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The Role of the EU in Shaping FDI Flows to East Central Europe*

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Abstract

East Central Europe's (ECE) recent record in accumulating FDI stock is notable even from a global perspective. While most scholarly works downplay the role of the European Union (EU) in this process, this article claims that in an attempt to manage the economic opportunities and threats that ECE posed after the regime change, the EU has actively shaped foreign capital inflows to the region. First, the EU triggered a liberal shift in ECE's FDI policies. Second, after enlargement, the EU has reinforced ECE's locational advantages through its practice of approving most of the incentive schemes offered to foreign investors. While investors mainly coming from the old EU Members began to dominate ECE economies, the region's heavy reliance on FDI has also produced a reverse effect: ECE investments have enhanced the global competitiveness of western European firms. To a certain extent, FDI has therefore transcended the traditional east–west divide.

Introduction

Foreign direct investment (FDI) has been one of the main drivers of economic restructuring in east central Europe (ECE) and significantly contributed to the region's integration into the European and global markets. However, in the first decade of transition foreign capital inflows remained low in ECE. Yet, only ten years after joining the European Union (EU), the new east European members show higher levels of economic internationalization than the old ones. Moreover, within this short time period, ECE economies have accumulated far higher levels of per capita FDI stock than many other major emerging markets.

What factors explain the outstanding record of ECE in securing FDI? Why did this region become so attractive to foreign investors? Contrary to most scholarly accounts, which attribute a marginal or at best passive role to the EU in generating FDI flows into ECE, this author claims that the EU has actively contributed both to the formulation of FDI-oriented economic strategies in ECE and to the subsequent high inflows of foreign investments. The article argues that the EU's active engagement in favour of FDI has enhanced the locational advantages of ECE, which explains why foreign investors have consistently preferred to enter this region.

Within two decades after the collapse of communism, ECE economies have become deeply embedded into global production networks. By 2009, in each non-financial sector the average share of foreign-controlled enterprises from the total production value

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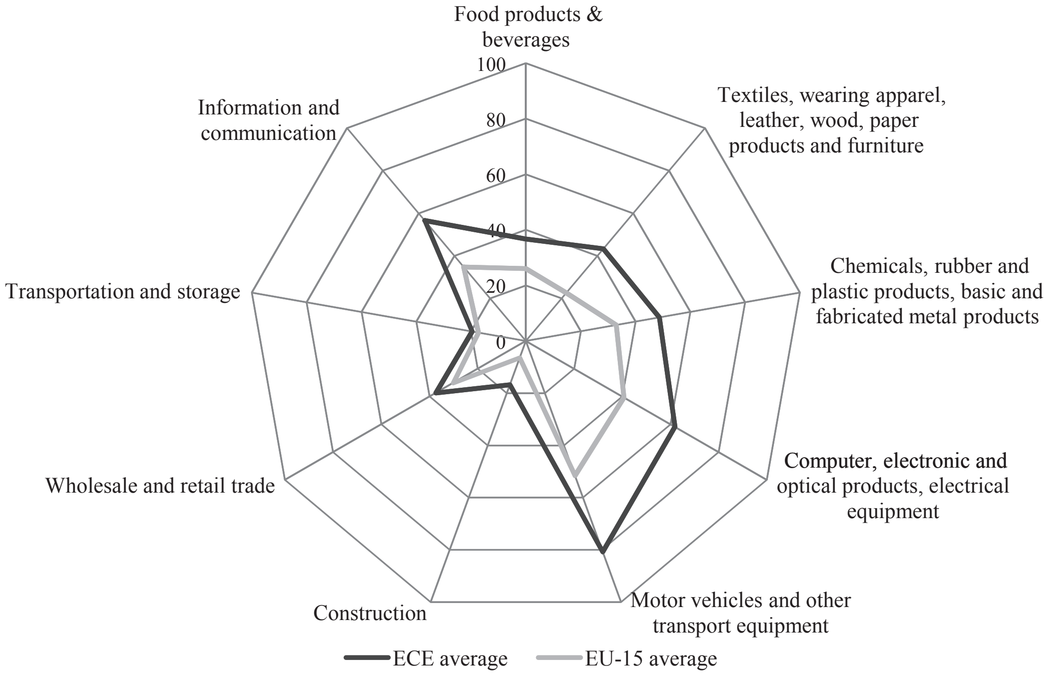
Figure 1: Sectoral Share (per cent) of Foreign-Controlled Enterprises from Production Value, 2009



Source: Author's own calculations based on Eurostat data.

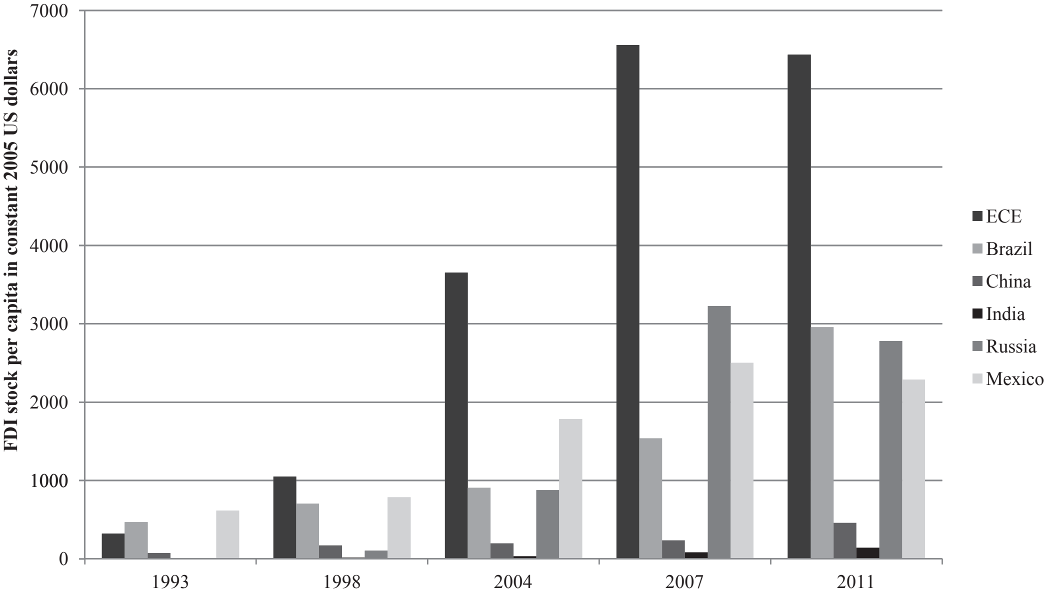
exceeded the corresponding figures for old EU Member States (Figure 1). Foreign involvement was especially strong in the export-oriented, capital-intensive sectors, but the information and communication sector also showed high levels of foreign control. Foreign penetration was lower only in those service sectors (transportation, retail and construction) where the size of the domestic market limits expansion. Although the average figures hide variations across countries, they demonstrate a striking feature of ECE economies: the eastern European 'pupils' have outperformed their western 'masters' in terms of economic internationalization.

These figures reinforce Nölke and Vliegenthart's (2009) argument that a new variety of capitalism – the dependent market economy – has emerged in ECE, which heavily relies on foreign capital inflows and foreign ownership. As the EU-15 is responsible for two-thirds of total foreign-controlled production in ECE, the old EU Members are the region's primary source of FDI.[1]

ECE's attractiveness to foreign investments becomes more puzzling from an international perspective. As Figure 2 shows, while FDI was slowly accumulating in the 1990s, it began to pour into ECE in the run-up to EU accession and continued to enter the region until the outbreak of the global economic crisis. Even though the crisis slowed down the

[1] It is beyond the scope of this article to discuss the sectoral variation and performance of FDI within ECE. While dependence on foreign capital has been associated with rising regional disparities, the crowding out of domestic investments and the birth of dual economies (see, for instance, Brown *et al*., 2007; Hardy, 1998; Pavlínek, 2004), FDI has also contributed to the narrowing of the developmental gap between eastern and western Europe (see Epstein, 2014).

Figure 2: FDI Stock per Capita in ECE and in Other Emerging Markets



Source: Author's own calculations based on UNCTAD data.

pace of FDI accumulation, compared to other major emerging markets ECE has remained the most penetrated by foreign capital.

Such a strong foreign involvement in ECE economies is remarkable with respect to the fact that a little more than two decades earlier these countries were under Soviet political and economic influence and even at the end of the 1990s the region demonstrated low levels of FDI. Why has ECE become so attractive to foreign investors if well into the transition period it showed relatively poor records of FDI, and what role did the EU play in this process?

I. Existing Work Explaining FDI Flows into ECE

The main approaches that dominate the literature on FDI flows to ECE attribute a marginal or at best passive role to the EU. The economics-based arguments emphasize the favourable host country characteristics and also refer to the positive effect of the EU's single market in attracting investments. Accounts that adopt the perspective of economic sociology challenge the economics-based view by arguing that the investors' behaviour is socially embedded and their location decisions are mostly determined by trade networks and cultural ties rather than objective cost–benefit calculations. These studies also stress the socializing effect of the EU in triggering investor-friendly policies in ECE. Finally, the political economy approaches highlight the significance of the initial domestic policies towards FDI, the timing and depth of economic reforms, and the interactions between foreign investors and domestic political elites. While all of these approaches bring important dimensions to the debate about FDI inflows to ECE, they treat the EU rather as a marginal actor in shaping investment flows. This leaves a gap in the literature which is discussed in detail below.

Most economic accounts found that low labour costs, the well-trained workforce and the expanding local markets attracted foreign investors to ECE (see, for instance, Galego *et al*., 2004; Gauselmann *et al*., 2011). Bevan and Estrin (2004) drew similar conclusions but they also showed that the mere announcement of prospective EU membership had an immediate positive effect on FDI inflows. Other studies (Baldwin *et al*., 1997; Breuss, 2002) argued that EU membership would improve risk perceptions and this, together with the effect of the EU's single market, would generate massive capital inflows: the 'less conservative' estimates of Baldwin *et al*. (1997) predicted a 68 per cent rise in the capital stock of the new eastern European members. While Narula and Bellak (2009) stressed the positive relationship between EU membership and FDI inflows, they also argued that membership would become decreasingly important for foreign investments in an expanding EU. However, as Figure 2 shows, these studies underestimated the volume of FDI inflows as ECE foreign capital stock more than tripled between 1998 and 2004 and this process did not lose momentum after accession.

Although the economic approaches highlight the general motivations of both the market- and efficiency-seeking foreign investors, they do not explain why in per capita terms ECE is far more attractive than other emerging markets, such as Brazil and Mexico, which offer even lower labour costs and bigger domestic markets. In addition, referring to the highly trained, cheap workforce being present in ECE ever since the transition began fails to explain the low levels of FDI in the 1990s and the sustained high flows in the next decade.

Challenging the above views from the perspective of economic sociology, Bandelj (2008) refers to the bounded rationality of foreign investors and argues that their investment decisions were socially embedded, mostly driven by cultural ties and social networks. She also attributes a greater role to the EU in influencing FDI as she claims that it 'exerted significant pressures on postsocialist states to commit to FDI in practice, not just on paper' (Bandelj, 2008, p. 83). Yet, Bandelj (2010) considers the EU as an ideational rather than a coercive actor: she claims that the frequent interactions with liberal-minded EU elites compelled ECE decision-makers to promote foreign investments. While her framework acknowledges the EU's formative role in FDI-friendly policies, it does not follow the EU's influence beyond accession and does not provide an explanation to the sustained or rather increasing FDI inflows to ECE after enlargement. Domestic commitment to foreign investments alone does not explain consistently high FDI inflows in an increasingly competitive global environment.

Among the political economy approaches, Drahokoupil's (2009a, b) work presents a compelling theory of the politics of FDI to ECE. He argues that the failure of the initially inward-oriented economic policies, which limited foreign capital inflows, allowed for coalitions between transnational capital and domestic political elites to trigger policy shifts and place ECE economies on a foreign capital-led growth model, which led to the rise in FDI inflows. Drahokoupil downplays the role of the EU in this process as he claims that external coercion does not explain domestic policy outcomes without accounting for intervening variables such as the coalitions between foreign investors and domestic elites. In their recent contribution, which draws a nuanced picture of the peculiarities of regime formation in ECE, Bohle and Greskovits (2012) also emphasize the interactions between multinational companies and domestic political forces. They argue that initial structural similarities to western production profiles and the timing of reforms were responsible for the variations in FDI in the 1990s, and the established first mover advantages determined subsequent patterns of foreign investment flows into ECE. In this whole process they consider the EU merely as an external enabling factor. Although these accounts highlight the significant influence of multinational enterprises on domestic politics, they do not explain why the adoption of FDI-friendly policies occurred almost simultaneously at the end of the 1990s and why ECE as a whole has been an increasingly attractive investment location in the 2000s.

This article aims to fill this gap in the literature by arguing that the EU has been a key player both in placing ECE economies under the influence of foreign investors and in maintaining their post-accession attractiveness. The point of departure is Jacoby's (2010) argument about how the EU responded to those challenges that ECE posed after the change of regime: eastern Europe represented an opportunity for the EU to expand its sphere of influence to these markets, yet it also had to face a threat of low-cost competition from ECE. In managing these threats and opportunities, the EU first secured ECE markets both through prescriptive policy frameworks and less coercive persuasive tools, which triggered liberal, investor-friendly policies towards the end of the 1990s. At the same time, the EU tried to mitigate the old Member States' concerns about losing productive capacities to eastern Europe. Once ECE economies were relying on foreign capital inflows and were promoting foreign investments, the EU had to ensure ECE's compliance with European competition policy rules. However, the EU's practice of approving most of the incentives targeted to foreign investors reinforced the cost advantage of ECE economies over other locations. Hence the EU has created an investment regime which enhanced the location advantages of ECE and proved beneficial for investors that mostly came from the EU-15. As Ellison noted (2006, p. 157): 'The eastern enlargement fits neatly not only into a strategy of market expansion but also into a strategy of controlling the evolution of markets and promoting the global competitiveness of the old member states'. The next section briefly reviews the initial ECE approaches to foreign investments, which is followed by a discussion on how the EU triggered a major shift in those policies and how it continued to influence FDI flows into ECE both during the pre-accession period and after enlargement.

II. Variation in Initial ECE Approaches to Foreign Capital

After the change of regime, a neo-liberal economic model was envisaged for transition countries, which suggested that the exposure of these states to the world market would enable them to 'adopt economic structures that would lead to greater prosperity and convergence on the living standards of Western economies' (Dunford and Smith, 2000, p. 170). The advocates of the neo-liberal development model shared highly positive views on the likely effects of foreign investments as they maintained that the primary driver of economic development in ECE would be the rapid growth in the stock of capital through massive FDI inflows. FDI was regarded as a key factor in the process of building a market economy (Pickles and Smith, 2005) and was also expected to provide a source of capital beyond the limited domestic capacities. FDI was also supposed to intensify foreign trade and economic upgrading by bringing in new technology (Bradshaw, 2005) and was expected to benefit local businesses through the spillover of technological, managerial and organizational know-how to domestic firms (Rugraff, 2008).

However, in the early years of transition the governing elites of ECE generally were unwilling to respond positively to these external calls for FDI. In the 1990s the bulk of foreign capital entered eastern Europe through privatization but most ECE governments adopted privatization schemes that restricted foreign involvement in the sale of state-owned assets (Beblavy and Marcincin, 2000; Boda, 2005; Vachudova, 2005). The initial industrial and social policies also aimed to protect domestic companies from competition and the labour force from rising unemployment. However, two countries chose a different road: Hungary and Estonia opened their gates to FDI early on.

Hungary already had some initial experiences with foreign investors, as 'the relatively liberal Hungarian trade regulations in the 1980s had provided plenty of opportunities for commercial contacts to develop' (Szanyi, 1998, p. 37). The decision on launching large-scale privatization to foreigners was also motivated by the record-high debt level, which the reformers did not renegotiate with the international creditors (Bohle and Greskovits, 2001). The sale of state-owned assets to foreign investors involved hard currency cash receipts, which was crucial for the already declining state budget and for the debt service. As Mihályi (2001, p. 62) put it: 'Hungary has done things differently because it had been forced from the very beginning to divest its most valuable state-owned enterprises [. . .] against hard currency'.

Even though its reform process began later as Estonia gained independence only in 1991, the country soon emerged as the champion of transition. As a result of the radical neo-liberal reforms, privatization was nearly complete by the end of 1995. According to Bohle and Greskovits (2012), the political elites in the Baltic states perceived the inherited industrial structure and especially its predominantly Russian workforce as a threat to national independence. By selling state-owned assets directly to western European investors, Estonia chose a primary privatization technique that prevented the potential empowering of ethnic Russian managers.

Among those states that pursued national capitalism, Slovenia represented a special case. Although the country was the most westernized transition economy, thus the most likely target of FDI, its foreign capital inflows remained moderate throughout the 1990s. This can be attributed to several factors. As Crowley and Stanojević (2011) argue, Slovenia had a competitive export sector of large capital-intensive and western-oriented companies, which depended on skilled labour. On the one hand, the employers had a strong interest in the job security of their core workers. On the other hand, the powerful labour movement exerted pressure on the government to introduce a privatization strategy that favoured company managers and workers. As a consequence, the emerging tripartite co-ordination led to the birth of a neo-corporatist system, where strategic sectors remained closed to foreign ownership (Bohle and Greskovits, 2012). In addition, the Slovene economy was not in need of drastic fiscal adjustments because the state budget was in balance when the country gained independence (Pleskovic and Sachs, 1994). Slovenia thus did not need to generate cash revenues by selling state assets to foreigners and, because of its export competitiveness, it did not require an immediate and deep structural adjustment of its economy through FDI.

In sum, the initial domestic economic strategies allowed for large foreign capital inflows only in few ECE economies. The primary source of FDI was privatization in the

1990s but most privatization schemes restricted foreign involvement. This is the reason why overall FDI levels remained disappointingly low (Sinn and Weichenrieder, 1997). At the end of the decade it seemed unlikely that less than ten years later ECE economies would become highly internationalized. European integration in general and the EU's influence in particular are the reasons why the process of ECE's economic internationalization has gained momentum in the 2000s.

III. From Inspiration to Coercion: The EU's Role in Triggering Foreign Capital-Oriented Development Models in ECE

In the early years of transition, the EU's influence on ECE did not go beyond mere policy advice. As Jacoby (2006) noted, in this period the EU represented a source of inspiration for domestic policy-makers. Yet, through the provision of financial assistance for economic restructuring, the EU tried to actively promote the opening of these economies to foreign investors. In particular, the EU was the main funding source of those national investment promotion agencies which were established in the early 1990s. In most cases the EU covered their operational costs and also sent experts who trained staff and helped develop their institutional structure.[2] Although the role of these agencies was to facilitate foreign capital inflows, in many instances their operation was initially compromised because of the unfriendly domestic political environment towards foreign investors.

However, as ECE countries demonstrated increasing commitment to European integration by applying for EU membership in the mid-1990s, the EU gained more influence over their domestic policies: the enlargement process added an externally induced regulatory dimension to transition (Bruszt, 2002). The European Commission engaged in a thorough investigation of the applicants' economic, political and social background in order to assess their progress towards fulfilling the membership criteria. The country opinions, which were prepared by the Commission for the 1997 Luxembourg European Council, served as the main documents for the decision on whether an applicant would gain candidate status or not.

These documents, which echoed the neo-liberal view on foreign capital and severely criticized the national capitalist approaches, urged greater foreign economic involvement in ECE. In fact, they revealed that this was an essential condition of EU membership. Regarding the economic criteria and specifically the openness to foreign investors, only Hungary and Estonia received positive feedback. In December 1997, the country opinions gained greater political significance when the European Council decided to begin accession negotiations with only five applicants (Estonia, Hungary, the Czech Republic, Poland and Slovenia), while the others, mostly because of their insufficient progress in democratization, were relegated to the second wave of negotiations.

While the EU was pushing for more privatization and FDI, it lacked any specific legal instruments that it could directly apply to the candidates. Although the EU's competition law thoroughly regulates mergers, acquisitions and state aid frameworks, it evidently does not prescribe an expected level of foreign economic involvement for Member States. This is the reason why the EU had to rely on membership conditionality and quasi-legal

[2] Interviews with representatives of investment promotion agencies (Prague, November 2011; Warsaw, September 2011; Budapest, February and March 2012).

instruments in enforcing its requirements: in the accession partnership documents, which officially outlined the necessary steps for the candidates to take, further privatization and the promotion of foreign capital inflows appeared as key economic conditions of membership.[3]

The growing external pressure on ECE governments generated broad political repercussions also with respect to FDI policies. The policy prescriptions of the EU implied that a radical shift was necessary in the attitude of those governments that had actively limited foreign involvement in their economies. Non-compliance risked prospective EU membership, which was politically unviable. For this reason, the EU's policy road map represented more than just a source of inspiration: it became a coercive tool to shape domestic developments. As a consequence, policy changes in the applicant countries were widespread (Wenig, 1999).

The new Slovak government led by Mikulaš Dzurinda was one of the most active in seeking compliance with the EU's demands. After the prime minister's visit to Brussels, a high-level EU–Slovakia working group was established, whose objective was to facilitate the country's preparation for EU membership and to foster the fulfilment of the accession criteria. In the meantime, the Slovak parliament abolished the law that banned the privatization of strategic enterprises and approved a comprehensive programme of economic restructuring, including the privatization of the banking sector. A strategy on FDI and a comprehensive system of investment incentives was also adopted (Figel, 1999).

Latvia also speeded up the privatization process and sold large state-owned telecommunication, energy and shipbuilding companies to foreigners (Sulca, 1999). Following suit, the Lithuanian parliament adopted measures that removed barriers to market entry and exit and amended the enterprise law to allow foreign companies to open their subsidiaries (Vareikis, 1999). Bulgaria also embarked on privatizing strategic enterprises in the telecommunication and energy sectors (Daskalov, 1999). In Romania, the government introduced generous FDI incentives and privatized large state-owned businesses in the manufacturing, telecommunication, energy, transport and banking sectors (Herlea, 1999).

Those countries also introduced liberal economic reforms that entered the first wave of accession negotiations but received criticism from the EU because of their restrictive privatization policies and sluggish enterprise restructuring. Even Slovenia, the most unlikely candidate to give in to external pressures, reformed its laws and even its constitution to provide foreign and domestic investors equal investment protection and equal rights to enter and exit business. This shows how significant the EU pressures were for triggering domestic change. According to Bandelj (2004, p. 465), 'foreign investment policy in Slovenia had to be amended to comply with the EU legislation'. In line with this policy shift, a grant scheme offering financial incentives to foreign investors was also introduced in 2000. A recent analysis has shown that Slovenia's reliance on investment promotion has been growing as the intensity of the country's FDI promotion through this scheme has gradually increased during the last decade both in terms of the annual amount spent and in the proportion of grants to project values (Burger *et al*., 2012).

[3] The accession partnerships signed with the candidate countries followed the same structure: in each document sections 4.1 (short-term economic criteria of membership) and 4.2 (mid-term economic criteria) prescribed the completion of the privatization process and in certain cases also indicated sectoral preferences. *Source*: «http://ec.europa.eu/enlargement/archives/enlargement_process/past_enlargements/eu10/».

These domestic developments show the significant influence the EU had on the FDI policies of ECE. The alternative explanations to the domestic policy shifts do not marginalize, but rather reinforce, the EU's role. The Czech economic crisis in 1997, which negatively affected other ECE economies, demonstrated the failure of the national capitalist approaches. At the same time, the International Monetary Fund and the World Bank were also pressing for those structural reforms that the EU was demanding. In addition, the relative success of those countries that sold state-owned assets early on encouraged others to emulate this process (Jensen, 2006). As a result of these developments, the FDI-promoting coalitions between multinational enterprises and domestic political elites gained strength and the EU became their powerful legitimizing 'ally'. In this respect, turning to the implementation of the neo-liberal-inspired policy template of the EU was almost overdetermined as all other alternatives failed. With an ironic twist, however, the adoption of FDI-promoting policies in ECE represented a regulatory problem for the EU and an increasing threat of low-cost competition to old EU Members. In the process of managing ECE, the EU had to cope with this new challenge.

IV. From Coercion to Regulation: The EU's Regulatory Influence and Its Consequences

The EU-driven reorientation of FDI policies speeded up the process of privatization, which decreased the number of remaining state-owned enterprises. This also implied that the role of traditional sources of FDI, such as greenfield investments became more significant (Antalóczy and Sass, 2001; Jensen, 2006). Those foreign investors that entered the region through privatization were mainly market-seeking as they wanted to gain access to and serve the local ECE markets. However, greenfield investors, which set up brand new production plants, were primarily export-oriented and efficiency-seeking: they chose to enter those locations which offered the lowest production costs. In this sense they were mobile and tended to 'shop around' potential sites before making an investment decision. In order to attract them, many ECE governments adopted generous investment schemes that offered fiscal and financial incentives to lower the costs of the planned investments.

Because ECE markets already offered low production costs compared to western Europe, the primary purpose of the incentives was to outbid the regional rivals who offered comparable investment sites. Especially among the Visegrad countries, which, as suggested by Bohle and Greskovits (2012), were structurally most similar to each other, a fierce 'bidding war' for foreign investments was developing (Drahokoupil, 2009a). However, the new ECE strategies of courting foreign investors amplified the already existing threat of low-cost competition to the EU-15. Given the low eastern European wages and the vast supply of high-skilled workers, ECE offered substantial cost advantages relative to western European production sites. This is the reason why the governments of old EU Member States were concerned about the possible relocation of manufacturing and service activities to ECE (Bellak, 2004; Young, 2005). While western multinationals could potentially boost their competitiveness by relocating from western to new eastern European plants, EU-15 governments were worried about the subsequent loss in western production capacities and employment.

Hence the quest for FDI allowed transnational companies to play off these states against each other: the intensifying investment competition reduced each country's bargaining power towards foreign investors (Lönnborg *et al*., 2003). For instance, in 2004 Siemens AG threatened to close several production units in Germany and shift production to Hungary and China because of too high German labour costs (Bohle, 2009, p. 178). In a similar vein, Volkswagen (VW) planned to cut car production in its Spanish subsidiary, SEAT. In September 2002, the company's management announced that it had decided to relocate part of its production capacity to Slovakia. However, the Spanish media revealed what became the core issue of the dispute, that the Slovak government granted generous tax holidays to VW, which covered about 30 per cent of the investment over a ten-year period (documented in Lönnborg *et al*., 2003, pp. 29–30). Seeking to preserve domestic manufacturing jobs, the Spanish government was threatening to veto the Slovak EU accession negotiations unless the Slovak state aid would be lowered to a 'fair' level. In the end, the European Commission succeeded in reaching an agreement between the two governments, and the Spanish veto was recalled.

Anticipating the increasing low-cost competition from ECE, western European governments began to offer investment incentives in order to prevent industrial relocation. A recent analysis (Šćepanović, 2013) of the European automotive industry found that already in the mid-1990s many EU-15 governments were pressuring the Commission to consider the cost advantage of ECE locations when it decided about the EU-compatibility of targeted incentives for investment projects in western Europe. For instance, in 1995 the German government refused to withdraw aid granted to VW for its planned investment in Mosel and Chemnitz because these locations suffered from substantial cost disadvantages compared to the alternative site in the Czech Republic. In the end, the Commission yielded to the pressure and between 1998 and 2004 it included potential ECE investment sites in the aid assessments. Šćepanović showed that in this period, whenever a western and an eastern location was compared to each other, the average cost advantage of east European locations exceeded 30 per cent of the total costs of investment and at times even exceeded 50 per cent. It is, therefore, not surprising that in each case the Commission approved the proposed EU-15 incentive schemes.

While these Commission decisions clearly favoured the multinational investors, the unintended side effect of this practice was that ECE governments had the impression that without offering even more incentives, western companies would refrain from investing in their economies. This is the reason why instead of complying with EU law, the candidates' investment policies were 'in striking contrast to and even diverging from European rules before accession' (Blauberger, 2009a, p. 1031). First, the candidates, whose efforts were backed by the multinational investors' lobbying activity in Brussels, successfully defended those tax allowances and fiscal subsidies that had already been granted to foreign investors: at the accession negotiations the EU gave temporary derogations for the already awarded incentives (see, for instance, Bohle and Husz, 2005; Guagliano and Riela, 2005). On the other hand, the emerging incentive competition in ECE led to a paradoxical situation: hardly had the EU reached its goal of ensuring free FDI flows to ECE, when the subsequent policy deviations from European competition rules forced the European Commission to step in and regulate.

While the EU did not have a genuine hard law instrument in its hands to enforce privatization of state-owned enterprises to foreigners, it possessed massive legal powers regarding investment incentives. Under EU law, incentives provided for investment projects classify as state aid, which may violate the EU's competition policy: Article 87(1) of the EC Treaty prohibits any state aid that may distort competition within the EU.[4] As candidate countries had to adopt the *acquis* and adhere to the principles of competition policy already prior to EU membership, discriminating between domestic and foreign firms through targeted incentive schemes was, at least in theory, no longer possible.

However, the EU's competition policy allows for certain important exceptions, which benefited the new eastern members. While targeted sectoral aid is generally unsupported (as opposed to horizontal aid), Articles 87(2) and 87(3) of the EC Treaty list those categories of aid that are justifiable. For instance, state aid promoting the development of an economically backward area can be compatible with EU law (Blauberger, 2009b). This is especially relevant for ECE because the per capita GDP is well below the EU average in most of the region. Incentives provided for investments in these backward locations can therefore be justified by referring to their contribution to regional development.

In this vein, the European Commission has consistently approved targeted aid to investment projects in backward ECE areas, which has reinforced the already fierce investment competition. By mid-2013, the Commission has decided in nearly 180 state aid cases that involved targeted aid or tax allowance offered by an ECE government. The Commission approved most of these schemes (sometimes after conducting a formal investigation procedure) and only in 19 cases was either a negative decision announced or the Member State withdrew its request and refrained from the provision of aid.[5] Even though not all of these grants were offered to foreign firms, this Commission practice has ensured that foreign investors continued to enjoy special treatment in ECE. Both in the pre- and post-enlargement period foreign investors were the greatest beneficiaries of the EU's investment regime. Besides the sizeable cost advantages of investing in eastern European Member States, foreign investors also benefited from those incentive schemes that the EU justified based on regional development goals. As a consequence, ECE locations became even more attractive. In sum, the EU has substantially facilitated FDI inflows to ECE but as Jacoby (2014) shows, EU membership has contributed in several other ways to the region's improving economic performance in the early and mid-2000s.

Although significant foreign capital entered ECE after the applicants' EU membership perspectives had become credible, investments began to pour into these economies following EU enlargement (Table 1). The ratios of post- and pre-accession average annual FDI inflows demonstrate that average inflows were considerably higher in the post-accession period. Even when the post-accession years are compared to the pre-accession era following the Luxembourg Council decision (thus from 1998 until EU entry), post-accession average annual FDI inflows remain higher. The 'EU effect' on FDI has been notable even for Bulgaria and Romania, which, in many respects can be considered as laggards among the new Members. Nevertheless, as Langbein (2014) shows, they are still better off inside the EU than they would be outside of it. Given that the global economic crisis substantially decreased foreign investment activity after 2008, these figures are even more remarkable and reinforce the point about the enhanced locational advantages of ECE.

So far, this article has shown how the EU contributed to the adoption of FDI-oriented economic strategies in ECE and how its subsequent regulatory influence facilitated FDI inflows to the region. While this process has led to the dominance of mostly EU-15-based

[4] Since 1 December 2009, Articles 87 and 88 of the EC Treaty have become Articles 107 and 108, respectively, of the Treaty on the Functioning of the European Union (TFEU). In substance, the two sets of provisions are identical.
[5] *Source*: European Commission State Aid Register.

Table 1: The Effect of EU Membership on per Capita FDI Inflows to ECE

	Average annual per capita pre-accession FDI inflows (in constant 2005 US$) *(a)*	*Average annual per capita FDI inflows from 1998 until EU accession (in constant 2005 US$)* *(b)*	*Average annual per capita post-accession FDI inflows (in constant 2005 US$)* *(c)*	*Ratio of post- and pre-accession average annual per capita FDI inflows* *(c)/(a)*	*Ratio of post-accession and post-1998 but pre-accession average annual per capita FDI inflows* *(c)/(b)*
Bulgaria	196	312	704	3.6	2.3
Czech Republic	368	573	613	1.7	1.1
Estonia	286	412	1210	4.2	2.9
Hungary	353	341	450	1.3	1.3
Latvia	130	143	444	3.4	3.1
Lithuania	104	170	336	3.2	2.0
Poland	140	185	363	2.6	2.0
Romania	112	172	290	2.6	1.7
Slovakia	282	372	462	1.6	1.2
Slovenia	181	254	363	2.0	1.4

Sources: Author's own calculations; UNCTAD database.
Notes: Pre-accession period: 1992–2003: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia; 1992–2006: Bulgaria, Romania. Post-accession period: 2004–11: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia; 2007–11: Bulgaria, Romania.

firms in ECE economies especially in the export-oriented sectors, the dependence of ECE on foreign investments proved disadvantageous in the recent economic crisis. According to Myant and Drahokoupil (2012), the internationally highly integrated financial sector and the FDI-dependent export sectors transmitted the crisis to ECE. In other words, the advanced internationalization of ECE economies rendered these countries vulnerable to external shocks, and particularly sensitive to downturns in western European markets. Smith and Swain (2010, p. 21) put forward a similar argument by claiming that 'high levels of international economic openness created vulnerability to economic decline in core markets during the economic crisis'.

However, enhanced internationalization of ECE economies does not necessarily involve extreme fragility. As Epstein (2014) shows, the uniform application of the single market rules and the single market itself has limited economic vulnerability of the new Member States. Similarly, Jacoby (2014) argues that while EU membership has contributed to some of the economic vulnerabilities in ECE, through structural fund spending and, to a narrower extent, with emergency liquidity measures, the EU has also tried to buffer the new Member States from the grave consequences of the crisis. In other words, without EU membership, the same level of economic internationalization would have produced greater economic decline in ECE.

This is consistent with how the EU has managed ECE's transition since the change of regime: while the careful tying of ECE economies to western European markets enhanced their economic subordination to western Europe, this process has also generated a reverse effect: precisely because of the substantial western foreign assets invested in ECE, the degree of west European dependence on the new Member States is far from negligible. On the one hand, the share of ECE from the total European investments of the largest EU-15 FDI exporters has increased: while Austria has placed more than a third of its European investments in ECE, most notably, the region's share from Germany's European outward FDI has grown from 7 per cent in 2000 to 11 per cent in 2011. The trend is similar in the case of Scandinavian, Italian and French outward FDI.[6] On the other hand, reinvested earnings in total FDI inflows into ECE have gained more significance. This suggests that foreign businesses have generally turned profitable and the multinational companies in the region are likely to plan long-term operations. Epstein (2014) shows that this is also the case in the financial sector as many western European banks treat ECE as their 'second home market'.

Šćepanović's (2013) research on the European automotive industry brings further empirical support for the persistence of EU-15 FDI in ECE. She found that relying on the locational advantages of ECE, major German car producers shifted substantial production capacity to eastern Europe. Because of this strategy, they have successfully regained their competitiveness *vis à vis* both their European and global rivals. As a result, ECE has become deeply integrated in the value chain of German car producers even in the more complex and thus much less mobile segments of production. Evidence suggests that French automotive investors have similar ambitions in Romania (Egresi, 2007). These findings imply that with the active contribution of the EU, the eastern Member States have served as a platform for increasing the competitiveness of key western European businesses and in this sense they are mutually dependent on each other. To a certain extent FDI has therefore transcended the east–west divide in Europe.

[6] Author's own calculations based on Organisation for Economic Co-operation and Development (OECD) data.

Conclusions

By seeking an explanation to the outstanding record of ECE economies in securing FDI, this article has evaluated the role that the EU has played both during the pre- and post-accession period. Although the author acknowledges that host country characteristics and coalitions between multinational enterprises and domestic political forces have been important determinants of FDI flows to ECE, they do not convincingly explain why foreign investors consistently preferred ECE in the 2000s but to a great extent abstained from the region in the previous decade. For a complete explanation to this puzzle, we have to account for the active role of the EU.

As demonstrated here, towards the end of the 1990s the growing commitment of ECE governments to European enlargement provided the EU with significant leverage over domestic decision-makers. Consequently, the combination of the breakdown of national capitalisms and the EU pressures triggered radical shifts in the economic strategies of ECE. Once ECE had settled on the EU-induced model of FDI-based growth and began to offer incentives to foreign investors, the EU had to cope with the new challenge of emerging investment competition and mitigate the concerns of old EU Members about losing their production capacities to eastern Europe.

The EU's response to these challenges served the interests of foreign investors. First, they were allowed to keep those tax concessions that the new Member States had earlier granted to them. Second, in the post-enlargement period many foreign companies benefited from the EU's practice of approving the targeted state aid schemes for investment projects in ECE. Third, ECE continued to enjoy cost advantages over western European investment sites, which, combined with state aid, kept ECE a highly attractive premium investment location throughout this period. In the end, the new Member States have become deeply embedded into western European markets and production structures. Their dependence on foreign investments makes them vulnerable to external economic shocks. However, investing in ECE has also allowed western European businesses to enhance their global competitiveness. In this sense, the growing foreign dominance in ECE economies generated a reverse influence on western Europe, which implies that by now east–west economic relations within the EU can be considered interdependent.

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