THE IMPACT OF ENLARGEMENT ON THE RACE FOR FDI

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Working Paper No. 86
January 2004

Abstract
This chapter assesses the effects of “Eastern” EU-enlargement on the race for FDI and the policy implications. We start from the proposition that the evolving production patterns of incumbent and new member states determine the need for and the justification of location policy (LP) and FDI promotion policy (FDI-PP). On the basis of empirical production patterns, it is argued that while the specialisation outcome dominates in the short run, the convergence scenario is more likely to prevail in the medium term. Therefore, old and new EU-members will compete increasingly for the same type of FDI. How EU-enlargement per se affects the spatial distribution of inward FDI is described next. The role of FDI-PPs and LPs in an enlarged EU are discussed on the basis of the convergence outcome. Since the new economics of location competition and of FDI-promotion cast serious doubt on the economic justification and effectiveness of FDI-PP, the chapter concludes with a basic dilemma in the race for FDI: namely, the greater ineffectiveness of FDI incentives in the Single Market and fewer possibilities for differentiation of LPs. The latter is due to harmonisation pressures, which calls for innovative policy strategies by central and regional authorities.

Keywords: Multinational Enterprises, Foreign Direct Investment, Locational Competition, Location Policy

JEL-Code: F2, L6

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* forthcoming in: Pervez Ghauri and Lars Oxelheim (Eds.) European Union and the Race for Foreign Direct Investment in Europe, Elsevier / Pergamon: Oxford, Ch. 11. I would like to thank the participants of the Workshop at Södertuna Slott for helpful comments and suggestions.
6.1. Introduction

The past decade has brought various large leaps in European integration such as the Single Market Project (SMP, 1992), the EU-enlargement 1995 and the Economic and Monetary Union (EMU, 1999). According to Brenton (2002), the next big step in European integration, East European Enlargement\(^1\), will induce strong structural changes which will affect the competitive position of regions and countries. (see also Hall, 2003)

The envisaged EU-enlargement differs from earlier enlargement not only since it includes very different countries compared to the incumbent members, but also takes place in a far more integrated environment (Bellak and Cantwell 1997, 1998) where the response of Multinational Enterprises (MNEs) is highly uncertain (Young, 1992; Ruigrok and van Tulder, 1995). The enlargement will strongly affect the "rules of the game" for location competition within the EU-25, for although the EU is an (imperfect) single market, it is far from being a single jurisdiction.\(^2\) This likely impact of the EU-enlargement on location policies (LP) and FDI-promotion policies (FDI-PP) of countries and regions are the theme of this chapter.

More specifically, this chapter raises the question, how EU-enlargement by countries which differ widely from the current EU members will possibly affect the race for FDI (location competition). It is argued that the extent to which LPs and FDI-PPs will be introduced and are economically justified depends crucially on the evolving pattern of production, trade and FDI. The chapter concentrates on intra-EU location competition, as the challenges are huge both for incumbent and for new members, and since there is a separate chapter on extra-EU matters (see Chapter 3 on WTO issues).

The crucial question from a political point of view is what the incumbent members are likely to lose and what the new members are likely to gain (likely asymmetry)? It will be argued that although location competition is mainly regional, important policy tasks arise on the national and the supra-national levels. A race is actually the wrong metaphor, since inward FDI is not a zero-sum game! Yet, the perception of decision makers is the picture of a race. (I believe that economists have the task of correcting this view, although the Single Market is not yet complete, so that rents are accruing in different jurisdictions. The nation states are monopolies in many respects still. Welfare effects can shift through plant relocations and, thus

\(^1\) Subsequently: “EU-Enlargement”. The countries included are: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia, Malta and Cyprus.

\(^2\) And even if it were, location competition would still prevail on the regional level.
create a beggar-my-neighbour environment.)

We have been looking at evaluations of subsidies and FDI incentives (tax competition and low labour costs in particular), regional policies, convergence and structural policies, including public infrastructure\(^3\); since they capture most of what is generally known as LP. In addition, evidence on performance gaps between domestic and foreign firms (see Bellak 2003 for a review), also give rise to negative and positive spillover and agglomeration effects of inward FDI.

The chapter is organised as follows: The current setting and the evolving production patterns in the new member states are described in section 6.2. Causality issues between inward FDI and growth as well as inward FDI and LPs (or FDI-PPs) and along with the economic justification and expected outcome of both policies, are assessed in brief in section 6.3. How the EU-enlargement may affect the geographical distribution of inward FDI in EU-25 is discussed in section 6.4 (see also Ch. 2). How FDI promotion is affected by the EU-enlargement and how investors may react to changes in policy measures is assessed in section 6.5. In section 6.6, we pose the question, who competes with whom in an enlarged EU and whether the decisive factors in location competition change with the EU-enlargement?

The overall conclusion is that FDI-PPs in particular will be less relevant in an enlarged EU, while LPs will maintain their importance despite decreasing shares of public investment in infrastructural investment in practically all EU countries. The evidence from evaluations of past EU policies (Thomsen and Woolcock, 1993) do not convincingly support the view that policy interventions have been successful. From a purely economic standpoint, government failure is very striking. However, this does not invite the conclusion that the retreat of the state is all what is needed to improve the welfare of the host countries. Instead, section 6.7 concludes on the basic dilemma of governments: First, integration leads to a greater need for differentiation of LPs, yet fewer possibilities exist due to harmonisation pressures and a strong competition policy. Second, a greater ineffectiveness of FDI-PPs in the enlarged Single Market is envisaged, since important location factors converge across member states.

6.2. The Setting and the Evolution of Production Patterns

6.2.1. The Setting
A brief look at the starting position of incumbent and new member countries (Gligorov 2001)

\(^3\) i.e. public utilities, communications, transport, and land development. Intangible infrastructure such as a public education system or innovation system is also vital with regard to location decisions of MNEs.
with regard to inward FDI is necessary at the outset.

1. The importance of inward FDI increased dramatically in all Central- and East European Countries (CEEC), almost closing the gap vis-à-vis the World average. The level of development of adjacent non-member regions (i.e. the 2nd tier transition economies such as Bulgaria and Romania) is inducing shifts of production that had been attracted to 1st tier transition economies some years previously. (Appendix Table 6.2)

2. Foreign affiliates play a role in CEECs comparable to that in several EU economies, with Hungary being by far the most inward internationalised economy. (Appendix Table 6.1)

3. In terms of total size of inward FDI stocks, three groups are discernible, corresponding to country size: Poland; Czech Republic and Hungary; Slovak Republic and Slovenia. (Appendix Table 6.3)

4. The Netherlands is the largest investor in the CEECs with the exception of Poland and Slovenia. Austria and Germany are other major investors. France is primarily engaged in Poland and Slovenia. From the perspective of the investing country, only for Austria and Germany, their FDI to CEECs account for an important share in their total outward FDI. (Appendix Table 6.4)

5. The EU-enlargement process takes place at a time that is characterised by an unfavourable economic environment for FDI:
   - For the first time in decades, global FDI flows decreased substantially in 2002. (Appendix Figure 6.1)
   - Incumbent EU-members are concerned about the relocation of production to CEECs while at the same time they experience sluggish FDI inflows. Recession tendencies in major European economies may yet imply more outsourcing to the new members. This is reflected in the lower growth rates of FDI (Table 6.5). \(^4\) Sinn (2001) reports that incumbent EU states have already taken some measures of – as he calls it – “location safeguarding”. Among those measures there are some signs of a further downward pressure on corporate income taxes. Compared to the decade 1980-90, the average

\(^4\) Yet, this is partly an effect of the conversion of FDI stocks in local currency to the USD, if the local currencies depreciate vs. the USD.
annual growth rate of inward FDI stocks in a common currency has remained at the same level in the EU as a whole as well as in 5 single countries, while it has decreased in seven countries and increased only in three countries.

- Incumbent EU-members have become much more dependent on inward FDI as part of their capital stock building (see Table 6.6) or restructuring. Ratios above 100 percent reflect the large share of M&As (ownership change without new capital formation). The large share of M&As in total inward FDI flows is also an indication of the fact that FDI-PPs are becoming less relevant in determining the location patterns of production and that they affect an ever smaller share of inward FDI.

Inward FDI flows have generally increased as a percentage of gross fixed capital formation. Yet, insofar as inward FDI flows reflect M&As, they do not contribute to capital stock formation. Since the ratio of M&As to greenfield FDI is country specific and has risen over time, the data shown in Table 6.5 should no longer be interpreted as a growth effect of inward FDI.

6.2.2. The Evolution of Production Patterns

In a static context, the similarity of the current production structures of incumbent (Barry 2001), and new EU members (Brenton 1999, Ch. 1), and whether and how fast they are going to converge (Löhning 1999), will have a decisive impact on the FDI flows, both in qualitative and in geographical terms.

Since we are concerned here with the convergence of production structures, trade and specialisation patterns (Arndt, 2001), we exclude nominal and real income convergence here (Mencinger, 2003). Two extreme scenarios may be envisaged, of which the actual outcome will most likely comprise elements of both:

Specialization according to present comparative advantage

This proposition maintains that EU-enlargement will deepen the existing division of labour between old and new member states which, due to the diversity of the members in
an enlarged EU, offer different location advantages. Hence, governments in incumbent and new member states will not compete for the same investments. Within each of these two groups, competition for FDI will intensify as firms will try to adjust their production structures according to the changing comparative advantage. Yet, the specialization scenario would make convergence and cohesion more difficult.

Convergence of production structures

Convergence of production structures means specialisation, yet in similar (differentiated) production across old and new member states. The convergence scenario implies that EU-enlargement will lead to a faster catching-up by the new member states, suggesting stronger growth effects in CEECs than in incumbent EU members (Löhnig, 1999). This will result in direct competition between locations in incumbents and new members for increasingly similar types of affiliates.

6.2.2.1 Some empirical evidence on the emerging production patterns

A number of different approaches have been taken to measure the competitiveness of the industrial sectors, the strategies of MNEs and the degree of specialisation in trade, output and technology. The changing industrial, regional and structural distributions are linked to the extent of FDI. For example, Urban (2000, p. 168) concludes that major winning, losing and average performing industries have all attracted large shares of foreign capital. This points to a firm-specific rather than an industry-specific explanation.

(i) Strategies of firms

The adjustment of firms to policy changes also includes strategies to withdraw, divest or relocate. Thus these decisions have to be treated like location decisions. (For a discussion on new vs. established FDI and related policy implications see Sweeney (1993, p. 82).

A substantial part of the emerging production structures in the new member states will be determined by the conduct of foreign-owned firms, which is why they deserve special attention. As Rojec (2000) points out, their superior performance may be explained by their industrial distribution (macro-level), or efficiency at the company level (micro-level). For example, if the share of efficiency-seeking FDI into CEECs increases relative to market-seeking FDI, this may have strong positive effects on the catching-up process. The effects of EU-enlargement on the strategies of potential investors include more incentives for fragmentation, at least in the short run. In the short run, the relocation strategies of firms
(Mucchielli and Saucier, 1997) located in old member states will be important, due to the
differences in location factors. Yet, this may also imply that the CEECs will try to stay
competitive, mainly by cost-related factors, which may yet hamper catching up in the longer
run.

The geographical and sectoral distribution of production depends on the strategic
response of firms as described in Chapter 2 (Buckley). The more similar the production
patterns between incumbent and new members, the lesser the strategic responses of insider
firms concerning reorganisation and rationalisation investment. While both domestic and
foreign-owned firms restructure according to the comparative advantage patterns as one
would expect (Rojec 2000) it is important to note that firms in the new EU-member states,
classified according to ownership, restructure in very different ways. (Mrak et al. 2002, see
Table 6.7.).

Table 6.7. Trends in Value-added and Employment by Ownership Categories of Companies
in 1994-1997 (Index 1994=100)

<table>
<thead>
<tr>
<th></th>
<th>New 1)</th>
<th>Foreign 2)</th>
<th>Internal 3)</th>
<th>External 4)</th>
<th>Non-privat. 5)</th>
<th>State 6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value added per employee</td>
<td>121.4</td>
<td>113.0</td>
<td>108.5</td>
<td>107.9</td>
<td>111.5</td>
<td>88.9</td>
</tr>
<tr>
<td>Value added</td>
<td>131.9</td>
<td>120.4</td>
<td>105.5</td>
<td>106.6</td>
<td>100.3</td>
<td>72.9</td>
</tr>
<tr>
<td>Employment</td>
<td>108.6</td>
<td>106.5</td>
<td>93.5</td>
<td>98.8</td>
<td>89.9</td>
<td>82.0</td>
</tr>
</tbody>
</table>

Source: Mrak et al., 2002, p. 48

1) New companies in Slovenia
2) Foreign MNEs
3) formerly socially-owned
4) formerly socially-owned
5) formerly socially-owned
6) still socially-owned

Mrak et al. (2002) conclude that not only is the transition period mirrored in the investment
activity of firms when classified by ownership category, but that the superior performance of
foreign MNEs in Slovenia is also derived from the industry distribution: FDI gravitates
towards the high-productivity, large-scale, capital and export-intensive sectors.

(ii) Output and FDI
The sectors receiving the largest shares of inward FDI are shown in Table 6.8.
Table 6.8. The relative importance of the manufacturing sector as a recipient of inward FDI is evident. The services sector has been gaining in importance. Yet, since services are in many cases locally supplied and driven by the size of the market, the main concern in location competition is relocation (both from EU to CEECs and from CEEC members to CEEC outsiders) within the manufacturing sector.

Rojec (2000, p. 137) estimates that the trend towards factor-cost seeking FDI will further strengthen with enlargement. This would imply more vertical and more intra-EU FDI. Hunya (2002, pp. 14/15) reports that “owing to the presence of foreign firms, the share of high-tech branches has increased in the manufacturing sector in Hungary, the Czech Republic and Poland” and the “share of low-tech branches decreased radically”, which are clear signs of convergence. These countries have increased their market shares in EU-15 between 1995 and 1999.

On the regional level, Traistaru and Wolff (2002) show on the basis of a shift / share analysis of Bulgaria, Romania and Hungary, that regional differentials in employment growth are mainly driven by region-specific factors. Industry-mix plays only a minor role. Such results are somewhat in contrast to those for old member states and bear important implications for location policy measures and the attraction of foreign MNEs. Landesmann and Stehrer (2002a, b) show that the paths taken by the different CEECs have been quite varied. (see also Landesmann, 2003) They argue that a combination of a catching-up plus trade specialisation model is required to understand the patterns of specialisation emerging in the CEECs.

(iii) Trade

The following Tables provide evidence on the structure of exports by commodity groups (Table 6.9) and by export markets (Table 6.10).

Tables 6.9 and 6.10 about here

The share of the machinery sector has risen in all countries, except for Slovenia, where it has remained stable. For manufactured goods, the share of Hungary, Slovakia and Slovenia has fallen, while it remained constant in Poland.

Evolution of exports of CEECs by regions, divided between EU and CEECs is
interesting, since the market structure and the nature of competition differ substantially between the two areas. The extent to which CEECs succeed in EU markets is decisive for their catching-up process, since the markets of the latter are more demanding than those of the CEECs.

An evaluation of the evolving production, FDI and trade patterns lead to the proposition that competition for inward FDI within the enlarged EU will intensify. First, the new members are not very likely to keep up their growth rates of inward FDI, and second, the incumbent members need inward FDI to counterbalance low growth at home. With respect to the convergence or specialisation scenarios, we conclude that old and new members will increasingly compete for the same type of investment, while the present role of the new members as low-cost locations will be taken over by European countries further East (CIS, SEE).

The following subsection describes the economic rationale of location competition and its consequences in greater detail.

6.3. Some Economics of Location Competition and FDI-PP

The discussion about the welfare effects of location competition is characterised by the continued efforts of governments to attract inward FDI on the one hand, and theoretical and empirical research, showing the ineffectiveness of FDI-PPs, on the other.

6.3.1. Location factors as public inputs to private production

How is public infrastructure linked to private sector productivity? Empirical evidence on infrastructure and regional economic performance (Munnell 1990; Fernald, 1999; Seitz, 2001) suggests in general, a positive infrastructure elasticity of output. Seitz (2001) derives estimates for OECD countries of 0.12-0.17. On a regional basis and contrary to expectations, empirical results suggest that the marginal productivity of infrastructure investments is low in lagging regions and is most pronounced for developed regions. This would purport to explain why FDI is attracted to the latter.

6.3.2. Economic justification for FDI promotion

5 Important caveats must be made with respect to the underlying assumptions of the model (endogeneity problems; conditionality) as in most other studies on public and private investment. Seitz (2001) discusses the limitations in greater detail.
The market failure approach justifies subsidisation of FDI in the presence of positive externalities, where FDI is insufficient. The economic rationale for location competition, then, is driven by the idea that inward FDI is too low. The main problem is therefore how to increase the efficiency of incentives (UNCTAD 1997). Just as FDI itself, FDI promotion has effects (Graham, 2001): First, incentives increase the aggregate flow of FDI; and second, incentives may affect the spatial distribution of FDI. Besides a growing case-by-case evidence, authors like Haaland and Wooton (1998) show the ineffectiveness of location competition also on a theoretical basis.

The possible contribution of FDI to growth and cohesion should be carefully distinguished from the effects of FDI-PPs (Weise et al. 2001). In particular, the possible positive gains of FDI will be diminished or partly offset, by several negative impacts of FDI-PPs. (a) The welfare loss arising from “oversubsidising” due to location competition (i.e. international externalities between countries, or intra-national between regions; Besley and Seabright 1999). Also, the distributional consequences have to be considered, as the losses do not necessarily arise in the same jurisdiction as the gains. (b) The allocative inefficiencies arising from FDI diversion have to be accounted for. Thus, the main theorems of welfare economics – as in Systems Competition in general (Sinn 2001, p. 12) - do not hold for location competition. (see also Oates 2001; Oates and Schwab, 1991). Sweeney (1993, pp. 63-64 and p. 93ff) consequently proposed FDI-creation vs. FDI-diversion effects as a general guideline for the evaluation of FDI and for the development of policy conclusions.

Empirical analysis in this area suffers from two causality problems:

1. Concerns about causality between FDI and host country growth: The relationship of FDI capital to capital formation in the host country (see e.g. Lipsey and Mucchielli, 2002; Mencinger, 2003: pp. 6 and 9; Oman 2000, p. 115) may be both ways. An increase of FDI may actually follow growth, as it seems that growth attracts FDI and even FDI-promotion.

2. Concerns about the effect of FDI promotion on aggregate FDI as for investment location decisions of firms, incentives matter only marginally (Wells and Wint, 2000).

A final aspect has to be discussed here: Which component of FDI is really mobile? Hardly replacement investment (gross FDI), nor EU-enlargement market-seeking FDI, nor FDI driven by M&A activity. This leaves only greenfield FDI, whose share of the total has been declining substantially. Therefore, location competition via FDI-PP is limited to new investment, and FDI, similarly to domestic investment, fluctuates with the business cycle.

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6 Possible negative externalities of FDI may arise in two ways: (1) crowding out of domestic firms; (2) increase in market power due to takeovers, which threatens competition.
Indirectly, LP has an effect on expansionary FDI.

An appraisal of the economics of location competition casts serious doubt on the effectiveness of FDI-promotion measures. The upgrading of important location factors would therefore, seem a more reasonable strategy to pursue. Following this line of argument, we will now distinguish between the effects of EU-enlargement on inward FDI (6.4.) and the effects of EU-enlargement on FDI-related policies (6.5.).

6.4. Effects of EU-enlargement on Inward FDI

6.4.1. Lessons from earlier enlargements

The question that arises from the experience of Portugal, Spain, Greece and Ireland has often been raised. (see also Chapter Hood – Tavares) These countries are important, because they have been regarded as economically disadvantaged on the "EU-Periphery", a role which may now be assumed by the new members. (Buckley and Artisien, 1997; Hood, 1998) The general view is that the Eastern Enlargement differs from earlier rounds, at least with respect to FDI. Brenton (2002, p. 1), for example, notes four key differences from earlier enlargements:

- Broader dispersion of income levels
- New members are transition countries
- More EU legislation has to be adopted
- Substantial degree of pre-accession integration (although at least in the 1995 enlargement this was required as well, C.B.)

Concerning location competition the difference to earlier enlargements is that - unlike the earlier rounds – the new members are entering a Single Market, which functions quite smoothly as opposed to a customs union. Hence, there is less room for policies which lead to FDI diversion (see section 6.6. below). This also enhances the relative importance of location factors.

6.4.2. The Impact of Enlargement on the Volume of FDI

- FDI-related trade in intermediate inputs and final products will change, along with changing structural and geographical production patterns through a re-direction of FDI.
- Production relocation is not likely to occur on a large scale as many industries are characterised by overcapacity, and the cost advantages of the new member states will
be gradually eroded. Studies on the motives for FDI in the new member states have repeatedly shown the dominance of market-related FDI. Since production and cost-related advantages are affected by the Enlargement this pattern of motives of foreign MNEs is likely to undergo some changes. Barry (2002), analysing the lessons from the Irish experience, finds that the CEECs are actually more similar to Ireland than to the Southern EU-periphery.

- Due to expected EU-enlargement and to large scale privatisation, enlargement effects on inward FDI are expected to be low.
- East European Markets, at least in some areas, are already divided between the main competitors, (e.g. banking). Market entry is therefore difficult.
- There is a consensus among economists in Europe that the EU-enlargement process will not lead to strong shifts in intra-EU FDI, at least in the short run (Nunnenkamp 2002;). UNCTAD (2003) maintains that “there are differences in the type of FDI that accession and non-accession countries may attract”.
- There are several reasons, why such relocations are of less importance today: share of labour (costs) declining; manufacturing in the form of outsourcing, few direct production activities; etc. The relocation of production via independent producers and thus through international trade is much less visible, yet far more important in quantitative terms.

6.4.3. The impact of the shift of structural funds on the spatial distribution of inward FDI

One particular effect of EU-enlargement is the shift of Structural Funds for the creation of infrastructure leading to FDI-diversion. The hypothetical impact of the envisaged Structural and Cohesion Funds re-allocation as planned in Agenda 2000 on the FDI allocation in 1995/96 reveals an increase in FDI shares for Hungary, Poland, Czech Republic and Slovenia of 0.8 percentage points, mostly at the expense of Ireland and Portugal (Breuss et al. 2002, p. 14). Although these results are based on simulations of a shift of structural funds to the new members, the simulations are themselves derived on the basis of parameters set in various EU agreements.

**** Figure 6.2. about here

Higher GDP is not necessarily combined with higher inward FDI pc (see Fig. 6.2). The relationship is closer for poorer countries, while the richer countries are more dispersed as to
their inward FDI pc.

The following sections consider FDI-PPs and LPs in turn. FDI-PP is basically short term oriented, flow-oriented and is applied to classes of firms categorised by ownership (e.g. attraction of new foreign firms; bidding against other locations). LP, on the other hand, is more concerned with long-term objectives and comprises stock-oriented measures (e.g. investment after-care programmes; upgrading of infrastructure). It is not so much concerned with the classification of firms on the basis of ownership but utilises other criteria like size, industry, R&D-intensity, growth etc. Both FDI-PP and LP can be further broken down into fiscal and regulatory competition (UNCTAD 1996).

6.5. Effects of EU-enlargement on FDI-PP

6.5.1. Change of the Decisive Location Factors due to Enlargement
In section 6.4.1 it was argued that the relative importance of location factors will change due to Enlargement. From the viewpoint of investors, the main question is whether an investment in the new member states is more profitable than in old member states, no matter, whether is is market-seeking or efficiency-seeking FDI. While the answer is likely to be project related, in general the new member states will suffer disadvantages with regard to particular location factors such as stability, institutional environment, business culture etc. Here, we draw a distinction between those location factors which can only be indirectly influenced by governments (like wages, Sinn 2001) and those which can be directly altered by the state (like taxes, Murtha and Lenway 1994). Although both groups affect the location decisions and strategies of foreign MNEs, the former group may be more problematic in transition economies. The implication is, of course, that this substantially limits the scale and scope for policy interventions. The latter group of location factors has converged very rapidly towards EU standards (e.g. corporate tax levels). The present configuration of location factors in the new member states, in particular the relative labour-cost advantages and the availability of skilled labour, suggests a substitutive nature of certain production stages, while the market-seeking FDI are complementary from the viewpoint of the old member states. The former are highlighted by several headline cases (such as Conti – Semperit - Gislaved, see Chapter 1),

7 We focus here on the transparent measures of location policy. Thus we exclude case-by-case decisions, specific infrastructure supplied to only one firm and kinds of bribes and corruption. While we are aware of indications that with stricter competition policy, all governments are more inclined to shift into these grey areas, they are not amenable to quantitative analysis.
yet it is difficult to judge whether these investments would have been lost to new locations elsewhere, even if the opening of Eastern Europe had not occurred. The latter type of FDI is reflected in growing exports towards the new member states and is therefore, welcomed by the incumbent member states.

Empirical evidence is suggestive of the following factors:

- A wide variety of location factors is relevant in different regions and countries (e.g. Wheeler and Mody, 1992; Pennings and Sleuwaegen 2000; Veughelers, 1991; Mudambi 1995, 1999).
- Motives for FDI differ by region (e.g., Fallon and Cook, 2003 for the UK), which is why authorities should tailor their FDI policy mix according to the firms’ principle motives. This requires a degree of flexibility at the regional level, which may stand in conflict to the need for co-ordination at the supra-national level. (see policy conclusions below)
- The cyclical dependency of FDI inflows (Yeyati et al., 2003) may dominate short-run determinants of FDI.
- Rather than treating location factors as exogenous determinants of inward FDI, we have to acknowledge the endogeneity of location factors (e.g. Barry 2002). Egger and Egger (2002) on new members and Egger et al. (2000) on incumbent members show how the outsourcing activities of old member states (implying higher FDI to new members) drive up wages in the latter, thus making them less attractive as low-cost locations.
- High tax and wage elasticities point to more intense competition between regions than between nations.

EU-enlargement, therefore, changes the quality of FDI, while the quantity need not increase dramatically. The qualitative changes are based on a further shift towards a deeper international division of labour.

6.5.2. Competition via Taxes and Labour Costs: Race to the bottom?

It has been argued in the previous section that low taxes and labour costs are both powerful determinants of location decisions of foreign MNEs. Both cost factors, however, bear the danger of a race to the bottom, which mainly creates losers in the long run, including the location where the investment is carried out. Therefore, they deserve closer attention.

6.5.2.1. Location factor “tax” in comparative perspective
Two types of tax competition are normally defined in the literature: (i) locational attraction of production, i.e. MNEs; and (ii) locational attraction of tax revenues through low tax rates (Devereux et al. 2002). The latter type is not possible for most EU-countries, hence the production attraction (“tax base”) remains the only effective form of tax competition to increase welfare.

Based on the available empirical evidence, most authors agree on a marked decline and convergence of statutory and effective (marginal and/or average) tax rates in OECD countries, pointing to the important role of tax competition. (see Figures 6.3 and 6.4)

- The effective marginal tax rate has remained stable over the 1980s and 1990s; the effective average tax rates for projects earning positive economic profits have fallen over the 1980s and 1990s, and they have fallen more at higher levels of profitability; allowing for lower inflation implies a small reduction in the effective marginal tax rate, and a greater fall in the effective tax rate. (Devereux et al. 2002)

*****Figure 6.3. about here
Source: Devereux et al. 2002, p. 464, Figure 8. (For details of the calculation, see Notes)

- Sinn (2001, p. 7) reports that the average corporate income tax rates of US affiliates in the EU fell by more than 12 percentage points during the period 1986-1992.
- Altshuler et al. (1998, p. 25) reports on a decline in average tax rates between 1980-92 from 0.32 to 0.23 as well as a reduction in the standard deviation for 58 countries (manufacturing sector). Furthermore, an increased tax sensitivity in the location of real capital abroad by U.S. manufacturing companies is reported (ibidem, Table 2).

*****Figure 6.4. about here

While taxes are the prerogative of governments, the wage-bargaining process to which we now turn differs substantially in the degree of centralisation across EU-member states.

6.5.1.2. Is the past location advantage of low wages in CEECs eroded with enlargement?

With a rapidly declining share of labour (costs) in production (costs) and generally rising labour costs relative to productivity growth, the advantages of shifting production from
incumbent to future member states are declining. Capital deepening - as an alternative to relocation - will therefore become an important strategy of MNEs within the enlarged market. (See the chapter by Buckley who distinguishes three types of labour.) Therefore, EU-enlargement will only temporarily ease the cost of structural adjustment in incumbent member states via vertical FDI. The hub and spoke strategies of MNEs, as described in chapter xy (Buckley) will lead to the closure of peripheral plants. Of course, labour costs are a major factor in competitiveness only in mature segments of industries.

*****Table 6.11.

The reported rise in wages (see Table 6.11) may “destroy” the most important location advantage of the CEECs. Yet, this is only part of the story, as productivity and income effects have to be considered as well. As Table 6.12 shows, productivity growth was well above wage growth in all five countries – at least in the manufacturing sector.

*****Table 6.12.

The consequences for location competition in a scenario of tax competition, as given in the CEECs, paralleled by the gradual loss of labour-cost advantages in the new member states would be to reduce the incentive for outsourcing / fragmenting type of FDI. However, holding companies might consider re-location. This would lower tax revenue in old EU-members, yet would not threaten other headquarter functions (see Chapter by Braunerhjelm).

The following section now tries to provide an answer to the main question of the impact of EU-enlargement on the race for FDI in the light of the above discussion.

6.6. Impact of EU-enlargement on the Race for FDI

It has been argued that location competition affects the volume of FDI-inflows as well as the spatial/regional distribution of FDI. Furthermore, the institution and process of location competition itself will be affected by the EU-enlargement. It has been explained that the effect of EU-enlargement on FDI-PP and LP depends on the evolving production patterns and the subsequent trade and FDI-patterns. The effects are outlined in three parts:

6.6.1. Allocation-related
The convergence of production patterns to the EU-core is more likely than the specialisation scenario to lead to catching up. The convergence outcome is seen more as a threat than as a welcome force of structural change in incumbent EU-countries. Therefore, the old member states are likely to engage in measures to counterbalance the perceived losses of production, in view of the large amounts of money spent on structural change within the EU. It is not unlikely that short-run losses of the old members will be counterbalanced by medium-run gains as growing exports to the new members have already indicated. However, it has been pointed out that there is no guarantee that intensified location competition attracts more FDI (causality problem).

In terms of the dynamic effects of FDI-PPs, i.e. the possibility that FDI-diversion may lead to FDI-creation through expansionary investment, should not be ruled out, and may justify policy intervention (such as the envisaged shift of Structural Funds towards the new member states), despite the arising inter-generational and inter-regional burden.

The main thrust of location competition in the new members after the Enlargement will not be in low-tech areas, with pressure on environmental standards or labour costs. This is due to the favourable location factors (such as RULC or the skill level of human capital).

Contrary to competition between firms, location competition between local/national authorities tends to destroy some of the gains from MNE attraction.

6.6.2. Regional and distributional dimensions

Positive gains from FDI-attraction will be regionally concentrated and unevenly spread across industries. This has important labour-market consequences as to the wage differentials across industries and employment ratios across regions.

As regional governments attach considerable weight to the upgrading of regional competitiveness via FDI as a means of income convergence, the pressure for autonomous LPs will gain importance with enlargement.

6.6.3. Institutional Setup

The effects of FDI-PPs need to be distinguished from the effects of competition between authorities, which may well contribute to efficiency. In the light of the institutional problems of transforming the new members into market economies, this
efficiency effect should not be underestimated. Since investment promotion agencies are often internationally oriented, a good deal of learning has already occurred.

- The influence of the state on several location factors has been deliberately reduced (e.g. de-regulation of labour markets). Therefore, the instruments for LPs are less powerful than they used to be in the past.
- The basic dilemma of (regional, local) governments is that integration leads to a greater need for differentiation of locations, yet reduced possibilities due to harmonisation pressures. This dampens the effectiveness of incentives in the Single Market. Consequently, policy measures have to be designed carefully and supra-national institutions have to monitor them closely.

Based on these conclusions several policy implications are proposed in the final section.

6.7. Policy Implications
This chapter assessed the effects and policy implications of EU-enlargement on the race for FDI. FDI-creation and FDI-diversion effects have been proposed as a general guideline for the evaluation of FDI and for the development of policy conclusions. The policy implications are now grouped accordingly to the effects discussed in section 6.6.

6.7.1. Allocation-related
- Given that inward FDI constitutes a substantial share of capital formation within the EU, investment promotion measures need to be subject to competition rules. However, transparency in this area is still very low.
- FDI-diversion related welfare losses point to a general shift from FDI-PPs to LPs. To a certain extent this also implies a shift from fiscal to non-fiscal incentives. While LPs of the EU have been evaluated in a rather pessimistic sense (Besley and Seabright 1999; Deveneux et al. 2002, as to subsidies and corporate tax competition) they at least tend to be oriented towards the top rather than the bottom.
- However, one need not be overly pessimistic, because the abolition of certain types of location competition can lead to a shift of policy instruments to other areas. Sinn (2001) argues, for example, that a harmonised tax rate would lead countries to compete via public infrastructure.
A race to the bottom in some spheres (e.g. tax competition) would not be compatible with a race to the top in areas such as public expenditure on infrastructure.

Policy may provide incentives to turn a race to the bottom into a race to the top. Harmonisation in those areas where the race to the bottom is most likely, may shift the emphasis of location competition. Yet, while this is possible in areas like corporate taxation, it is not very likely in policy issues (like wage bargaining, social security systems etc.), where member states are not likely to give up autonomy. Therefore, the danger exists that the immobile factor labour will pay the price of harmonization in other areas.

From the literature on infrastructure elasticity with respect to private productivity (output, labour). Seitz (2001) concludes that neither a race to the top in public infrastructure investment, nor a reduction of public spending aimed at reducing the tax burden can be implied. In his view, public infrastructure spending should move in parallel with the structural changes in the economy. The evolving shifts in production patterns in the new member states, and the importance of regional factors explaining employment dynamics, make such adjustments of the public infrastructure vital for these countries. Focusing infrastructure on the needs of foreign investments only seems to be too narrow to achieve fast growth.

Theoretical and empirical evidence suggests the need to abolish discriminatory measures between domestic and foreign firms in the new member states, something which has been achieved to a large extent anyway. It implies that all FDI promotion is abolished (except whatever is allowed in a regional or cohesion context, and by the dictates of competition policy).

The quality of FDI counts as much as the quantity, although it has not been given the weight it deserves by EU policies. Therefore, any LPs should require the use of quality indicators, such as the quality of human capital employed; whatever expansionary investment is likely, local vs. regional effects etc.

6.7.2. Regional and Distributional Dimensions

Regional disparities (Dunford and Smith, 2000; Boldrin and Canova 2001; Braunerhjelm et al. 2000; Phelps 1997) may require that the EU puts relatively more weight on distributional gains than on allocative efficiency in evaluating FDI-PPs. Frequently, in view of possible aggravation of regional disparities through inward FDI, more cohesion and regional policies have been called for. However, evaluations
of regional, convergence and state aid policies cast doubt on the value of extending such policies in the wake of EU-enlargement, as strong doubts have been raised as to the effectiveness of certain policies (see e.g. Boldrin and Canova 2001). Independently of the evaluation in question, the following guideline should be followed: FDI-PPs and LPs should not be abolished under the competition-policy heading and then re-introduced through the back-door of regional policies.

- In addition to this visible part of LPs, the invisible part of location advantages should not be forgotten as it plays an important role in location decisions by firms. This comprises the role of the social partners; the (in-)efficiency of competition policy; the role of the regulators of public utilities (an area where more and more FDI is directed); availability of business-related services etc. (see below 6.7.3).

- Similarly to earlier enlargements (Brenton and Manchin, 2001) the EU should carefully open market access for adjacent non-members, since this helps the new members to catch up via production re-location.

- The high local concentration of FDI in the new members suggests measures to diversify the investments of MNEs on a regional basis in an enlarged EU, in order to prevent diseconomies of aggregation and to stimulate externalities in other regions. Recently, the local nature of technology spillovers to adjacent regions in major EU countries has been shown.

6.7.3. Institutional Setup

- Sweeney (1993) makes a strong case for the likelihood of government failure (“government policies are not made this (in an optimal, C.B.) way” (p. 66), which would support a reduction of government interventions.

- As the share of corporate tax revenues has continuously declined within the EU despite a massive increase in firm activity, no further burden should be put on immobile factors. Rather, the EU must cope with the problem of corporate tax evasion and tax havens outside the EU. Since real capital is not perfectly mobile and, indeed, in many respects highly immobile (especially the high value-added stages of production), mobility does not provide an excuse for low-tax policies.

- More co-ordination on the international, supra-national, national, bi-national or regional level would be welfare enhancing in the case of regional or international market failure. A realistic view would probably be that policy cannot prevent location competition, but it should try to limit the negative allocative and distributional effects.
Stability of policy is an important factor (Sweeney 1993), even so today for the new members which have to comply with EC rules. Since the Enlargement adds mainly lagging regions so that the limited Structural and Cohesion Funds have to be re-allocated, the re-introduction of FDI-PPs under this heading is tempting for old and new members alike. Old member states have to provide assurances of credible and “workable” regional policies for the lagging regions within their jurisdictions. This again stresses the importance of the national level with regard to LPs. Central and supra-national policy decisions should be aimed at the new member states in order to reach the co-ordination level necessary to avoid detrimental effects of location competition on welfare. Yet, the principle must not be overemphasised for fear of tying too much the hands of national and regional authorities.

How far have the new members come in following such policy advice? A short mailing survey of the investment promotion agencies in Hungary, Slovenia, Czech Republic, Lithuania and Slovakia has revealed that - with minor exceptions – all countries concerned have adjusted to EU-compatible FDI-PPs. Moreover, discrimination between domestic and foreign firms has been largely abolished, as practically all firms are eligible for investment promotion grants. Surprisingly, no intensification of co-ordination between the national agencies is intended, although there are some initiatives at the cross-border regional levels.

This chapter’s focus was largely on FDI-PPs and LPs geared to an objective of welfare improvements from higher efficiency and equity. The interplay with other policy areas such as competition policy, ownership restrictions, general investment policies, case by case decisions or public procurement were deliberately neglected. Although we have argued that the role of FDI-PPs should be limited from a purely economic viewpoint, in practical politics it may require efficiency distorting measures to reach other non-economic goals. The increasing spread of income per capita, the widening regional disparities, the shift of production “further East” etc. will create tensions and a potential for conflict between incumbent and new member states. This may create a need to counterbalance such developments with some of the policies outlined above.

6.8. References


UNCTAD (2003) Note to Correspondents, Enlargement of the European Union: A Boost to
Tables and Figures

Figure 6.1. Global Downturn

Figure 6.2. GDP per capita (squares; at PPPs in mn USD, OECD) and inward FDI stocks per capita (triangles; mn USD, OECD) 1999 sorted by GDPpc

Source: UNCTAD, DTI-FDI Database
Figure 6.4: Average and dispersion of effective tax rates in the sample and in the European Sub-sample

Table 6.1. The role of foreign affiliates in the economic performance of selected CEE countries, 1999, percentage

<table>
<thead>
<tr>
<th>Economy</th>
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<th>Employment of foreign affiliates as a percentage of total employment</th>
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Table 6.2. Inward FDI stocks as a percentage of GDP in CEE countries, 1995 and 2000

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<th>2000</th>
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</tr>
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<tr>
<td>CEE average</td>
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<td>World average</td>
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Source: UNCTAD, FDI/TNC database.

Table 6.3. Foreign direct investment inward stock (USDmn)

<table>
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<tr>
<th>Year</th>
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<th>Poland 2</th>
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<td>72</td>
<td>9,523</td>
<td>109</td>
<td>-2</td>
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<tr>
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<td>8,572</td>
<td>11,463</td>
<td>2,659</td>
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<td>1,998</td>
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<td>14,587</td>
<td>5,427</td>
<td>2,083</td>
<td>2,207</td>
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<tr>
<td>1997</td>
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<td>16,086</td>
<td>22,479</td>
<td>8,504</td>
<td>2,890</td>
<td>2,277</td>
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<tr>
<td>1998</td>
<td>14,375</td>
<td>18,517</td>
<td>26,075</td>
<td>13,634</td>
<td>3,188</td>
<td>2,682</td>
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<td>19,299</td>
<td>33,603</td>
<td>20,108</td>
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<tr>
<td>2000</td>
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<td>19,804</td>
<td>39,000</td>
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<td>23,562</td>
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Notes:
- Czech Republic: equity capital cash + in kind + reinvested earnings from 1997 + loans from 1997; excluding privatization revenues.
- Hungary: equity capital cash + loans from 1996.
- Poland 1: equity capital cash + in kind + reinvested earnings + loans - on a transaction basis. 2001: WIIW estimate.
- Poland 2: equity capital cash + loans - on a cash basis.
- Slovak Republic: equity capital cash + reinvested earnings + loans.
- Slovenia: equity capital + reinvested earnings + loans.
Source: WIIW Handbook, p. 457, Table VIII/3.2

Table 6.4. Foreign direct investment inward stock, by country of origin (as of December 2001, shares in %)

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Source: calculated on the basis of UNCTAD DTI-FDI database
Table 6.6. Inward FDI flows as a percentage of gross fixed capital formation: EU-25

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Central and Eastern Europe

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Southern Europe

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<td>9.6</td>
<td>31.1</td>
<td>96.5</td>
<td>69.5</td>
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<tr>
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<td>6.1</td>
<td>3.1</td>
<td>4.9</td>
<td>4.4</td>
<td>8.2</td>
<td>10.6</td>
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</table>

Source: based on UNCTAD, WIR 2002, Table B5

Table 6.8. Foreign direct investment inward stock, by activities (as of December 2001, shares in %)

<table>
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<tr>
<th>NACE classification:</th>
<th>CZ</th>
<th>HU</th>
<th>PL</th>
<th>SK</th>
<th>SI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>38.1</td>
<td>36.8</td>
<td>41.2</td>
<td>43.8</td>
<td>36.2</td>
</tr>
<tr>
<td>Wholesale, retail trade, repair motor veh.</td>
<td>15.0</td>
<td>12.4</td>
<td>11.4</td>
<td>10.5</td>
<td>13.9</td>
</tr>
<tr>
<td>Financial intermediation</td>
<td>14.7</td>
<td>11.3</td>
<td>23.1</td>
<td>25.9</td>
<td>28.3</td>
</tr>
<tr>
<td>Total, USD mn</td>
<td>21,644</td>
<td>10,310</td>
<td>53,152</td>
<td>4,687</td>
<td>3,209</td>
</tr>
</tbody>
</table>

Notes:
Selected sectors only, therefore data for each country do not add up to 100 percent.
Data for the Czech Republic and Hungary refer to 2000.
Deviations from the general methodological definitions, see table 3.
Hungary: Survey done among the largest FDI enterprises by National Bank and Central Statistical Office.
Poland: Realized investment with more than USD 1 mn capital given by Polish Agency for Foreign Investment.
Slovak Republic: Excluding loans.

Source: WIIW Handbook, p. 459, Table VIII/3.4
### Table 6.9. Exports by commodity groups (current prices, per cent of total)

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<tr>
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<td>1)</td>
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<tr>
<td>CZ</td>
<td>Manufactured goods class. by materials</td>
<td>24.4</td>
<td>32.3</td>
<td>26.9</td>
<td>26.0</td>
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</tr>
<tr>
<td></td>
<td>Machinery and transport equipment</td>
<td>37.7</td>
<td>30.3</td>
<td>40.6</td>
<td>42.4</td>
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<td>26.2</td>
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<td>30.3</td>
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<tr>
<td>HU</td>
<td>Manufactured goods class. by materials</td>
<td>18.5</td>
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<td>12.4</td>
<td>11.5</td>
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<td>Machinery and transport equipment</td>
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<td>57.3</td>
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<td>26.7</td>
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<tr>
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<td>Machinery and transport equipment</td>
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<td>37.4</td>
<td>39.4</td>
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<tr>
<td>SI</td>
<td>Manufactured goods class. by materials</td>
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<tr>
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<td>Machinery and transport equipment</td>
<td>38.1</td>
<td>31.4</td>
<td>36.6</td>
<td>35.5</td>
<td>35.9</td>
</tr>
</tbody>
</table>

Notes:
1) See general footnotes table 10.
2) 1990-1992 excluding the Slovak Republic.
3) In 1990 state trade only.
4) After 1997 including exports of firms with customs free legal status.
5) 1990-1992 excluding the Czech Republic.
6) 1990 and 1991 excluding former Yugoslavia.

Source: WIIW Handbook, pp. 405-412

### Table 6.10. Evolution of Shares of EU and CEEC export markets 1990-2001

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<td>CZ</td>
<td></td>
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<tr>
<td>Share of EU (15)</td>
<td>38.37</td>
<td>60.52</td>
<td>63.99</td>
<td>69.21</td>
<td>68.57</td>
<td>68.94</td>
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<tr>
<td>Share of CEEC (3)</td>
<td>n.a.</td>
<td>22.07</td>
<td>20.28</td>
<td>17.58</td>
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<tr>
<td>Share of EU (15)</td>
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<td>70.01</td>
<td>68.29</td>
<td>70.45</td>
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<td>8.42</td>
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<tr>
<td>Share of EU (15)</td>
<td>42.11</td>
<td>62.66</td>
<td>72.96</td>
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<td>75.10</td>
<td>75.00</td>
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<td>Share of CEEC (3)</td>
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<td>9.07</td>
<td>7.83</td>
<td>8.15</td>
<td>9.04</td>
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<td>SK</td>
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<tr>
<td>Share of EU (15)</td>
<td>40.75</td>
<td>37.40</td>
<td>55.65</td>
<td>59.38</td>
<td>59.03</td>
<td>59.86</td>
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<td>Share of CEEC (3)</td>
<td>n.a.</td>
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<td>29.76</td>
<td>30.22</td>
<td>30.04</td>
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<td></td>
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</tr>
<tr>
<td>Share of EU (15)</td>
<td>64.72</td>
<td>67.01</td>
<td>65.46</td>
<td>66.00</td>
<td>63.76</td>
<td>62.18</td>
</tr>
<tr>
<td>Share of CEEC (3)</td>
<td>5.51</td>
<td>5.26</td>
<td>6.71</td>
<td>7.29</td>
<td>7.93</td>
<td>8.01</td>
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</table>
Table 6.11. Average monthly gross wages and labour costs in manufacturing industry (current prices) (in EUR) Manufacturing total (NACE: D)

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<td>333</td>
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<td>378</td>
<td>438</td>
<td>627</td>
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<td>243</td>
<td>286</td>
<td>302</td>
<td>341</td>
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<td>188</td>
<td>253</td>
<td>248</td>
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<td>408</td>
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<tr>
<td>SI</td>
<td>433</td>
<td>607</td>
<td>709</td>
<td>744</td>
<td>787</td>
<td>1068</td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1) Estimated total labour costs (gross wages plus indirect wage costs).
2) In 1990-1996 data based on enterprises with 100 or more employees, from 1997 with 20 and more.
3) Enterprises with more than 5 employees, from 1999 all enterprises covered. Including mandatory premium for social security from 1999.
4) Data based on enterprises with more than 20 employees, from 1999 with more than 5 employees.
5) In 1991-1996 data based on enterprises with 25 and more employees, from 1997 with 20 and more.

Source: WIIW Handbook, pp. 151-156

Table 6.12. Labour productivity in manufacturing industry (annual growth rates in %) Manufacturing total (NACE: D)

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<tbody>
<tr>
<td>CZ</td>
<td>3.1</td>
<td>11.1</td>
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<td>4.9</td>
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<td>PL</td>
<td>12.9</td>
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<td>7.0</td>
<td>1.8</td>
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</table>

Notes:
1) Estimated total labour costs (gross wages plus indirect wage costs).
See general footnotes Table 8
Source: WIIW Handbook, pp. 158-163

Table 6.12. Labour productivity in manufacturing industry (annual growth rates in %) Manufacturing total (NACE: D)

<table>
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<tr>
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<tbody>
<tr>
<td>CZ</td>
<td>3.1</td>
<td>11.1</td>
<td>5.8</td>
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<td>7.2</td>
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<tr>
<td>PL</td>
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<td>5.0</td>
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<tr>
<td>HU</td>
<td>18.1</td>
<td>11.0</td>
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<td>16.7</td>
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<tr>
<td>SK</td>
<td>-3.6</td>
<td>7.8</td>
<td>13.5</td>
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<td>14.1</td>
<td>8.4</td>
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<tr>
<td>SI</td>
<td>-5.1</td>
<td>7.9</td>
<td>5.3</td>
<td>1.6</td>
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<td>1.8</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1) Estimated total labour costs (gross wages plus indirect wage costs).
See general footnotes Table 8
Source: WIIW Handbook, pp. 158-163