussed in greater detail below).

The autumn 2004 update of the *State Aid Scoreboard* includes data on state aid expenditure in Central and Eastern Europe over the period 2000-2003. According to this report, the findings for Hungary are generally consistent with findings for the broad range of Central and East European countries. On average, the New Member states spent some 78% of state aids on vertical measures. Estonia is the only country to stand out as a significant outlier, with 100% of state aids spent on horizontal measures. As in the case of Greece, some of this aid is for regional development (33%, in fact 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 recorded in these statistics. Apart from Estonia, all of the Central and East European countries still have significant vertical state 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).

Of Square Pegs, Round Holes and Bargaining Hurdles

To return to the previous distinction drawn above between *economic growth* and *economic development*, the central question to emerge from the above discussion is whether the EU policy framework is suitable to sustainable long-term economic development in Central and Eastern Europe. In the long run, this remains an open question. As noted above, most of the previous fiscal measures employed to promote investment in Hungary, for example, were classified as state aids during the accession negotiations. As a result of this clash of interests,[67] these measures have now been reworked, whittled down, eliminated in some cases, or modified and shifted over into regional measures that are more compatible with the EU policy framework. While on the one hand it is often seen as advantageous for the countries of Central and Eastern Europe

[66] 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).
[67] Batory, for example, emphasizes the fact that the EU and the Central and East European countries tended to view this issue very differently and had competing interests (2003: 15).

to adopt EU policy approaches, this point needs to be more thoroughly debated, 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 Central and East European countries 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 Central and Eastern Europe 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 in this process. As noted in the *State Aid Scoreboard*, over the period 2000-2003 86% of the total state aid in Central and Eastern Europe 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 likewise used investment promotion schemes to retain FDI, these were not classified as state aid and thus are not included in the *State Aid Scoreboard*.

Thus many of the governments of Central and East European countries have been able to attract foreign investment by promising lucrative tax holidays and industrial enterprise zone arrangements, the use of which is gradually being restricted by the EU. Hungary was, by most accounts, the pioneer in this process and other countries such as the Czech Republic only began to follow suit much later (Sass, 2003: 16). While such arrangements have been controversial in the EU framework, they may have been crucial to the stabilization, emergence and profitability of several important sectors in Hungary—in particular the automotive and electrical engineering sectors—and in the broader range of Central and East European economies. And 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 Central and East European countries. The current shift in emphasis in Hungary from the simple attraction of foreign direct investment to more diverse forms of investment 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 is one of the few Central and East European countries (apart from Estonia and Slovenia) that has begun shifting more of its state aid to more horizontal measures (European Commission, 2004c: 21). However, there are likewise several potential problems with 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.[68] In this regard, it may be possible to think of the *Lisbon Agenda* as part of a longer term plan for promoting re-nationalization over redistribution in the EU policy-making framework. 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. 2/3rds of this expenditure is expected to come from the private sector.[69] Moreover, discussion of EU spending on the Lisbon Agenda is firmly rooted in the context of movement away from more vertical forms of state aid.[70] As such, this policy approach provides a framework for arguing against the logic of current forms of EU-level funding. Moreover, the levels of domestic R&D expenditure promoted by the EU are likely to be difficult for the Central and East European countries to achieve under 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. In Hungary, the regional aid intensity map agreed with the European Commission allows for investment promotion incentives that refund between 35% and 50% of the original investment. Similar aid intensity levels apply for the other Central and East European countries.[71] However, the previous aid intensities granted to individual investing firms in the pre-accession phase often far exceeded these levels. Mutti and Grubert (2004) suggest in fact that multinational corporations producing for export rather than domestic markets from developing countries are more and more sensitive to host country taxation. To the extent this is true, the modification of investment promotion schemes used in Central and Eastern European countries may have a significant impact on FDI flows to the region.

Two further observations likewise serve to illustrate the problems that might arise from 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 thus far attracted the highest levels of foreign direct investment. This may be a good thing insofar as this shifts investment and economic development to those regions that have thus far attracted less of it. 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 (see for example Martin, 2003). Moreover, investors may be more likely to avoid less developed regions to the extent that infrastructure and

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[68] 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 European Union, November 26, 2003: 7-9).

[69] See for example "Investing in Research: An Action Plan for Europe", COM(2003) 226 final/2.

[70] Ibid: 19.

[71] Most of Hungary qualifies for a 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 on individual country aid intensities, see the EU's aid intensity maps for the New Member States at the website of the Directorate General for Competition: http://europa.eu.int/comm/competition/state_aid/regional/2004/.

human capital remains underdeveloped. In this regard, the lack of significant structural and cohesion funds to support the building of infrastructure and human capital potential in underdeveloped regions may further hamstring the success of regional development measures.

For another, the EU's Regional Development focuses on underdeveloped regions at the expense of more advanced regions. Although the Central and East European countries would presumably like to see investment rise in less developed regions, this focus may not be compatible with the desire to attract continued investment and long-term, sustainable economic development in those areas that have already attracted significant amounts of FDI. In keeping again with the notion of clustering and the weak embeddedness of Central and East European firms, to some extent it may be important to continue to promote investment in these more developed regions as well.

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 (such as 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 economic development of the automotive and electrical engineering sectors could ultimately be one of the early casualties of future sustainable economic development strategies.[72] Despite the fact that the Lisbon Agenda, for example, 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 likewise find themselves constrained by the combination of EU restrictions on aid intensity, on the use of state aids and the limitations of CEE government budgets.

As noted above, the remaining Central and East European states—Latvia, Lithuania, Bulgaria and Romania—have had virtually no opportunity to introduce significant investment promotion mechanisms. Thus far, these countries have been far less successful at attracting significant amounts of FDI. While this is true for many reasons, in particular due to their inability to introduce successful market reforms and promote political stability, the slow process of reform has produced a lag that may be more difficult to overcome once inside the EU. As EU members, these countries may have a difficult time initiating similar investment promotion schemes and attracting comparable amounts of FDI. In this regard, all of the above observations raises significant questions about the ability of Central and East European states to integrate seamlessly into the EU policy framework.

In important respects, the central question being raised is whose interests are served by the adoption of EU policy and any resulting "leveling of the playing field". Quite apart from considerations of *optimal* policy measures, there are clear economic and political interests in Western Europe that favor horizontal rather than vertical policy measures. As Seabright (1998) has pointed out, the EU and EU firms have been likely to

[72] One response to this in Hungary may be to fund such projects from national level expenditure, but at relatively low levels so that these expenditures stay below EU state aid reporting requirements (Interview with Magdolna Sass, March 24th, 2005).

attempt to use insistence on the minimization of states aids in Central and Eastern Europe as a tool to reduce competitive pressures. In fact, several EU sectoral producer organizations lobbied the EU in order to ensure that basic competition concerns were resolved prior to the completion of the enlargement. Quite early on in the transition process, Eurofer repeatedly made clear to the European Commission that steel production in Central and Eastern Europe benefited from state subsidies and encouraged the Commission to assist in restricting their use.[73] The pharmaceuticals and the chemical industry produced one or more position papers outlining competitive concerns. In the pharmaceutical industry, the primary concern was the protection of intellectual property rights (EFPIA, 2000, 2003), while in the chemical sector the principal concern was state ownership and state subsidies (CEFIC, 1998). The general aim of "leveling the playing field" is now being taken up in the context of debates over corporate tax rates and EU funding.

The analysis presented above provides strong support for an interpretation of competing interests in the New Europe in the context of the literature on state-led development. Government efforts in Hungary—and presumably in other states—follow a consistent logic of promoting economic development. Projects such as the *Szechenyi Plan* and the *National Development Plan* reflect concerted attempts by Hungarian governments to define continued national strategies of economic development and to target specific industries and economic activities. Moreover, such strategies build upon industrial development strategies whose origins, as noted above, in fact predate the enlargement. In the long term, given that both the former EU cohesion countries and the broad range of New Member states are prone to utilizing more vertically-oriented forms of state aid, interests in state intervention are likely to continue to diverge from those of the more advanced states for some time to come. In addition, since integrating the Central and East European countries into the EU context greatly increases the number of less developed countries likely to favor such policies, this divide will likely be reinforced.

At the same time, it would be a mistake not to mention some of the potentially negative features of these development strategies. A number of potential criticisms can be levied at such policies. 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 whether or not they undertook further investments. In this regard, Estonia's strategy of encouraging continued investment 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).[74]

[73] Interview conducted with Eurofer, March 27, 1996. See also Eurofer's position paper on the Enlargement (http://www.eurofer.org/positionpaper/EUenlarge/enlargement.htm).
[74] Current Estonian corporate taxation only concerns the distribution of dividends to investors, gifts and non-business related expenses (see the web pages of the Estonian Ministry of Finance:

There are likewise potentially very real tradeoffs between government subsidized investment promotion schemes and the ability of governments to fund other projects. The budget for social welfare expenditure in particular may have been constrained by such policies. Greskovits and Bohle (2003), note that Slovakia has progressively lowered its corporate tax rate from 40% to 29% in the year 2000, and from there to 19% in 2004.[75] 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 this event and 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 do not represent explicit losses in government revenues. As such, they are not directly paid for out of the government budget. On the other hand, while tax exemptions do represent potential losses in terms of government revenues, two additional observations are required. First, without such tax exemptions, the rate of foreign investment in Hungary and other countries might not have been as high. In order to be able to calculate the loss in government revenues, this point must be considered. Second, attempting in particular to attract *large* investments may well have the impact of creating significant *sunk costs* which foreign investors are then unlikely to be willing to uproot once the tax incentive schemes have run their course. In this regard, the important number of large-scale investments made in the Hungarian economy may well provide a more solid tax base for the future, despite the potential for such firms to continue taking advantage of future tax schemes.[76]

Two observations suggest that investment promotion schemes may have had significant payoffs for the average citizen in Central and Eastern Europe. For one, though the evolution of relative income inequality across Central and Eastern Europe is uneven,[77] Hungary and the Czech Republic in both 1989 and 2001 remain well below the average level of income inequality (measured on the basis of Gini coefficients) in the OECD in the mid-1990's. Poland, Estonia and the other Central and East European countries (Slovakia was not included in this measure), however, had all risen above the OECD average by 2001 (UNECE, 2004b: 165-6).[78] For another, the evolution of real wages in Central and East European countries is generally favorable for countries that

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

[75] 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 partially compensate for the related loss in government revenues, along with the rise in the VAT, excise duties and energy prices were raised (Greskovits and Bohle, 2003: 23-4).

[76] In this regard, the issue of "aid intensities"

[77] Hellman likewise pointed out a correlation between lower levels of income inequality in Central and Eastern Europe (despite overall rises in income inequality) in countries that had pursued more extensive reforms (1998: 224-5).

[78] 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 Central and East European countries, begins to rise of the lower levels in the former CIS states (UNECE, 2004b: 166).

have pursued investment promotion schemes. Only four of the Central and East European countries 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). Combined, these two measures suggest that governments were not only likely to secure future revenues, but citizens benefited from these policies as well.

Another objection concerns the degree of tax competition that has resulted between the countries of Central and Eastern Europe. While this may well be a very real problem, this approach may misconceive the real axis of competition over investment resources in Europe. To some extent, Central and East European countries are competing for investment with the more advanced European economies. While the Central and East European economies have very real advantages vis-à-vis investment locations such as Germany—a significant supply of skilled and comparatively cheap labor—they lack a number of other advantages present in the more advanced regions of Europe—highly developed infrastructure, a larger supply of highly skilled labor, long established centers of research, development and product innovation. As suggested by the data on FDI flows in Table III above, the advantages of Central and East European are not great enough to significantly reverse regional investment flows.

Finally, the problem of *capture* deserves some attention. Clearly it is not always in the interest of the individual governments to subsidize firms. There were, however, significant differences in the strategies pursued by Hungary and some of the other countries of Central and Eastern Europe. Hungary's approach was strongly focused on moving firms out of the sphere of state ownership.[79] This strategy of large scale privatization was pursued earlier in Hungary than in the other Central and East European economies. Thus, as pointed out by Antalóczy and Sass, significant concessions granted to foreign investors first assisted the state in the process of privatization (including even monopoly control of some sectors and/or protected markets). Later, Hungarian FDI strategies focused on promoting continued investment in greenfield projects (Antalóczy and Sass, 2001: 44). This later strategy employed what I call "neutral (performance) criteria" and was typically not directed at individual firms. 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 "*commercialization*" 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). Thus,

[79] Though rapid privatization to foreign owners was in part inspired by the Hungarian level of foreign debt in the early years of transition, Mihalyi likewise points to an added benefit of selling Hungarian firms to primarily foreign investors. This strategy also apparently facilitated avoiding accusations of corruption (2001: 63-66).

many of the Central and East European countries were less successful at avoiding the cost of hanging on to large public sector firms.

In Poland the slow restructuring of the steel sector, for example, cost the Polish government considerable sums of money and weighed heavily on the state budget. Polskie Huty Stali (PHS)—accounting for approximately 70% of polish steel production—was privatized in 2004. The agreement with LNM Holding, included payments of $850 million to cover PHS debts and $600 million in guaranteed investments.[80] Moreover, the privatization agreement was spurred forward by demands from the European Commission that the Polish government stop providing state aids to the steel sector. 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.[81] Moreover, this figure may well understate the amount of real indirect government subsidies provided to PHS. Most 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.[82]

At the same time, though many see the impact of EU pressure as positive in this regard,[83] it is difficult to ignore the important 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 labor structure. The polish government ultimately signed an agreement that traded EU funding for the restructuring the 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 those firms in the Polish steel industry that had already privatized and invested in new technologies by reducing their ability to compete in the EU marketplace. Moreover, by artificially limiting future market shares, these production quotas presumably had a significant impact on the ability of the Polish government to later privatize the steel sector.

On the other hand, despite Hungary's greater degree of early privatization, it has still held on to state-owned firms that are a significant drain on the budget and a number of firms remain in state ownership.[84] One example, MALEV 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 Malev in the summer 2004, but the deal was later dropped. In early 2004, MALEV had an accumulated debt of 36.4 Billion

[80] PAP News Wire (3/5/2004).
[81] Official Journal (9/23/2003: 948).
[82] Official Journal (9/23/2003: 948). A Polish government audit of the effects of state aid deemed that 9 out of 12 cases of aid to the Polish steel sector were "inefficient and ineffective" (Sowa, 2003: 28).
[83] Moravcsik and Vachudova, for example, refer to "blocked bailouts of uncompetitive firms" as one of the positive benefits of EU pressure (2003: 47).
[84] As noted at the outset of this paper, the APV Rt. still administrates some 99 or more state-owned firms.

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).[85] 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.

The reintroduction of the holdings of the Hungarian National Development Bank (MFB)—along with the Hungarian Privatization and Holding Company (APV Rt.), one of the two agencies in Hungary responsible for managing the assets of state firms—back into the budget of the Hungarian national government in 2002 was in fact one of the principal factors explaining the significant rise in the government's budget deficit to -9.3% of GDP that year.[86] In addition, however, 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. These funds were previously used to pay down the government debt and were not subject to parliamentary approval. Since January 2003, however, this has been changed and privatization revenues can only be used for specific purposes subject to parliamentary approval.[87]

The above examples suggest—at least in the long term—that there may be few alternatives to the eventual privatization of state holdings in large firms. However, future privatization strategies are subject to the EU investment promotion criteria that limit the latitude of Central and East European governments to pursue these goals. 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 and may have mitigated some of the more dramatic impact of the transition process. In Poland too, fears of the social impact of closing some of the state-owned steel sector kept the government from pursuing this path. In this regard, the share of the actively employed labor force in Hungary is somewhat lower than that for Poland or the Czech Republic.[88]

In the long run, the above observations may point to serious potential limitations to the EU decision- and policy-making framework. Structured at it is on the basis of states and intergovernmental 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

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[85] See for example: http://english.budapest.hu/engine.aspx?page=news&artname=20040916-cikk-malev, "MALEV Hopes to Break Even" (9/16/2004).

[86] I am in part indebted here to an observation from Kalman Dezseri. 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).

[87] Ibid. However, since most Hungarian firms have already been privatized, there have been few revenues from privatization since about 1997.

[88] In 2002, the share of the actively employed labor 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 Magdolna Sass for this observation.

Constitutional Treaty preserves the unanimity principle, and thus the right of individual states to veto policies related both to total revenues (i.e. taxation policy) and to total EU spending (i.e. the EU's multi-annual Framework Perspectives).

With the older and larger EU Member states far more concerned about growth and employment on their own territories, they are likely to favor policies that benefit their own constituencies more so than those of other countries. Under such circumstances it is difficult to imagine strong support for a renewed redistributional agenda in the EU framework—at least one that favors the less developed economies of Central and Eastern Europe. In fact, if anything, the EU will likely move in the opposite direction. 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 structural and cohesion funds. As policies such as the Lisbon Agenda promote policy objectives from which the more advanced EU Member states are likely to benefit, these states are likely to attempt to focus attention on these policy agendas, potentially at the expense of alternative policy agendas.

And this may be all the more true as the EU potentially grows larger and larger. There are some 10-12 more states standing in the wings that are likely to pursue EU membership in the not too distant future.[89] 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 all the current large states. In this regard, the future potential expansion of the EU is likely to result in ever reduced emphasis on cross-border redistributional funding. Gaining support for funding in Central and Eastern Europe 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 redistributional measures.[90] At the same time however, this fact is unlikely to dampen the interest of the less developed economies in attempting to promote such policies.

Conclusion

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. First, Susan Strange (1992) once noted that globalization drives states to compete over scarce resources—in particular capital. Whether it is open borders or the level of economic development that drives states to compete in this way, one or both of these factors has had a significant impact on Central and Eastern Europe strategies of investment promotion. States went to considerable lengths to attract capital, even to the extent of fully subsidizing the cost of large investments over time. Second, the neo-liberal view that states simply need to open

[89] Croatia was also scheduled to begin membership negotiations in March, 2005 and Turkey is scheduled to begin negotiations in October 2005. Additional states likely to pursue EU membership in the future include the Ukraine, Moldova, Belarus, Bosnia-Herzegovina, Yugoslavia, Macedonia, Albania and possibly some of the Southern Mediterranean states.
[90] I am indebted here to a conversation with Alina Mungiu-Pippidi.

their borders to foreign capital in order to attract investment—while not necessarily rejected by the Central and East European 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[91] 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 in fact ultimately went much further.

Third, many have suggested that the insertion of the Central and East European countries into global production networks will provide the foundation for long-term sustainable economic growth.[92] The extensive privatization of the Central and East European economies may however prove problematic for at least two basic reasons. For one, as suggested above, extensive insertion into the global production networks of multinational firms may in fact 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; 1) may limit the relative autonomy of domestic firms foreign affiliates to develop independent strategies that promote greater embeddedness, 2) it may have the undesirable impact of crowding out domestic potential for the creation of technology and innovative capacity, and 3) it 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 Central and Eastern Europe, 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 should avoid FDI as a solution to promoting economic growth. This is certainly 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. In fact, the supranational level of decision-making may well prove inferior to the national-level. Countries that are distinguished by significant differences in the level of economic development may have significant difficulties coordinating compatible policy goals. At least for the Central and East European countries, their relative room for maneuver has been considerably reduced by the advent of EU membership. The EU accession process has been used to limit and constrain the behavior of the Central and East European states 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 Central and East European states.

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[91] Sass (2004).

[92] See for example Eichengreen and Kohl (1998).

Despite the common assumption that the supranational or EU level of decision-making is somehow superior where the Central and East European countries 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.[93] 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 Central and Eastern Europe, 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 New Member states. 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 Central and East European countries. This paper in fact 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 in fact strongly criticized the Hungarian strategy (2001: 64). In the context of developmental models of the state, this paper in fact 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 neofunctional or intergovernmental models are best suited to understanding what drives the process of European integration. From the above, interests appear to drive the behavior of states in the context of European integration. EU member states have used the accession process not only as a means of constraining the behavior of Central and East European states, but also as a means of increasing their grip on many of the EU's distributional resources (see also Ellison, 2005). Thus, while the EU framework is one in which the Central and East European countries may hope to have some influence on the decision-making process and the legislative framework in the European Union, it is likewise a framework in which the EU can more successfully control the behavior of the Central and East European countries.

This does not mean that the Central and East European states 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 Central and East European interests in redistribution. And while the Lisbon Agenda's focus on the knowledge economy may potentially be beneficial to the countries of Central and Eastern Europe—in particular to

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[93] 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).

those such as Hungary who are further along the path of economic restructuring and may realistically hope to benefit from such a focus—the Central and East European countries generally have limited resources to dedicate to such a program. Moreover, even in Hungary, a few big projects still remain (such as the railways, infrastructure more generally and the electric utilities) that are likely to require significant expenditures for some years to come. Thus the relative 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, distributional and resource struggles are destined to remain strongly intertwined in future debates and policy-making struggles in the New Europe.

At least potential weaknesses of this paper are worth addressing. This paper may over-emphasize the actual role of the investment promotion schemes pursued by different Central and East European countries. The counterfactual that such investment would not have flowed to Central and Eastern Europe without such investment incentives is hard to disprove. In response to this objection, the degree and shape of foreign investment might well have been very different. Though Hungary was prepared quite early to engage in significant privatizations and allow significant foreign investments, it still felt compelled (even without regional inter-state tax competition at this early stage) to offer significant incentives to investors. This single point remains 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 Central and East European countries. As already suggested by the analysis above, there is a considerable amount of variation in the economic development strategies that the different countries of Central and Eastern Europe 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 have not even been discussed—such as Slovenia’s resistance to foreign capital or Estonia’s more neo-liberal approach. Further exploring the depths of these differences, their outcomes and the factors that explain them should ultimately provide a richer understanding of the future developmental prospects of Central and East European states.

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Table I: Proposed EU Expenditures on Structural and Cohesion Funds 2006-2013

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

Table II: Average Rates of Corporate Taxation 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 Old EU Member States), 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).

Table III: 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%

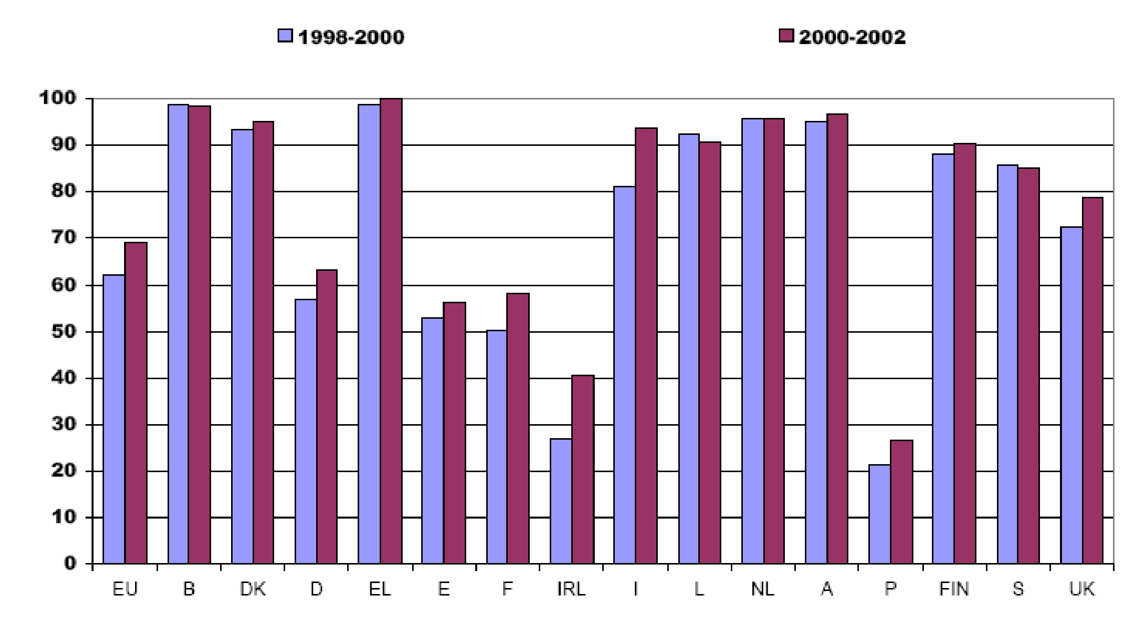
Source: Calculated on the basis of data from the OECD International Direct Investment Statistics (2001).

Table IV: 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).

Figure I: Share of State Aid Spent on Horizontal Objectives, 1998-2002



Source: European Commission (2004b: 21).