

The
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Resource Struggles, and
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Abstract

Within the context of neofunctionalist and intergovernmental models, European integration—and thus membership in the European Club—is typically seen as a win-win proposition. Viewed through the lens of economic models based on increasing returns or literature on the developmental state, the advantages of European integration become more ambiguous. This essay argues that the incorporation of the Central and East European states into the European Union ultimately favors Western interests. Based on an analysis of Hungary's Great Transformation, I evaluate the compatibility of the EU policy framework with Hungarian and other Central and East European interests in economic development. Forced to abandon many competitiveness tools, new member states may find the EU policy framework less accommodating and quite possibly more constraining. Western states benefit from the enlargement by raising the degree of policy control over Eastern states.

Glossary

APV Rt – Hungarian Privatization and Holding Company
CEE – Central and Eastern Europe(an)
CEEC's – Central and East European countries
CRC's – Cooperation Research Centers
EMU – Economic and Monetary Union
EU – European Union
FDI – Foreign Direct Investment
GDP – Gross Domestic Product
HUF – Hungarian Forint
IFTZ's – industrial free trade zones
ITR – Implicit Tax Rate
MFB – Hungarian National Development Bank
MNC 's – Multinational Corporations
MVM – Hungarian Power Companies Ltd.
NMS's – New Member States
OMS's – Old Member States
PAKS – Hungarian Nuclear Power Plant
R&D – Research and development
SCF's – Structural and Cohesion Funds (of the European Union)
SME's – Small and Medium-sized Enterprises

The “New” Europe provides a fascinating testing ground for assumptions about the relative efficacy and feasibility of supranational versus national-level decision-making arrangements. Neofunctionalist models assume the supranational level of European decision-making will yield more efficient, welfare-enhancing policy outcomes—thereby “upgrading the common interest.” Intergovernmental models suggest policy outcomes are a product of power struggles between states. Due to variation in relative power across states, winners and losers are a likely outcome. While all states are considered net winners, losses are possible in individual policy areas. Dropping the assumption of perfect information (common to the intergovernmental approach), I argue that states—due to uncertainty (imperfect information)—can be “net losers” as well.¹ In particular, newcomers to the European Club not present at the inception of individual policies are likely to suffer the consequences of policy mismatch.

Economic competitiveness debates are highly relevant to the more general political science literature on European integration. Nestled in the reassuring world of traditional trade theory, European economic integration easily fits the mold of the intergovernmental and/or neofunctionalist models. The presumed welfare-enhancing effects of economic integration lead authors to view membership in the European Union (EU) as a win-win proposition. Yet the factors that drive the creation of dynamic economies remains disputed in academic circles. Seen through the lens of economic models based on increasing returns, or placed in the context of developmental debates, conventional interpretations of what drives European integration—and in particular the so-called Eastern enlargement—rapidly become more problematic.² For less-developed economies, uncertainty arises in particular from the potential impact of economies of scale, external increasing returns, and economic geography.

The essay blends two literatures—one on the developmental state and the other on European integration—to analyze the policies employed to promote economic competitiveness and development in both pre-accession states and the New Europe. It explains Hungarian economic success and analyzes the compatibility of Hungarian interests with the EU policy framework. EU models of economic governance have progressively circumscribed Central and East European (CEE) policy strategies, gradually forcing the elimination of many of the more successful pre-accession tools. The Lisbon strategy, the EU’s structural and cohesion funds (SCFs), competition policy, and rules regarding the use of state aids will likely come to define a nexus of heated policy debate in the New Europe.³ By implication, one Western motivation for the Eastern enlargement stemmed from an interest in restricting the policy

strategies of CEE states. Competing policy preferences and the divergence of policy interests in the New Europe are a likely outcome of these debates.

In the first section, I discuss the strategies pursued by the Central and East European countries (CEECs) prior to EU membership. Next I consider the current and evolving EU policy framework. The third section reveals potential weaknesses of current economic development in Hungary and then ponders the compatibility of CEE interests with the EU policy framework. The conclusion follows.

Competitiveness and the Struggle for Resources

Economic competitiveness is the subject of much debate both within and beyond the borders of Europe. The advent of EU membership for ten new less-developed states has resulted in a renaissance of literature on economic competitiveness.⁴ This essay addresses economic development in Central and Eastern Europe. Given that EU membership further intensifies economic competition across the borders of the New Europe, concerns about future CEE prospects are at a new pitch, focusing renewed attention on EU policy measures intended to assist the new member states in promoting sustainable, long-term economic development. The Lisbon strategy, the EU's SCFs, competition policy, and rules regarding the use of state aids define a nexus of highly salient and potentially heated policy debate in the New Europe.⁵

What drives economic competitiveness and the creation of dynamic economies is hotly contested in academic and intellectual circles. For many, the answer lies in the complete elimination of barriers to trade and the establishment of free market entry (Sachs and Warner 1996). For others, the key lies in removing the state from its involvement in the economy.⁶ Others argue for inflation targeting (Fischer, Sahay, and Végh, 1996). For others still, economic competitiveness is a function of the government's role in market-supporting activities, in particular the development of infrastructure and human capital. This approach likewise places a considerable emphasis on the importance of institutions (Kolodko 2000, chap. 5; Rodrik 2002). The potential role of *external* increasing returns, economies of scale, and economic geography introduce a further degree of uncertainty regarding the consequences of economic integration—in particular for less-developed economies.⁷

In recent years, strong intellectual and ideological claims, strengthened in particular by globalization, have reinforced and supported a shift away from state involvement toward a more neoliberal agenda. There are essentially three core elements of the neoliberal agenda. The first involves a narrow attack on the state and its interventionist role in economic affairs.⁸ The second involves a much broader

attack on the fundamentals of the practice of *import substitution industrialization* and promotes in its place *export-led industrialization* or, even more broadly, what has come to be referred to as the Washington Consensus. The Washington Consensus in particular strongly advocates the role of the market at the expense of the state, exposure to international competition, and the free movement of capital and goods.⁹ The third core element involves the rollback of the welfare state.¹⁰

For states seeking economic development, the Washington Consensus and its implied neoliberal agenda has posed perhaps the most direct threat to national decision-making autonomy and government intervention. Controversial from the start,¹¹ the Washington Consensus prescribes a set of policy measures for states seeking to become more economically developed.¹² In response to Washington Consensus and non-state interventionist views, a number of authors focus instead on the consequences of the withdrawal of the state from the role of economic management. Weiss (2003) and others argue that globalization, rather than constraining the behavior of states, has increased the likelihood of reliance on, and the potential importance of, the state. Rodrik has consistently criticized the wisdom of removing the state from the realm of economic management. His early analysis of the Latin American and East Asian cases suggests the role of government was fundamental to explaining the relative success of the East Asian Tigers (1996).¹³ More recently Rodrik has shifted attention to China and India, suggesting again that the role of the state is crucial in explaining overall economic performance (2002).

While the notion of the *developmental state* may have lost credibility in the late eighties and early nineties, many authors argue that the involvement of the state is crucial for achieving successful and sustainable economic development (see, e.g., Beeson and Islam 2004; Beeson 2003; Weiss 2003). 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

Authors writing on CEE suggest these countries have done better than countries further east (including Russia) precisely because they chose not to follow a strictly neoliberal approach to economic adjustment and renewal (Kolodko 2000, chap. 5; 1999; IMEPI-RAN 2001). National-level CEE competitiveness strategies vary considerably. While the Hungarian case exhibits similarities with other countries in the region, it also shows important differences. For one, compared to most CEECs, Hungary started quite early both with an extensive project of privatization and a comparatively dynamic program for attracting foreign direct investment (FDI). Hungary was the principal CEE recipient of FDI during the period from 1989 to 1997, while

other CEECs only began catching up after 1997. Looking at accumulated per capita FDI stocks, Hungary remains the principal investment target in CEE (Sass 2004). This relative success at attracting FDI requires explanation. While many might cite investor anticipation of EU membership, such explanations fail to account for why Hungary quite early on was so much more successful at attracting FDI than other countries pursuing EU membership (e.g., the Czech Republic, Poland, Estonia, or Slovenia).

Two questions emerge from the above discussion. First, in the context of the developmentalist literature, we would like to know what factors best explain Hungarian and CEEC economic success. As argued below, Hungary and other CEECs were no strangers to state-led involvement in the economy. Hungary provides an interesting case study in the context of the developmental state literature. I will strongly argue that state involvement played a crucial role in Hungary's economic development.

Second, in the context of the European integration literature, we would like to know to what degree the continued economic development of Hungary and other CEECs is ensured by EU membership. Given the relative importance of economic growth, an analysis of the compatibility of EU policy approaches with CEEC economic development policies and interests provides a compelling test case for neofunctionalist and intergovernmentalist arguments that all states tend to benefit from European integration.

As argued more vigorously elsewhere (Ellison 2006a) current neofunctionalist and intergovernmentalist accounts may overstate the advantages of EU membership. While intergovernmentalist accounts argue that due to power asymmetries some states can be net losers in individual policy areas, both approaches assume that—in the aggregate—all states benefit from European integration. However, due to the tremendous uncertainty surrounding the potential gains from EU membership, the new member states may also lose in the aggregate. In particular, EU enlargement may ultimately favor the older and more advanced EU member states at the expense of the less-advanced new members. A more complete test of this proposition must ultimately consider a much wider range of policy areas than possible here.¹⁵

The development strategies used by Hungary and other CEECs to promote economic growth and development have important implications for the potential compatibility of CEE interests with the basic features of the EU policy framework. While I focus predominantly on Hungary, some data and related conclusions are drawn for other CEECs. However, I do not claim that all CEECs have been constrained by the EU policy framework. It is certainly possible that, for some countries, EU membership has offered more benefits than suggested herein.

Investment Promotion Strategies and the Foundations of Economic Growth

Throughout the 1990s, the CEECs were primarily focused on the shift from centrally planned to market economies and on the privatization of industry. Hungary in particular was remarkably successful at attracting FDI and privatizing the economy. As Hunya notes, the degree of foreign penetration of the Hungarian manufacturing sector is extensive: in 2001, some 72.5 percent of output 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 percent of trade (64). In 2001, such manufacturing firms played a determinant role in net sales revenue (72.1 percent), value-added production (64.9 percent), and were responsible for 45.1 percent of manufacturing employment (Szanyi 2003a, 28).

Tax benefits/holidays, monopoly concessions, as well as protective trade barriers have all been introduced in order to encourage investment.¹⁶ A significant number of the firms benefiting from these concessions are foreign, and the early laws explicitly favored foreign investors. While Hungarian firms likewise benefited from these arrangements, foreign firms—due either to outright favoritism or the magnitude of required investments—were often the principal beneficiaries.

Investment promotion incentives were introduced in Hungary beginning in 1988, prior to the collapse of the East Bloc (see appendix table 1).¹⁷ Though these schemes evolved from 1988 to 2003, there is remarkable continuity. Firms investing large sums in the Hungarian economy received significant tax concessions, including five- to ten-year tax holidays of 50 to 100 percent on earned profits. In the early years, tax concessions explicitly favored foreign investors, in particular in select manufacturing activities.¹⁸ These tax concessions were gradually broadened in 1995 to include all investments (foreign and domestic alike), but required ever larger initial investments (rising from 25 million to 10 billion HUF between 1988 and 2002). Other requirements included increases in exports, turnover, or the number of jobs created. From 2003 on, investment promotion incentives were brought into compliance with EU competition policy norms and began to shift toward building stronger ties between large firms and domestic small and medium-sized enterprises.

Further investment incentives were promoted with “industrial parks.” Prior to 1996, they were financed predominantly through FDI (Rakusz 1999, 97), but later the Hungarian government progressively promoted industrial parks, in part as an attempt to foster the development of small and medium-sized enterprises. From

1996, firms investing in such parks were eligible for a five-year tax holiday (Éltető 1998, 11–12). In addition, the government dedicated 400 million HUF to their development in 1996 and 800 million HUF per year from 1997 to 1999 (Rakusz 1999, 98). In 2004, there were some 165 industrial parks encompassing 2600 firms with an output of 4700 billion HUF; they exported 72.3 percent of that amount (www.gkm.hu Oct. 27, 2005).

Additional investment funds were made available, including grants, interest-free loans, interest subsidies, and even direct state participation. Between 1991 and 1994 the Investment Incentive Fund distributed approximately 100 billion HUF to ninety-eight different “high technology” projects, primarily the automotive industry and suppliers. This investment fund was replaced by two new funds in 1995, the Economic Development Fund and the Allocation Fund (Éltető 1998, 10–11). The government also offered tax reductions in the first year for investments in research and development (R&D) activities for up to 20 percent of initial investment costs (Szanyi 2003b, 16).

Hungary further promoted industrial free trade zones (IFTZs). First introduced in 1982, they offered several advantages (Sass 2004, 75; Antalóczy and Sass 2001; Antalóczy 1999). Companies could import equipment, machinery, and other production inputs free of import duties and take advantage of local labor. They were further eligible for the above-noted investment promotion incentives, but were only permitted to produce for export. Over one hundred firms set up IFTZs by January 2002. They rapidly grew to produce a significant share of Hungarian exports. Between 1995 and 1998, their share of exports rose from 10.6 percent to 36 percent (Antalóczy 1999, 59).

Sass (2003) argues that fiscal incentives played an important role in attracting foreign capital. Other countries in the region did not attract comparable amounts of FDI until 1997 and beyond, when they began adopting similar investment policies—long after the Hungarian market was substantially saturated. Poland, the Czech Republic, and Slovakia never established IFTZs, and the Czech Republic and Slovakia only began to create industrial parks after 2000 (Sass 2003, 17).¹⁹ Hungary was likewise the first country in CEE to begin privatizing its “core” strategic industries. Other CEECs resisted privatizing sectors such as energy, banking, telecommunications, and chemicals until 1994 or 1995 (Mihalyi 2001, 72). These factors, as well as legislative decisions granting foreign investors easy and broad access to Hungarian industry, helped Hungary to attract more investment capital than other CEECs.

Hungarian tax benefits account for a significant share of state aid. Depending on whether state support for the railroads is excluded, state aids in the form of tax benefits amount respectively to 76.8 percent or 46.4 percent of all state aids in the year 2000. Between 1998 and 2000, tax benefits amounted to between 72.9 percent and 76.8 percent of state aid (State Aid Monitoring Office 2002, 17, table 9). In previous years, the share of tax benefits in overall state aid was smaller (58.7 percent and 58.2 percent in 1996 and 1997 respectively), but the government then granted substantially more direct support to the steel sector. 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 (2000, 21, table A2; 2002, 35, table A2, 37, table A4).

Investment promotion incentives and other fiscal measures appear to have played an important role in several CEECs. Measured in per capita terms, FDI stocks are greatest in Hungary, the Czech Republic, Slovakia, and Poland (Sass does not provide data on Estonia) (Sass 2003, 14). Investment promotion incentives appear to play a strong role. As noted in the “State Aid Scoreboard,” over the period 2000–2003, 86 percent of the total state aid in CEE was spent by three of these countries; Poland, the Czech Republic, and Hungary (European Commission 2004c, 5). As noted above, and in order of magnitude, Slovakia (72.4 percent), Hungary (61.5 percent), Latvia (57.1 percent) and Poland (34.5 percent) likewise granted the largest shares of state aid through tax exemptions. While Estonia appears an outlier, its investment promotion was not classified as state aid. Despite the smaller window of opportunity in the Czech Republic, Poland, or Slovakia, it has been used to their advantage.

Arrangements of this type ran afoul of EU competition and state aid policies during the accession negotiations.²⁰ In December 2003, a government decree introduced EU-required aid-intensity limits on investment promotion. On the basis of the amended 1996 tax law, firms investing 10 billion HUF in developed regions and 3 billion HUF in less-developed regions were eligible for tax deductions up to 35–50 percent of the original investment depending on the region in which the investment took place (no longer a 0 percent rate on all Hungarian operations over a ten-year period as under the 1998 law).²¹ This deduction could be carried forward up to five years or until 35–50 percent of the original investment had been deducted. Qualifying as “regional development,” the revised strategy no longer contravenes EU state aid restrictions.

Hungary was likewise required to revise many of the agreements made with foreign investors between 1996 and 2002. According to representatives from the Hungarian Ministry of Finance, these revisions essentially allowed large investors

who started investments prior to January 2000 to recoup up to 75 percent of the “eligible investment costs” and, for investments occurring after January 1, 2000, up to 50 percent. Special agreements were put into effect for the auto industry, reducing these limits even further (European Commission 2002, 19). As IFTZs were deemed incompatible with EU regulations, Hungary and other CEECs were required to abolish them. However, given the very high share of trade with the EU and the free movement of single market goods, the impact was presumably negligible.

The January 2003 changes to the corporate tax law raised concerns. Foreign direct investment—despite Hungary’s remarkable ability to attract foreign capital in the early transition years—began to decline. Apart from the general decline in 2001 and 2002, some blamed the 2003 law. The Hungarian corporate tax rate was further amended in 2004, reducing it from 18 percent to 16 percent.²² As suggested by representatives from the Ministry of Finance, the Hungarian government would not have adopted the January 2003 revisions had it not been for the obligations of EU membership (Interview 2003). Whether or not these factors are directly responsible is more complex. For one, FDI inflows rose again substantially in 2004. For another, the end of privatization in Hungary and world business cycle effects also played a role.

Other methods used to attract foreign capital were also threatened by EU membership. A number of “concessionary” or monopoly agreements were negotiated with foreign investors in order to attract sizable investments in infrastructure. In the case of Matáv (the Hungarian telecommunications company, now fully owned by Deutsche Telekom), the government was able to attract FDI by guaranteeing an eight-year monopoly in telecommunications (Szanyi 1993). Without this arrangement, Matáv might not have been able to put together the capital necessary to rebuild its telecommunications infrastructure.²³ Similar arrangements were made in the mobile telephone sector with first two and then three foreign investors. Initiated in 1992, the monopoly agreements in these sectors were renegotiated in 1994 to admit one additional market player.²⁴ Both concession arrangements were terminated as one of the conditions of EU membership.

Similar arrangements were made in order to promote investment in the construction of Hungarian motorways or the privatization of Hungarian power plants. Apart from the publicly owned MVM (the Hungarian electricity company controlling the national electrical transmission network) and PAKS (the Hungarian nuclear power plant), all remaining power stations in Hungary were privatized with the help of preferential agreements including long-term 8 percent profit guarantees. EU membership has affected only some of these agreements. In the energy sector, for example,

the complete liberalization of the energy grid was introduced as of 2004 (for all nonhousehold energy consumption) and was in 2007 (for all consumption). How this will affect the preferential purchase agreements remains unclear. It will likely have a negative impact on MVM's bottom line.²⁵ Most of the Hungarian motorway agreements ran their course prior to the final date of enlargement.

More recently, Hungarian strategies have shifted away from simple capital attraction schemes to strategies promoting the diffusion of knowledge and technology and the continued clustering of economic and related R&D activity. While many fiscal mechanisms have been curtailed or reduced in scope, a new generation of programs is being put in place. In response to the deficiencies of previous capital-seeking strategies, these programs hope to expand R&D and build upon potential synergies between firms and research institutions. The government's "Smart Hungary" program applied to investments as of December 31, 2002, and offered additional incentives to support the development of R&D capacity. Firms investing in R&D were able to deduct up to 200 percent of those costs from their corporate tax base.²⁶

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 are most enthusiastic about the development of Cooperation Research Centers in 2001 funded by government grants of between 0.2 and 1 million USD and established at different universities in Hungary with the goal of including business partners in their research activities. Centers have been established in Budapest (two), Pécs (in cooperation with partners in Budapest and Szeged), Veszprém, and Szeged. Further projects have been established since this initial set of five. Furthermore, the cooperative research these centers engage in is eligible for tax deductions (22–23). Other projects the government has initiated appear less successful.²⁷

Buzás and Szanyi are less enthusiastic about the advantages of industrial parks. As noted by the Association of Hungarian Industrial Parks, there were 165 industrial parks distributed throughout Hungary by May 2004.²⁸ Buzás and Szanyi note that Infopark in Budapest—one of the more successful—brings together the Ministry of the Economy, the Prime Minister's Office, two Budapest universities, and has attracted the participation of large firms (Matáv, IBM, Hewlett Packard, Nortel, and Panasonic). However, Infopark has not been successful at attracting further investors or centralizing information sharing, leading individual firms to create their own services and minimizing technology sharing (2004, 28).

Thus significant progress on the path to economic growth appears to have been facilitated by the tools of state intervention in Hungary. Joining the EU has

ultimately had the effect of reducing the potential effectiveness of such policies. The following section asks whether the EU policy framework is compatible with CEEC competitiveness and economic development concerns.

Adopting the EU Policy Framework

Several elements of the EU policy framework target the problem of competitiveness and economic development and are of potential interest to the CEECs. In the context of the Eastern enlargement, at least three policy areas exhibit strong potential for diverging interests: (1) the future distribution of SCFs; (2) debates over corporate taxation; and (3) the role of state aids and competition policy.

Structural and Cohesion Fund reform provides evidence of the potential divergence of interests in the New Europe. The UK's vision of future EU regional policy is expressed in *A Modern Regional Policy for the United Kingdom* and recommends both concentrated EU regional policy spending on the least-advanced states along with a renationalization of regional policy for the more-advanced states (Department of Trade and Industry, 2003, 25–28). Further, the Lisbon Agenda and in particular the Sapir Report have launched a debate that may forever change the face of EU regional policy.²⁹ This debate addresses the divide between innovation-oriented and redistributive policy goals and lays bare much of the core of current distributional struggles over the future shape of EU regional and industrial policy (see Ellison 2006c). Renationalization appears more strongly supported by “net contributors” to the EU budget (in particular Germany, the Netherlands, Sweden, Austria, and the UK). On the other hand, the new member states have strong incentives to maintain or increase SCF spending.

The more advanced Western, net-contributor states appear less and less willing to dedicate significant resources to economic and social cohesion. The amounts set aside in the commission's initial February 2004 proposal for Financial Perspective 2007–2013 provided only minor increases over previous amounts (see appendix table 2).³⁰ Between 2006 and 2007, total EU spending would have increased by 10 percent (when Bulgaria and Romania join), but by much smaller amounts in following years. Seen in per capita terms, the amounts remain almost constant between 2006 and 2007, rising from 0.26 to 0.27 euros per person, easily erased by inflation. These amounts are startling in the context of the commission's *A New Partnership for Cohesion: Third Report on Economic and Social Cohesion*, which notes a doubling in the EU population living below 75 percent of the EU average per capita GDP in 2007 (European Commission 2004a, ix–x).

Despite no mention of renationalization in the *Third Report*, the final spending amounts agreed between the Council of Ministers and the European Parliament in April 2006 represent a significant start in that direction. Total spending has been reduced from an average of 1.14 percent in the February 2004 proposal to 1 percent of EU GDP for the 2007–2013 Framework Perspective. Total spending on the SCFs was reduced from 344.9 million to 308 million euros. While this drop was outpaced by a greater decline in Lisbon type expenditures (the “Competitiveness, Growth and Employment” category in Table II), the overall 1 percent cap on EU spending favored by the net contributor states ultimately means resources will be freed up at the national level.³¹ The CEECs, on the other hand, will be required to pick up a far greater share of the economic restructuring and adjustment tab than former cohesion countries.³²

Debates over corporate taxation exhibit a similarly strong insistence on national interests. Wrangling over EU tax harmonization was initiated by Chancellor Gerhard Schröder in March 2004, two months prior to the enlargement date. Germany, supported by France and other countries, led the charge against the comparatively low corporate tax rates offered in the CEECs. Schröder complained of “fiscal dumping,” noting that these countries have average corporate tax rates below 20 percent, while the West European average hovers around 31–32 percent. Several states, including Germany and Sweden, argued that low corporate tax rates in CEE were being propped up by EU funding. France and Germany, occasionally joined by Poland, launched an attempt to introduce a minimum rate of corporate taxation, and France’s finance minister, Nicholas Sarkozy, explicitly linked SCF spending to compliance with a future EU-regulated minimum level of corporate taxation. The CEECs—including Poland—opposed this effort.³³

Corporate taxation issues predate the December 2002 membership agreement (see, e.g., Radaelli 2001). Estonia’s “liberal” corporate tax regime was criticized by then Commission President Romano Prodi as a potential “problem” as early as March 2002. France, Italy, and Spain were concerned that Estonia’s rates constituted an “unfair” competitive advantage.” Presumably in response to the enlargement, several countries in Western Europe lowered their corporate tax rates. In particular, effective January 1, 2005, Austria lowered its rate from 34 percent to 24 percent. Germany likewise lowered its federal corporate tax rate from 40 percent for retained earnings and 30 percent for distributed earnings to a flat rate of 25 percent in January 2001.³⁴ Germany is considering a further reduction to 19 percent.³⁵

While enlargement may bring corporate tax harmonization to the bargaining table, several countries will resist. The UK insisted on retaining the right to a

national veto on taxation in the proposed constitutional treaty. Moreover, Britain appears steadfastly opposed to any move toward tax harmonization.³⁶ Both Cyprus and Ireland—currently sporting the lowest corporate tax rates in Europe—have every reason to continue to oppose harmonization. Thus, given CEEC opposition and the unanimity requirement, corporate tax rates are not likely to be harmonized any time soon. However, some old member states concerned with the consequences of corporate tax competition in the New Europe may still link this issue to others (in particular the SCFs) and either pressure the new member states into compliance or lobby for a gradual phasing out of the SCFs.

Justifying the need for corporate tax harmonization across countries is more problematic. Appendix table 3 provides data on statutory and implicit tax rates³⁷ across regions. There are significant differences between the unweighted average rates in the old member states and the CEECs (29.5 percent and 20.6 percent using statutory, and 29.9 percent and 15.1 percent using implicit tax rates). Average rates across the Old and New Europe (EU27) suggest a potentially significant drop from the previous average rate of corporate taxation (29.5 percent to 25.5 percent, or 29.9 percent to 25.5 percent respectively).

Population-weighted average corporate tax rates potentially provide a more relevant yardstick. Although some countries have quite low rates of corporate taxation, the relative size of the employable population provides something of an upper bound on investment. Weighted averages across the Old Europe and the CEECs remain significantly different (33.6 percent and 20.6 percent using statutory, or 30 percent and 19.5 percent using implicit tax rates). But differences across the Old and the New Europe (EU27) are small (33.6 percent and 30.8 percent, or 30 percent and 28.5 percent respectively). Given the recent rise in effective rates due to the requirements of EU competition policy, differences between implicit average corporate tax rates is likely to be somewhat smaller.

Data on the FDI behavior of the old member states and the United States (see appendix table 4) suggest that relative to investment in the European core (the old states minus the cohesion countries: Greece, Ireland, Portugal, and Spain), capital has not been pouring into CEE. While a few countries exhibit a shift in their regional FDI strategies—pronounced for Austria but moderate for Germany—the remaining Western states typically exhibit a mild shift in their investment behavior toward CEE. The majority of old member states have investment shares in CEE around or below 5 percent of total investment in the former European core. In 2002, France's CEE FDI, for example, amounted to 5 percent of its European core investments.

In Germany, however, CEE investment represented a good 10 percent of its European core investments in the same year. Oddly, Austria, though so far not a party to the complaints of France, Germany, and Sweden, has witnessed extraordinarily high rates of investment in CEE. Greece as well remains an outlier, with CEE investments almost equaling investments in the European core in 1998, though tapering off quickly in later years. For other countries as well, there has been some leveling off or reversal of investment trends in CEE in more recent years.

Data on the shift in the FDI behavior of old member states and the United States from the former cohesion countries (Greece, Ireland, Portugal, and Spain, see appendix table 5), suggest that much of the investment in CEE may well occur at their expense. The relative share of investment in CEE has risen extremely rapidly for Austria and significantly for Denmark, Finland, and Germany. Though this pattern is not typically accompanied by a decline in absolute FDI figures in the former cohesion countries, in the absence of the fall of the East Bloc a share of CEE investment might well have gone to the former cohesion countries.

Competition policy and the role of state aids likewise remain high on the EU agenda. As noted above, several new member states were required to substantially modify generous tax holidays and other investment promotion schemes. Ultimately, the EU viewed these methods of promoting FDI as state aids, and Hungary and other countries were required to dismantle or modify them.

EU industrial and state aid policy has begun a shift toward “horizontal” measures and eschews sectoral or “vertical” state aids. Horizontal state aids are those focused on broadly applicable principles of economic development (human capital development, infrastructure, R&D), and thus are potentially useful to a broad range of economic sectors. Sectoral or vertical state aids frequently prop up declining economic sectors and/or firms (e.g., the coal, steel, clothing, and textile sectors in Western Europe).³⁸ Across the EU as a whole, however, some 51 percent of member state aid still goes to the manufacturing sector, suggesting states themselves are unwilling to relinquish vertically oriented interventionist traditions (European Commission 2004b, 13).

The EU continues to permit vertical intervention in two sectors: agriculture and railways. Although the shift to horizontal measures has typically not affected agricultural policy, the June 2003 reform of the Common Agricultural Policy introduced a general but extremely gradual trend toward the elimination of direct agricultural supports and their replacement by rural development. While aid to the railway sector is typically detailed in the European Commission’s “State Aid Scoreboards,” it remains a separate category not subject to state aid restrictions.

Regional policy remains somewhat more firmly rooted in vertical interventionist traditions. Within the framework of the EU's state aid regulations, states are permitted to engage in national projects of regional development. While the commission's "State Aid Scoreboard" classifies regional aid as "horizontal," regional aid is far more likely to benefit individual firms and investors. Though national-level aid can be distributed using broad neutral criteria, given the scale of regional and local development strategies, projects are more likely to benefit or target individual firms and are only subject to EU aid-intensity criteria. In 2002, some 31.5 percent of EU horizontal aid was defined as "regional" state aid (European Commission 2004b, 20).

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

Whether horizontal or vertical measures are best suited to solving the economic development and restructuring problems of the CEECs should perhaps be at the core of debates in the New Europe. Germany recently raised objections to the strictures of the Lisbon Agenda, arguing that investment promotion schemes are the best tool for attracting firms to less-developed German regions.³⁹

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 have made the smallest transition toward horizontal state aid over the period 1998–2002 (see figure 1). Portugal, Ireland, Spain, and France exhibit the highest share of vertical state aid, ranging from 26 to 58 percent. In contrast, only eight member states distribute more than 90 percent of aid through horizontal measures, while two further states (Sweden and the UK) distribute significantly large shares of horizontal aid. Two of the more advanced EU member states—France and Germany—distribute significantly large shares of vertical aid. Greece appears to be an outlier and distributes surprisingly few resources through vertical measures. However, 74 percent of Greek state aid is for regional development, the highest share of any single EU member state (European Commission 2004b, 14, 20).⁴⁰

Vertical state aid measures are the norm in CEE. In Hungary, horizontal measures accounted for only 8.2 percent and 9.3 percent of state aids in 1999 and 2000

respectively.⁴¹ The autumn 2004 update of the “State Aid Scoreboard” includes data on state aid expenditure in CEE over the period 2000–2003. According to this report, the findings for Hungary are generally consistent with findings for the broad range of CEECs. On average, the new member states spent some 78 percent of state aid on vertical measures. Estonia is the sole outlier, with 100 percent of state aid spent on horizontal measures. As with Greece, some of this aid is for regional development (33 percent, the largest single category in Estonia). However, Estonia’s investment promotion strategy (see below) was not classified as “state aid” and thus not recorded in these figures. Apart from Estonia, all the CEECs still have significant vertical state aid expenditures (European Commission 2004c, 21).

Tax exemptions are the typical form of aid. Apart from Cyprus (80.9 percent) and Malta (36.6 percent), Hungary (61.5 percent), Latvia (57.1 percent), Poland (34.5 percent), and Slovakia (72.4 percent) 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).

While the EU was previously more generous with acceding countries—in particular Spain, Portugal, Greece, and Ireland—the Eastern enlargement has witnessed a significant reduction in EU regional expenditure. This shift is likely to weigh heavily on the new member states. Moreover, EU distributional politics—as witnessed, for example, by the struggle over foreign capital resources—have only become more pronounced. Finally, development policies themselves have changed in ways that may not benefit the less-advanced regions in Central and Eastern Europe.

FDI, Economic Development, and the Constraints of EU Membership

Something of a consensus is emerging in CEE about the need to go beyond simple privatization and industrial restructuring. While this literature typically does not criticize privatization or FDI, it does suggest the accumulation of foreign capital alone may not be sufficient to achieve sustainable, long-term patterns of economic development. As Szanyi points out, previously the principal indicator of economic competitiveness was thought to be the introduction of technologically sophisticated production techniques. Current research suggests the actual technology and knowledge content of the work performed in CEECs more strongly emphasizes the

assembly of products and less frequently their design and development. Thus theoretical and empirical work has begun to measure the share of the local contribution (Szanyi 2003c, 2003a, 21).

Four points are most relevant to determining whether multinational affiliates and/or domestic firms have developed sustainable, long-term patterns of economic development. First, to what degree do the activities of Hungarian affiliates transcend simple assembly work and involve the accumulation of organizational and research-related tasks in the hands of affiliates or supplier firms (*embeddedness*)? Second, to what degree does the presence of foreign multinationals lead to technology spillover to other local firms? Third, to what degree has the R&D activity of multinationals been transferred to local firms? Fourth, to what degree are domestic firms incorporated into the production (supplier) networks of larger foreign multinationals operating on domestic soil?⁴²

The relative degree of embeddedness of Hungarian affiliates is considered superficial (Szalavetz 2003). The degree of integration of Hungarian affiliates into the global production networks of foreign multinational partners is thin, that is, the range of potential responsibilities of Hungarian affiliates is limited by the demands of foreign multinational headquarters. Szalavetz finds that Hungarian affiliates of foreign multinationals are caught up in hierarchically fixed vertical production networks leaving them vulnerable to the whims of foreign capital and fluctuations in the international market. Pavlínek comes to similar conclusions, adding that vertical integration makes local firms more vulnerable to fluctuations in the international economy and to the strategic decisions of multinational firms (2004, 52).

The rate of technological diffusion is given low marks. While direct recipients of FDI have often seen significant changes in their technological capacity (Sass 2004, 81), the rate at which technology has diffused across firm boundaries is more controversial. Some analyses suggest the principal changes in productivity in the late nineties were the result of labor shedding rather than the introduction of new technology (Novák 1999). Evidence on technological spillovers is thin. Novák (2003), for example, finds only a marginal impact on domestic firms. Competition effects and the presence of linkages with foreign multinationals had a stronger impact on technological change. Pavlínek likewise surveys a number of authors who find little or no evidence for technological spillover (2004). Schoors and Van der Tol (2002) are among the few to find positive evidence for spillover. The principal barriers to technological spillover appear to be weak linkages with domestic firms and/or attempts by foreign affiliates to control the likelihood of spillover.⁴³

Important anecdotal examples of the transfer of capital, technology, *and* research and innovation potential exist. General Electric (GE) transferred both production and R&D activities to Hungary. Its investments in Tungsram resulted in the transfer of 90 percent of European production activity and 50 percent of global R&D activity (Berend, 2000: 58). A number of other firms made significant investments in R&D centers. Pavlínek notes that the motor-building part of Germany's Audi built a new R&D center in Győr in 2001, and the German truck and bus brake manufacturer Knorr-Bremse built an R&D center in Budapest in 1999. Further examples exist in neighboring countries (Pavlínek 2004, 62). The Hungarian Investment and Trade Development Agency points to evidence of R&D activities by some thirty large corporations (Kilian 2003, 14). And Sass notes that firms such as Nokia, Ericsson, Siemens, and Compaq have all transferred parts of their R&D activities to Hungary (2004, 81).

Satisfaction with the transfer of R&D activity is low. Pavlínek, for example, points out that there is an international hierarchy of R&D activities. Large multinational firms are likely to keep primary R&D activities close to national headquarters and may even transfer R&D activities from affiliates to multinational headquarters. When R&D activities are transferred to local affiliates, these are likely related to either local product development or small-scale applied research (2004, 59). All in all, Pavlínek is skeptical about the likely transfer of R&D activities. 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 percent of GDP in 1988. By 1999, this sum dropped to approximately 0.68 percent, a far cry from the Lisbon Agenda's suggested 3 percent of GDP. Expenditures for R&D in old member states average 1.8–2 percent of GDP (2001, 11–12). While few expect Hungary's R&D expenditure to reach pre-1989 levels, the gap between the old member states and CEECs is a cause for concern.

There are examples of increasing links between suppliers and multinational corporation affiliates in Hungary. Sass points to differences in the types of FDI and their relative impact on supplier networks. Privatization FDI, for example, led frequently to the maintenance of local supplier networks, while greenfield FDI (investment in new production facilities) is frequently associated with weak links between local suppliers and foreign affiliates (Sass 2004, 79). An interesting comparison in this regard is that between Czech and Hungarian car industry FDI. In Hungary, most car industry investment was greenfield investment (prior to World War II there was a Hungarian car industry; the socialist era Hungary focused primarily on the production of buses and some car parts). Thus, new foreign car industry FDI had no pre-existing network of suppliers organized around car assembly plants, leading presumably to

a low level of local integration (Sass 2004, 80). According to Pavlínek, the Czech privatization of Skoda led to the restructuring of Skoda's supplier network and thus to a greater level of local integration. At the same time, Pavlínek points out problems with the degree of embeddedness of local suppliers, noting only minor assembly operations for products primarily produced elsewhere (2004, 54–55).

Even with all the different government programs introduced to promote greater levels of R&D and technological diffusion, significant barriers persist. Taking Szalavetz's approach, local affiliates have insufficient latitude to deepen their sphere of responsibility vis-à-vis multinational headquarters. Ownership barriers make it difficult for affiliates of large firms to autonomously define their sphere of operation. Hierarchical relationships with multinational corporations may represent inflexible vertical barriers that impede the development of horizontal activities (see Sass 2004, 80). Domestic firms may be able to engage in such practices more easily than fully owned foreign affiliates. Videoton is a good example of a Hungarian firm whose diversified production strategies are not dependent upon production goals set by a multinational. Videoton acts as a publicly traded firm while foreign affiliates are 100 percent (or close to 100 percent) foreign-owned.⁴⁴

Both the degree of incorporation into global production networks and the degree of foreign ownership may prove a liability rather than an asset. The greater the share of foreign ownership in individual firms, the more difficult to promote deeper embeddedness in multinational production strategies. Affiliates that are 100 percent foreign-owned have little authority to engage in the diversification of tasks, whereas publicly traded Hungarian firms are potentially better positioned. The degree of foreign ownership may paradoxically hinder economic development goals.

Identifying which factors best explain the ability of CEEC's to go beyond economic growth to real economic development has become a primary focus of current research. Mere capital deepening may fail to create the foundations for long-term economic development. Capital deepening modernizes technology and improves productivity. But know-how, the capacity to produce new technologies, to innovate and promote long-term economic development may depend on other factors. Thus, achieving domestically driven economic growth and capital deepening may depend on the ability to independently spearhead technological innovation. Such an account does not denigrate the value of imported technology and capital deepening; by all accounts, FDI has explicit advantages.

Complete reliance on exogenous forms of technology and innovation may fail to create the necessary conditions for long-term, sustainable economic development. Moreover, complete dependence upon exogenous sources for capital deepening and

innovation further raises specific concerns about the footloose nature of investment capital for the future competitiveness and sustainability of CEE economic development. Such concerns are reinforced by discussion of the declining rate of FDI in Hungary and whether FDI is likely to move further east (Kalotay 2003a). Though FDI flows rose again in 2004, even with the inclusion of reinvested profits in the calculation of FDI flows (omitted by previous Hungarian FDI flow data), inflows in 2003 were almost half those in 2001 (Sass 2004, 68).

Though potentially overstated, examples exist of foreign multinationals leaving the territory to produce further east (Kalotay 2003a; Pavlínek 2004, 55–56). There are even examples of investors trying to minimize sunk costs to retain greater geographic flexibility. Pavlínek points to the example of a supplier firm that owns the machinery and equipment in a plant in the Czech Republic, but not the actual building (2004, 58). The smaller states are the most vulnerable to the strategies of the larger multinationals. The Czech Republic, Hungary, and Slovakia are currently dependent upon the strategic interests of individual firms; Volkswagen accounted for 14 percent of Czech and 16 percent of Slovak exports in 1999 (Pavlínek 2004, 63, 65). A significant share of Hungarian exports can be attributed to IBM.⁴⁵

The Hungarian National Development Plan, published as part of its application for EU SCFs for the period 2004–2006, outlines Hungarian concerns about declining levels of FDI and focuses attention on this shift in investment strategies. In particular this report emphasizes the goal of promoting 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).

Whether the EU policy framework is suited to the goals of long-term economic development remains an open question. Most of the previous measures employed to promote investment in Hungary were classified as state aids during the accession negotiations. As a result, these measures have been eliminated, reduced in scope, or modified into regional measures compatible with the EU policy framework. While many view the adoption of EU policy approaches as advantageous, this needs more thorough debate. What follows analyzes the impact of EU membership and adopting the EU policy framework on the potential for CEECs to pursue the objectives of economic growth and long-term, sustained economic development.

Some elements of the evolving EU policy framework are likely compatible with the interests of the more advanced CEECs. The shift in emphasis in Hungary from the simple attraction of FDI 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—is broadly compatible with horizontal EU

objectives. In this regard, Hungary, Estonia, and Slovenia have shifted more of their state aid to horizontal measures (European Commission 2004c, 21).

However, several potential problems emerge. The Lisbon Agenda's promotion of broad-based horizontal policy initiatives is primarily based on raising national-level expenditures and/or redirecting EU-level expenditures.⁴⁶ In this regard, it is potentially part of a redistributive renationalization plan. Most of the Lisbon Agenda—perceived as the new engine of economic growth and development within the EU—is focused primarily on state-level expenditures. To promote knowledge-based economies, states are urged to increase R&D expenditures to 3 percent of GDP by 2010, with two-thirds expected to come from the private sector.⁴⁷ Discussion of EU spending on the Lisbon Agenda is also firmly rooted in the context of movement away from vertical forms of state aid,⁴⁸ providing a venue for lobbying against EU funding practices. Further, increased domestic R&D expenditure is problematic for the CEECs given budgetary pressures.

Whether the EU's regional development policy and state aid framework provides enough flexibility to promote sufficient levels of investment, in particular in the less-advanced regions, is open to question. EU regional aid-intensity maps set precise limits on the share of nationally funded state aid. Aid intensities granted to individual investing firms in the pre-accession phase often exceeded these levels. Mutti and Grubert (2004) argue that multinational corporations producing for export rather than domestic markets are more and more sensitive to host country taxation. Thus this modification of CEE investment promotion schemes may significantly impact regional FDI flows.

The following observations serve to illustrate problems concerning reliance on the EU's regional development tool. For one, allowable aid-intensities for tax exemptions or grants are much lower in regions that have attracted the highest levels of FDI. Shifting investment and economic development to those regions that have thus far attracted less is potentially positive. But this may not augur well in conjunction with seemingly natural economic tendencies to “cluster” investment in regions with previously existing concentrations of economic activity (Martin 2003). Investors may simply choose to go elsewhere, making it difficult to capitalize on the last decade of economic restructuring and FDI flows.

Further, EU aid-intensities may be unable to attract sufficient investment to less developed regions in CEE. Investors may be more likely to avoid less-developed regions to the extent that infrastructure and human capital remain underdeveloped. Thus, the CEECs may be hamstrung by EU policies in several ways. Pressures to shift spending to Lisbon-type strategies may be inappropriate for less developed

CEE regions, and limitations on overall SCF spending in CEE may hamper the development of infrastructure and human capital resources.

Finally, limits on aid intensity may slow the further refinement of economic development. In particular, strategies targeting specific types of economic activity or promoting stronger ties between domestic and foreign firms may be among the most disadvantaged by EU policies. Hungary's focus on the sustainable and embedded development of the automotive and electrical engineering sectors—in particular regarding ties to domestic firms—could potentially be one of the early casualties of integration in the EU policy framework.⁴⁹ Further, the Lisbon Agenda's promotion of "private sector" resources, and the reduction in overall SCF resources, raises problems in the context of CEE capital scarcity. Though CEE governments feel compelled to fill the gap between the lack of private sector resources and their development interests, they are constrained by the combination of EU restrictions on aid-intensity, rising budget deficits, and the requirement of progress toward the EU's Economic and Monetary Union.

Many CEECs—Latvia, Lithuania, Bulgaria, and Romania—have had virtually no opportunity to introduce investment promotion mechanisms. Far less successful at attracting FDI, the slow process of transition has produced a lag that may be more difficult to overcome once inside the EU. As EU members, these countries will find it more difficult to initiate similar investment promotion schemes and attract comparable FDI inflows. All the above observations thus raise important questions regarding CEE ability to integrate seamlessly into the EU policy framework.

A number of potential criticisms can be levied at investment promotion strategies. For one, their shape varies across states. Hungarian strategies were strongly geared toward attracting large initial investments. Hungary did manage to avoid the potential pitfalls of a flat tax regime such as that later introduced in Slovakia.⁵⁰ However, since firms could benefit from ten-year tax concessions without additional investments, few incentives encouraged large firms to continue investing in the Hungarian economy. Estonia's strategy provides a meaningful comparison. Though its overall rate of corporate taxation remains high (23 percent on the distribution of dividends), Estonia adopted a 0 percent corporate tax rate for reinvested profits. Though criticized by the EU, this policy does not contravene EU regulations (Radaelli 2001).⁵¹ Thus modified policy features might have been optimal.

Further, tradeoffs may exist between government subsidized investment promotion schemes and the ability of governments to fund other policies such as social welfare expenditure, a policy that appears to have emerged with particular force in Slovakia (see, e.g., Greskovits and Bohle 2004, 23–25). Several caveats

deserve attention, however. For one, tax exemptions for large investments are not directly paid out of the government budget and do not necessarily reduce the existing budget, though they do represent potential losses in government revenues. For another, without such exemptions, FDI rates in Hungary and other countries might have been lower (with a parallel impact on government revenues). Finally, attracting large investments may result in significant sunk costs once tax incentive schemes run their course, thus providing a solid future tax base.

Two observations suggest that investment promotion schemes had significant payoffs for the average citizen in CEE. First, though the evolution of income inequality across CEE is uneven, Hungary and the Czech Republic in both 1989 and 2001 remained well below the average level of income inequality in the OECD in the mid-1990s.⁵² Poland, Estonia, and the other CEECs (Slovakia was not included in this measure), however, all rose above the OECD average by 2001 (UNECE 2004, 165–66). Second, the evolution of real wages is generally favorable for countries that pursued investment promotion schemes. Only four CEECs were able to achieve wage levels at or above 1989 levels by 2001: the Czech Republic, Estonia, Hungary and Poland (though Slovakia lags on this measure, the respective changes in government policy occurred in 2000 and 2004) (UNECE 2004, 167). These data suggest governments were able to secure future revenues and citizens benefited as well.

Another objection concerns the degree of tax competition between CEECs. Such an analysis may entirely miss the real axis of competition over investment resources in Europe. The CEECs are also competing with the more advanced European economies for investment resources. Significant advantages persist vis-à-vis Western investment locations—a significant supply of skilled and comparatively cheap labor. But the CEECs lack advantages present in the more advanced regions of Europe: highly developed infrastructure, a large pool of highly skilled labor, and long-established centers focused on R&D and product innovation. As suggested by regional FDI flows, CEE advantages have not significantly reversed European regional investment strategies.

The problem of capture likewise deserves attention.⁵³ Hungary's approach was strongly focused on moving firms out of the sphere of state ownership. This strategy of large-scale privatization was pursued earlier in Hungary than in other CEECs.⁵⁴ Significant concessions were granted to foreign investors to assist the state in the process of privatization (including monopoly control and/or protected markets) and the later promotion of investment in greenfield projects (Antalóczy and Sass 2001, 44). However, Hungarian investment promotion schemes employed neutral performance criteria not directed at individual firms (though early policies clearly

avored foreign investors). Any firm was eligible to receive tax exemptions from the government (neutrality) and exemptions were based on investment amounts and occasionally export, output or employment criteria (performance-based).

Other countries held on to large state enterprises and provided direct subsidies longer than presumably advisable. While slow privatization—for instance, in the Czech Republic—may have mitigated the negative employment effects of transition, it resulted in significant costs.⁵⁵ Poland pursued a conscious strategy of “commercializing” state-owned firms (Kolodko and Nuti 1997, 26). Yet the slow restructuring of the steel sector imposed heavy costs on the Polish state budget.⁵⁶ According to Protocol No. 8 of the Accession Treaty, Poland spent some 62.4 million PLN (approx. \$15.6 million) in restructuring aid between 1997 and 2001 (*Official Journal*, Sept. 23, 2003, 948). Moreover, since subsidies to the Polish steel, coal-mining, and railway sectors were composed of frequently unrecorded tax reductions and other debt write-offs, this figure may understate real indirect government subsidies (Sowa 2003). Protocol No. 8 limited restructuring expenditures to 3.1 billion PLN (approx. \$770 million) in 2002 and 2003 and banned further aid.⁵⁷

Though many see the impact of EU pressure as positive,⁵⁸ Western interests have also played a negative role in the Polish case. In the late 1990s, 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 accepted EU funding for the restructuring of the Polish steel industry in return for Polish government control over the allocation of EU established production quotas to Polish steel producers (Keat 2000). As Keat argues, this agreement failed to reward firms that had privatized and invested in new technologies, effectively reducing their ability to compete in the EU marketplace. Moreover, by distributing market shares, production quotas presumably impacted the ability of the Polish government to privatize the steel sector.

Despite more extensive and early privatization, some Hungarian state-owned firms still represent a significant drain on the state budget.⁵⁹ The reintroduction of the holdings of the Hungarian National Development Bank (MFB)—the MFB and the Hungarian Privatization and Holding Company (APV Rt.) both manage the assets of Hungarian state firms—into the Hungarian national budget in part explains the rise in the government’s budget deficit to 9.3 percent of GDP in 2002.⁶⁰ Thus, while there are few alternatives to the privatization of state holdings, subjecting future privatization and investment promotion strategies to EU aid-intensity criteria may limit the latitude of CEE governments for future sales.

Hungary's most recent deficit problems raised eyebrows at the European Commission and elsewhere. With the highest EU budget deficit in 2006 (9.2 percent), some might be tempted to attribute Hungary's budgetary problems to its failure to collect sufficient corporate taxes. While there may be an element of truth to this argument, alternative arguments need to be considered. For one, whether as many firms and jobs would be available in Hungary without these investment incentives remains an open question. Moreover, some have argued that Hungary's investment incentives did much to increase the overall tax base and revenues from corporate activities.⁶¹ For another, many appear to overestimate the degree of government flexibility regarding foreign investors in Central and Eastern Europe. When Hungary recently attempted to impose an additional 4 percent "solidarity tax" on top of its 16 percent corporate tax rate, Audi, one of Hungary's largest investors, raised objections and threatened to stall future investments. The government ultimately backed down.⁶²

Moreover, Hungary's budget deficit has multiple explanations, only one of which is the lack of tax revenues from large corporations. Despite mounting budget deficits, Hungary balked at thorough reforms of its healthcare and educational sectors prior to fall 2006. Budgetary overruns, in particular in healthcare but also in a broad range of other primarily public sector firms and services, have caused significant problems. As noted above, declining privatization revenues have likewise imposed a strain on the Hungarian budget. Further, while the costs of EU membership and completion of the accession process typically go unmentioned, these are significant. Hungary has spent massive resources improving its highway network, in part in response to EU requirements, in part to contribute to the extension of Europe's trans-European transport network, in part also to simply improve Hungarian infrastructure. Finally, 2006 was an election year, and like many other Western nations, the governing parties spent significant resources attempting to boost their election bid. In some senses one might also argue that Hungary's relative success in attracting FDI is its Achilles' heel in terms of failed government reforms, though in this respect, Hungary is not unlike other CEECs.

Finally, one should not underestimate the bind in which CEE governments are placed by the combined and conflicting constraints of fulfilling EU requirements and balancing the budget. Progress toward the euro includes fulfilling the requirements of the convergence criteria. In particular, the management of inflation poses significant problems for rapidly growing economies. Higher interest rates (to drive down inflation) result in higher export prices, lower the revenues of firms producing for export, and thus reduce regional FDI incentives,⁶³ not to mention the combined impact of these on growth, employment, and the availability of government revenues

for further economic restructuring. Moreover, declining export-based profits also mean declining government tax revenue. Thus Hungary and other CEECs are caught in a particularly powerful vice. Higher budget deficits—equally unacceptable under the convergence criteria—are a likely outcome.

Conclusion

This analysis has implications for a broad range of literature on European integration, comparative politics, and international political economy. A first set of conclusions relates to the theoretical literature on globalization and neoliberal approaches to economic transition. As Strange (1992) argues, globalization drives states to compete fiercely over scarce resources—in particular capital. However, the neoliberal view that open borders are sufficient to attract foreign capital is not strongly supported by the CEE experience. The CEECs—in particular Hungary—went to considerable lengths to attract capital, even to the extent of fully subsidizing the cost of large investments over time. Even Hungary, enjoying a clear first-mover advantage (Sass 2004) due to its early establishment of a stable legal framework for foreign investors, ultimately went much further.

Many have suggested the inclusion of the CEECs in global production networks will provide the foundation for long-term sustainable economic growth (see, e.g., Eichengreen and Kohl 1998). However, involvement in global production networks may ultimately impede the potential for sustainable, long-term economic development. A high degree of insertion into global production networks (1) may limit the relative autonomy of domestic affiliates in developing independent strategies to promote greater innovation or embeddedness; (2) may have the undesirable impact of crowding out domestic potential for the creation of technology and innovative capacity; and (3) may make firms and countries more vulnerable to fluctuations in the international marketplace and the strategic considerations of multinational headquarters. The potential promotion of path dependence further emphasizes the need for countervailing strategies. While the Hungarian case suggests that FDI is a possible solution to promoting economic growth, this appears an important but not sufficient condition for promoting long-term economic development.

A second set of conclusions relates to the potential advantages of supranational versus national-level decision-making. Countries marked by significant differences in the level of economic development may have difficulties coordinating compatible policy goals with more advanced countries. At least for the CEECs, their relative

room for maneuver has been considerably reduced by the advent of EU membership, suggesting that the older and more advanced member states have used the EU accession process to limit and constrain the behavior of the CEECs. From restrictions on the use of tax holidays and state aids to restrictions on monopoly concessions, the accession process has gradually circumscribed and limited the range of competitiveness and investment promotion strategies available in CEE.

Despite common assumptions regarding the advantages of the EU level of decision-making, some of the steps Hungary made to promote economic competitiveness and investment were initiated prior to the fall of the East Bloc. The investment promotion strategies that emerged in later years improved upon the early experience of the mid to late eighties. Moreover, while some contend that accession has improved the practice of economic management in CEE, in the Hungarian case at least, EU membership has allowed Western member states to better control the fiscal and regulatory practices of the new members, thereby having a potentially profound impact on the regional distribution of resources.

A third conclusion relates to a commonly held assumption that EU membership should be equated with economic success. This essay suggests that EU membership is potentially a constraining variable limiting the range of strategic choices. As Mihályi notes, Western experts strongly criticized the Hungarian strategy (2001, 64). In contrast, this argument provides strong support for state-led models of economic development. This point has profound implications for the shape of future tensions in the EU decision-making process.

A fourth conclusion relates to whether neofunctional or intergovernmental models are best suited to understanding 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 CEE practices, but also as a means of strengthening their grip on the EU's redistributive resources (Ellison 2006a). Thus, while the EU framework is one in which the CEECs may hope to have some influence on the decision-making process and legislative output, it is likewise a framework in which the EU can more successfully control the behavior of the CEECs.

While the CEECs will be the principal recipients of SCFs for the 2007–2013 Framework Perspective, pressures for the continued renationalization of EU spending appeared to have a significant impact on the final allocation of funds. While the Lisbon Agenda's focus on the knowledge economy may potentially benefit the CEECs—in particular, countries like Hungary that are further along the path of economic restructuring—they have limited resources to dedicate to such a program. Big

and/or expensive projects remain (e.g., railways, infrastructure, sewage treatment, electrical utilities, and the environment) requiring significant expenditures for years to come. These will be difficult in the context of EU co-financing requirements, severe budgetary constraints and progress toward EMU. Moreover, the value of more horizontal regional measures for the less-advanced regions of Central and Eastern Europe is questionable. The economic policy interests of new and old member states are thus likely to diverge in important ways. Redistributive struggles will presumably remain strongly embedded in future EU policy-making struggles.

Two potential weaknesses in my argument are worth addressing. First, I may overemphasize the role of investment promotion schemes in promoting economic growth. That such investment would not have flowed to CEE without these incentives is hard to prove. The degree and shape of FDI, however, might well have been very different. Though Hungary was early engaged in extensive privatization and encouraged FDI, it still felt compelled at this early stage—even without strong regional interstate tax competition—to offer significant promotional incentives to investors. FDI did not flow in similar amounts to other countries of the region until similar strategies were introduced. These points remain difficult to explain without discussing the importance of the role of government and strategies of the developmental state.

Second, by emphasizing the case of Hungary, I select on the dependent variable. While I provide some analysis of other countries, ultimately more work could be done on the remaining CEECs. As already suggested, there is considerable variation in the development strategies CEECs have pursued. The outcome in terms of long-term, sustainable, economic development and its distributional impact on citizens is likewise varied. Some important elements of variation, such as Slovenia's resistance to foreign capital or Estonia's more neoliberal approach, have not been discussed. Moreover, this analysis may not be meaningful for all new member states. Further exploring the depths of these differences, their outcomes, and the factors that explain them should ultimately provide a richer understanding of future CEE development prospects.

Appendix

Table 1: Hungarian Investment Promotion Incentives (1988–2003)

	Type of Investment	Tax Write-Off	Time Period	Additional Requirements	Legal Text		
1988	Specific economic sectors and Hotel Facilities	100%	5 years	<ul style="list-style-type: none"> • 30% Investment share from foreign sources • Min. investment 25 million HUF • 50% of revenues from Manufacturing • (or) revenues from Hotel Facilities 	XXIV/1988		
		60%	+5 years				
	Other economic sectors	60%	5 years	<ul style="list-style-type: none"> • 30% Foreign investment share • Min. investment 25 million HUF • 50% of revenues from Manufacturing 			
		40%	+5 years				
	Small investments	20%	None indicated	<ul style="list-style-type: none"> • 20% Investment share from foreign sources • (or) min. foreign investment 5 million HUF 			
	1991 (investment must be initiated before Dec. 31, 1993)	Specific economic sectors and Hotel Facilities	100%	5 years		<ul style="list-style-type: none"> • 30% investment share from foreign sources • Min. investment 50 million HUF • 50% of revenues from Manufacturing • (or) revenues from Hotel Facilities 	LXXXVI/1991
60%			+5 years				
Other economic sectors		60%	5 years	<ul style="list-style-type: none"> • 30% Investment share from foreign sources • Min. investment 50 million HUF • 50% of revenues from Manufacturing 			
		40%	+5 years				
1993 (in effect from Jan. 1, 1994 to Dec. 31, 1996)		Large (granted on case-by-case basis)	100%	5 years	<ul style="list-style-type: none"> • 500 million HUF in assets • 200 million HUF investment • 50% Revenues from environmentally friendly products • (or) sales from modern technology and/or scientific research • Raise exports or create new jobs 	XCIX/1993 (amends 1991 law)	
			60%	+5 years			
On reinvested profits	100%	In any tax year	<ul style="list-style-type: none"> • Must have 100 million HUF in assets • (or) reinvest profits >25 million HUF • Cannot distribute dividends for 5 years 				

Table 1 Cont'd

	Type of Investment	Tax Write-Off	Time Period	Additional Requirements	Legal Text	
1994	Attempted to reduce 60% category in 1993 modification of 1991 law to 20%, but reversed by Constitutional Court in July 1996					LXXXIII/1994
1995 (on investments between Dec. 31, 1995 and 2002 tax year)	Large	50%	5 years	<ul style="list-style-type: none"> • Min. 1 billion HUF • Raise firm exports 25% • Raise exports min. 600 million HUF 	CVI/1995 (amends 1991 law)	
	Regional/Agriculture	100% (only on agric/hotel sales, not other economic activities)	5 years	<ul style="list-style-type: none"> • Where unemployment > 15% • Only on agricultural activities • Raise sales by 1% • (or) raise sales by 5% of original investment 		
	Specific			<ul style="list-style-type: none"> • In enterprise zones • (or) in hotels 		
1996 (on investments between Dec. 31, 1995 and 2002 tax year)	Large	50%	5 years	<ul style="list-style-type: none"> • Min. 1 billion HUF • Exports > 600 million HUF • Exports > 25% of original investment 	LXXXI/1996	
	Regional	100%	5 years	<ul style="list-style-type: none"> • Where unemployment > 15% 		
	Hotels	100%	5 years	<ul style="list-style-type: none"> • In hotel facilities • Raise sales by 25% 		
	Agriculture	100%	5 years	<ul style="list-style-type: none"> • Where unemployment > 15% • Raise sales by 5% of original investment 		
	Enterprise Zones	100%	5 years	<ul style="list-style-type: none"> • Raise sales by 1% 		
	Regional Enterprise Zones	6% of investment costs	1 year	<ul style="list-style-type: none"> • Related to machinery • Related to machinery, facilities or infrastructure 		

Table 1 Cont'd

	Type of Investment	Tax Write-Off	Time Period	Additional Requirements	Legal Text
1997 (investments between Dec. 31, 1996 and 2011 tax year)	Large	100%	10 years	<ul style="list-style-type: none"> • Min. 10 billion HUF • Add 500 new jobs • In manufacturing 	CVI/1997 (amends 1996 law)
	Regional	100%	10 years	<ul style="list-style-type: none"> • Min. 3 billion HUF • In manufacturing • In specified less-developed regions • (or) where unemployment > 15% • Add 100 new jobs • Raise annual sales > 5% of original investment 	
	Modify 1996 Large Investments	50%	5 years	<ul style="list-style-type: none"> • Raise annual sales (not exports) by 5% 	
2002 (investments before Dec. 31, 2002)	Large	Tax advantage determined by government on case-by-case basis		<ul style="list-style-type: none"> • Min. 10 billion HUF • Raise wages 1500 times min. wage • Min. 50% local SME suppliers 	XLII/1996 (amends 1996 law)
	Regional			<ul style="list-style-type: none"> • Min. 3 billion HUF • In specified less developed regions • Raise wages 900 times min. wage • Min. 50% local SME suppliers 	
	Telecommunications/ Environmental Protection			<ul style="list-style-type: none"> • Min. 100 million HUF 	
2003 (investment promotion schemes brought into compliance with EU aid-intensity requirements)	All	35–50% of total investment (including all direct subsidies)		<ul style="list-style-type: none"> • EU aid-intensity map defines percent allowed depending level of regional development 	Govt Decree 275/2003 (amends 1996 law)

Table 1 Cont'd

	Type of Investment	Tax Write-Off	Time Period	Additional Requirements	Legal Text
2003	Large	Tax advantage subject to government approval on case-by-case basis (subject to aid-intensity requirements)	10 years	<ul style="list-style-type: none"> • 3 billion HUF • Create +100 jobs • Min. 30% local SME suppliers • Raise wages 600 times min. wage 	XCI/2003 (amends 1996 law)
	Regional				
	R&D, education, or research institutes				
	Raising hygiene of animal production, broadband, environmental protection, film and video, or job creating investments				
2004	Large	Tax advantage subject to government approval on case-by-case basis (subject to aid-intensity requirements)	10 years	<ul style="list-style-type: none"> • 3 billion HUF • 1 billion HUF • In specified less developed regions 	CI/2004 (amends 1996 law)
	Regional				
	All 2003 spec. categories				
	All SMEs				
	Regional SMEs				
2005	Minor modifications to 2004 format (enabled tax advantages for investment in the development of existing broadband networks and made government approval necessary only for large investments)				XXVI/2005 (amends 1996 law)

Sources: CompLex (2006). Other sources that I cited some of this information are: Éltető (1998, 9–10), Antalóczy and Sass (2003, 12), Szanyi (2003c, 12, 15). For all discrepancies, I have considered CompLex the definitive source on Hungarian law. Note: SME = small and medium enterprises.

Table 2: Total Financial Perspective for 2006 and Financial Perspective 2007–2013
(in Euros)

Appropriations	2006	2007	2008	2009	2010	2011	2012	2013	2007–2013
Total (commission proposal, Feb. 2004)	120,688,000	133,560,000	138,700,000	143,140,000	146,670,000	150,200,000	154,315,000	158,450,000	1,025,035,000
Percent increase		10.67%	3.85%	3.20%	2.47%	2.41%	2.74%	2.68%	28.0%
Total (approved financial perspective, Apr. 2006)	120,688,000	120,702,000	121,473,000	122,564,000	122,952,000	124,007,000	125,527,000	127,091,000	864,316,000
Percent increase		0.01%	0.64%	0.90%	0.32%	0.86%	1.23%	1.25%	5.2%
Structural and Cohesion Fund									
Expenditures (proposal, Feb. 2004)	38,791,000	47,570,000	48,405,000	49,120,000	49,270,000	49,410,000	50,175,000	50,960,000	344,910,000
Percent change		22.6%	1.8%	1.5%	0.3%	0.3%	1.5%	1.6%	29.6%
Expenditures (approved version, Apr. 2006)	38,791,000	42,863,000	43,318,000	43,862,000	43,860,000	44,073,000	44,723,000	45,342,000	308,041,000
Percent change		10.5%	1.1%	1.3%	0.0%	0.5%	1.5%	1.4%	16.2%
Competitiveness, Growth, and Employment									
Expenditures (proposal, Feb. 2004)	8,791,000	12,105,000	14,390,000	16,680,000	18,965,000	21,250,000	23,540,000	25,825,000	132,755,000
Percent change		37.7%	18.9%	15.9%	13.7%	12.0%	10.8%	9.7%	118.7%
Expenditures (approved version, Apr. 2006)	8,791,000	8,404,000	9,097,000	9,754,000	10,434,000	11,295,000	12,153,000	12,961,000	74,098,000
Percent change		-4.4%	8.2%	7.2%	7.0%	8.3%	7.6%	6.6%	40.5%

Sources: My own calculations based on appropriations data from “Building Our Common Future” (COM(2004) 101 final: p. 29); the Interinstitutional Agreement between the European Parliament, Council, and the Commission (provisional draft, April 26, 2006); and population data from Eurostat’s online data.

Table 3: Average Rates of Corporate Taxation in Europe

	Unweighted Averages (2006)	Unweighted Averages (ITR 2003)*	Weighted Averages (2006)	Weighted Averages (ITR 2003)*
EU15	29.5%	29.9%	33.6%	30.0%
CEEC10	20.6%	15.1%	20.6%	19.5%
EU27	25.5%	25.5%	30.8%	28.5%

Sources: Calculations based on data from Eurostat's online data (population) and corporate taxation rates from European Commission (2006, 83, 86).

* The latest data on ITR (implicit tax rates) from the above source are from 2003 and 2004. Since the 2004 data have too many missing values, I have used the 2003 data. In addition, the 2003 data are potentially affected by the persistence of some investment promotion schemes in different countries. In both cases, the results are presumably affected by these weaknesses in the data.

Table 4: Direct Investment Abroad: Ratio of Outward Investment Position in CEECs Relative to Outward Investment Position in European Core* (1989-2003)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Austria	0.06	0.17	0.26	0.43	0.55	0.73	0.64	0.66	0.73	0.60	0.62	0.66	0.82	0.86	
Belgium/ Luxembourg	0.00	0.00	0.03	0.01	0.12	0.00	0.03	0.09	0.08	0.07	0.01	0.00	0.01		
Denmark			0.00			0.02				0.07	0.10	0.06	0.08	0.10	
Finland				0.00	0.00	0.02	0.01	0.02	0.01	0.01	0.03	0.04	0.04	0.04	
France	0.00	0.00	0.00	0.00	0.01	0.01	0.02	0.02	0.03	0.03	0.04	0.04	0.05	0.05	
Germany	0.00	0.00	0.01	0.02	0.04	0.05	0.06	0.08	0.09	0.11	0.10	0.10	0.10	0.10	
Greece										0.99	0.77	0.00	0.65	0.48	0.00
Ireland															
Italy	0.00	0.00	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.03	0.03	0.03	
Netherlands	0.00	0.00	0.00	0.00	0.01	0.02	0.02	0.04	0.05	0.06	0.05	0.06	0.06		
Portugal							0.00	0.00	0.01	0.03	0.24	0.10	0.10	0.07	
Spain	0.00	0.00	0.00	0.01	0.00	0.05	0.03	0.04	0.01	0.01	0.01	0.08	0.01	0.00	0.12
Sweden		0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.02	0.03	0.05	0.07	0.07	
UK	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.02	0.02	0.01	0.00	0.01	0.02	
Norway	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.02	0.02	0.04		
Switzerland					0.01	0.01	0.02	0.02	0.02	0.03	0.03	0.04	0.04	0.03	0.03
USA	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01

Sources: OECD International Direct Investment Statistics Yearbook (2005, 2001). All data prior to 1999 is from the 2001 edition.

* Includes: Austria, Belgium/Luxembourg, Denmark, Finland, France, Germany, Italy, Netherlands, Sweden, UK.

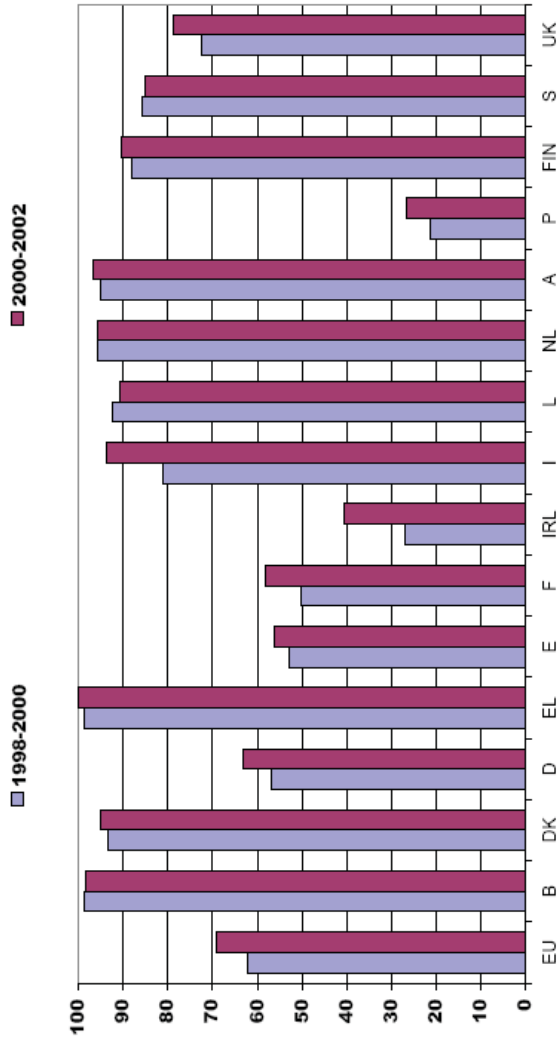
**Table 5: Direct Investment Abroad: Ratio of Outward Investment Position in CEECs
Relative to Outward Investment Position in Old Cohesion Countries* (1989–2003)**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Austria	1.92	3.76	4.24	9.09	6.66	7.85	9.06	9.09	8.58	9.54	10.15	28.95	38.10	48.52	
Belgium/ Luxembourg	0.02	-0.01	0.92	0.03	0.87	-0.01	0.18	0.20	1.71	0.24	2.27	0.19	0.04		
Denmark			0.04			0.17				0.85	1.32	1.27	1.76	1.42	
Finland				0.00	0.00	0.24	0.23	0.39	0.36	0.45	2.09	1.64	1.63	2.15	
France	-0.02	0.00	0.01	0.03	0.04	0.05	0.11	0.14	0.17	0.20	0.37	0.51	0.53	0.49	
Germany	0.01	0.01	0.04	0.09	0.17	0.23	0.31	0.42	0.51	0.68	0.75	0.98	1.08	1.06	
Greece										160.32	73.71	0.00	11.11	6.66	0.00
Ireland															
Italy	0.00	0.00	0.01	0.02	0.12	0.13	0.00	0.00	0.00	0.00	0.00	0.25	0.26	0.23	
Netherlands	0.00	0.00	0.00	0.00	0.09	0.13	0.16	0.28	0.32	0.33	0.37	0.41	0.34	0.34	
Portugal							0.00	0.00	0.01	0.02	0.06	0.07	0.09	0.05	
Spain	0.00	0.00	0.00	0.01	0.03	0.08	0.43	0.05	0.03	0.05	-7.53	0.48	0.13	0.02	0.51
Sweden				0.00	0.00	0.00	0.00	0.10	0.19	0.22	0.31	1.14	0.84	0.92	
UK	0.00	0.00	0.00	0.01	0.01	0.04	0.04	0.05	0.13	0.16	0.04	0.04	0.13	0.14	
Norway	0.00	0.00	0.00	0.09	0.17	0.18	0.16	0.19	0.23	0.30	0.77	0.71	0.69		
Switzerland					0.10	0.12	0.22	0.19	0.17	0.27	0.22	0.24	0.29	0.29	0.23
USA	0.00	0.01	0.01	0.03	0.10	0.13	0.15	0.14	0.13	0.11	0.14	0.12	0.11	0.10	0.10

Sources: See table 4.

* Includes: Greece, Ireland, Portugal, and Spain.

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



Source: *European Commission* (2004b, 21).

Note: The country names are as follows: Belgium (B), Denmark (DK), Germany (D), Greece (EL), Spain (E), France (F), Ireland (IRL), Italy (I), Luxembourg (L), the Netherlands (NL), Austria (A), Portugal (P), Finland (FIN), Sweden (S), and the United Kingdom (UK).

Notes

1. Ellison (2006a) argues that social constructivist (Schimmelfennig 2001) and intergovernmental (Moravcsik and Vachudova 2003) accounts of the Eastern enlargement (among others) fall short in their analysis of Western interests, thus overestimating the gains from EU membership, underestimating its costs and ultimately failing to recognize the potential for aggregate losses in CEE.
2. Alt et al. (1996) argue that the implications of increasing returns are more ambiguous for economic integration outcomes and the related structure of interests.
3. See, e.g., Bachtler, Wishlade, and Yuill (2003).
4. Perusing economics journals in Hungary (e.g., *Közgazdasági Szemle, Külgazdaság*, the working papers of the Institute for World Economics), reveals a large number of articles that address this topic from multiple directions. The development of economic competitiveness literature has been something of a cottage industry in CEE from the initial stages of the transition and has not lost momentum with the advent of EU membership.
5. There is, in fact, growing interest in this topic. See, e.g., Bachtler, Wishlade, and Yuill (2003).
6. See, e.g., 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.
7. See, e.g., Martin (2003) on economic geography and labor mobility. See Ellison and Hussain (2003) on external increasing returns and uncertainty in the context of European integration. On external increasing returns and economic geography see Krugman (1991).
8. Krugman (1987) argues that governments are not able to make economic decisions since they are likely to put political interests before economic considerations and they lack the relevant economic expertise.
9. The Washington Consensus is the most prototypical expression of the neoliberal agenda. See Williamson (1990). While Williamson himself has explicitly contested the use of the term neoliberal agenda (Williamson 2000), it seems particularly appropriate in comparison with the range of proposed alternatives to the Washington Consensus.
10. Although this is an important element, my principal focus is on the government's role in the management of the economy.
11. Rodrik (1996) offers one of the more potent criticisms. But this approach continues to inspire strong criticism (see Beeson and Islam 2004; Rodrik 2002; and Kolodko 2000, chap. 5).
12. In general, the neoliberal prescription favors strong measures of fiscal prudence and reductions in government expenditure, tax reform, competitive exchange rates, and secure property rights. The Washington Consensus eschews any form of market protectionism or state involvement and

promotes instead extensive price, trade, and financial liberalization; thorough-going privatization of the economy; and deregulation. Finally, the Washington Consensus supports the elimination of barriers to the free entry and exit of foreign capital.

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

14. See the interview with the World Bank's executive director, Carole Brookins, *Transition Newsletter*, December 2003–January 2004: 1–3. The World Bank has vacillated on these points. *The World Development Report 1997: The State in a Changing World* 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).

15. I have reached similar conclusions in studies of other policy areas. See Ellison (2006a, 2006b, 2004) and Ellison and Hussain (2003).

16. Nagy (1994) argues that the European Agreements were used to protect the interest of Western investors.

17. Hungary first began permitting foreign investors in 1972, but limited FDI to minority shares. Further changes were made to Hungary's investment laws in the mid-80's. The first major change was undertaken with the 1988 law (Marton 1993).

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

19. Poland established "special economic zones," but, according to Uminski, the regulations associated with them discouraged significant FDI inflows (2001, 91–92). Poland requested a transition period for economic zones until 2017, but the commission vetoed this request (EP Fact Sheet 2003).

20. Some problems arose prior to the accession negotiations. The EU used the Association Agreement as the foundation for objecting that tax reductions based on export performance were a form of export promotion. Hungary thus altered the tax law in 1996 to focus on output (Éltető 1998, 9).

21. Most of Hungary qualifies for the maximum aid-intensity of 50 percent, but the metropolitan area of Budapest only qualifies for an aid-intensity of 35 percent, while the larger Pest County surrounding Budapest qualifies for 40 percent. Two western counties in Hungary qualify for 45 percent. See the EU's aid-intensity maps for the new member states at: http://europa.eu.int/comm/competition/state_aid/regional/2004/.

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

23. Matáv's financial position in the early nineties made it virtually impossible to undertake the investments required to modernize Hungarian telecommunications. In the late eighties, Matáv

published a ten-year plan estimating the cost of required investments at 380 billion HUF. At that time, annual government expenditure on all infrastructure needs amounted to only 30 billion HUF (Tóth 1993, 39–41).

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

25. The preferential agreements signed by Hungary ultimately bound the MVM to pay more to electricity producers than the sale price to consumers and remain valid for some 20–25 years from the date of signing (approximately 1997). MVM (i.e., the Hungarian government and Hungarian citizens) will have to compensate significant losses in the energy sector for some years (2017–2023) (see Bakos 2001). Complete liberalization of the energy sector may lower energy supply prices, having a further impact on related costs to the Hungarian government (and presumably the Hungarian taxpayer). Bakos estimates potential losses at 300 billion HUF (1129). This estimate fails to account for the costs of liberalization, suggesting the total loss will be higher.

26. See both the program announcement from the Ministry of Economy and Transport (2002), and Ernst & Young and ZEW (2003, 33–34).

27. For example, the offering of grants to entrepreneurs with scientific academic backgrounds to turn their knowledge into business enterprises, or to establish Technology Learning Offices at universities, has been largely unsuccessful (Buzás and Szanyi 2004, 25–26).

28. See the website of the Association of Hungarian Industrial Parks, <http://www.datanet.hu/ipe/>.

29. For more on the Lisbon Agenda, see European Commission (2000). For the Sapir Report, see Sapir et al (2004).

30. “Building Our Common Future: Financial and Political Outlook for the Enlarged Union, 2007–2013,” (COM(2004) 101 final).

31. See the “Joint Letter From Mr. Blair, the Prime Minister, and the President of France, the Chancellors of Germany and Austria, and the Prime Ministers of the Netherlands and Sweden,” Dec. 15, 2003.

32. For a more detailed analysis of the final distribution, see Ellison (2006c).

33. See the series of articles published at www.eubusiness.com: “New EU States Use Low Tax Rates as Investment Bait,” April 25, 2004; “Warsaw, Berlin, and Paris Call for Harmonisation of EU Taxes,” July 22, 2004; “Poland Joins Outcry Against French Proposal on EU Funds,” Sept. 9, 2004; and www.Reuters.com: “Paris Idea to Link EU Funds, Tax Gets Cold Reception,” Sept. 6, 2004.

34. See www.eubusiness.com, “Commission Questions Estonia’s Liberal Corporate Tax Regime,” March 8, 2002; the Austrian government website, <http://www.austria.gv.at/>; and the German government’s information website: http://www.germany-info.org/relaunch/business/taxes/german_tax_rates.html.

35. "Taxing Times," *Economist*, March 21, 2005. Given high local corporate tax rates, the effective corporate tax rate in Germany will remain much higher: 38.7 percent at the current rate and 32.7 percent at the suggested rate.
36. See www.eubusiness.com: "Chancellor Schroeder Slams 'Fiscal Dumping' by New EU States," April 29, 2004, and "EU Embroiled in Taxing Debate Over 'Fiscal Dumping,'" Sept. 11, 2004.
37. As indicated by the discussion of investment promotion incentives in Hungary, countries do not apply the same corporate tax rate in all cases. Implicit rates attempt to adjust for different incentives by measuring corporate taxation rates based on actual government revenues. For more information, see European Commission (2006).
38. For an excellent overview of state aid measures, see Martin (1999). Early discussion of the shift toward horizontal measures can be found in "Industrial Policy in an Open and Competitive Environment: Guidelines for a Community Approach" (COM(90)556), and "An Industrial Competitiveness Policy for the EU" (COM(94)319 final).
39. See www.Euractiv.com: "German Government Says It Knows Best What Is Good for Growth," May 5, 2006.
40. Luxembourg is next in line with 61 percent of state aid going to regional development, then Belgium with 52 percent (European Commission 2004b, 20).
41. All data on Hungarian state aid is derived from State Aid Monitoring Office (2002, 17, 35, 37).
42. Sass (2004) provides a good overview of the literature on these last two points.
43. Though illegal under EU law, Lorentzen and Møllgaard (2000) found many foreign investors imposed "vertical restraint agreements" prohibiting affiliates from using transferred technology for production activities outside the framework of the joint-venture agreement.
44. Pavlínek cites the example of the Czech firm PAL Praha, which manufactures small electric engines for a larger foreign firm (Magna). Within the context of a joint venture project, PAL invested in its own R&D center for which it remains fully responsible, thereby retaining considerable managerial autonomy from Magna. Nor does PAL transfer its R&D results to Magna (2004, 62). Such a constellation would presumably not be possible for most affiliates without managerial autonomy of the type provided by the joint venture relationship between PAL and Magna.
45. In March 2005, IBM announced it would undertake investments totaling \$35.5 million in Hungary between 2003 and 2008. Further investments were planned, promising to employ 17,000 workers. See www.nol.hu: "IBM: 6.5 milliárdos beruházás, 700 munkahely" (IBM: 6.5 billion HUF Investment, 700 jobs), March 3, 2005.
46. The Council of Ministers' response to the Lisbon Agenda recommended the commission focus efforts on redirecting expenditures and that states try to find the resources for such expenditures within existing budgetary limitations ("Final Report on the European Action for Growth,"

Council of the EU, November 26, 2003, 7–9). Though later dropped from the final agreement, the commission’s 2004 proposal for Financial Perspective 2007–2013 did, however, include substantial funding for the Lisbon Agenda.

47. “Investing in Research: An Action Plan for Europe,” COM(2003) 226 final/2.

48. *Ibid.*, 19.

49. One response may be to fund projects from national expenditure but at low levels in order not to contravene EU state aid restrictions (interview with Magdolna Sass, March 24, 2005).

50. The Slovakian government attempted to attract investments by introducing a flat 17 percent tax rate on corporate profits, value-added, and income tax.

51. Estonia abolished its tax on reinvested corporate profits in January 2000 (Hunya 2004, 106).

52. Hellman likewise notes a correlation between lower levels of income inequality in CEE (within the overall context of rising income inequality) in countries that pursued more extensive reforms (1998, 224–25).

53. Hellman provides a discussion of the very real problems of capture in CEE economies (1998). Krugman (1987) argues that capture is one of the principal reasons governments should not intervene in the economy.

54. Though rapid privatization to foreign owners was partly inspired by high levels of Hungarian foreign debt, selling Hungarian firms to foreign investors further facilitated avoiding accusations of corruption (Mihályi 2001, 63–66).

55. In Poland too, the government was motivated by fears of the social impact of closing the state-owned steel sector. The share of the actively employed labor force in Hungary is somewhat lower than that for Poland or the Czech Republic.

56. Accounting for approximately 70 percent of Polish steel production, Polskie Huty Stali (PHS) was privatized in 2004. The agreement with LNM Holding included payments of \$850 million to cover PHS debts and \$600 million in guaranteed investments (PAP News Wire, March 5, 2004).

57. *Official Journal*, (Sept. 23, 2003, 948). A Polish government audit of the effects of state aid found that nine out of twelve cases of aid to the steel sector were “inefficient and ineffective” (Sowa 2003, 28), providing strong evidence that privatization was a more effective route.

58. Moravcsik and Vachudova, for example, refer to “blocked bailouts of uncompetitive firms” as one of the positive benefits of EU pressure (2003, 47).

59. The APV Rt. still administrates some ninety-nine state-owned firms. Significant examples of state-owned firms, some with significant losses, are MVM (see above), MALEV airlines (see, e.g., <http://english.budapest.hu>, “MALEV Hopes to Break Even,” Sept. 16, 2004), the Budapest public transport system (BKV), the Hungarian railway (MÁV) and the Hungarian regional bus system (VOLÁN).

60. See the IMF's country annual "Reports on the Observance of Standards and Codes," in particular the May 2003 report on Hungary at <http://www.imf.org/external/np/rosc/rosc.asp>.
61. Interview with Magdolna Sass, March 24, 2005.
62. See, e.g., www.portfolio.hu: "Audi confirms keeping up investments in Hungary," Nov. 10, 2006. Audi ultimately threatened to withdraw a five-year investment totaling approximately 1 billion euros and relocate its investments elsewhere in the region.
63. Kalotay notes that this has been a particular problem for Hungary (2003b, 7).

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