



## MORE INTEGRATED BUT ALSO MORE DIVIDED:

### INTENDED AND UNINTENDED CONSEQUENCES OF FOREIGN DIRECT INVESTMENT AND THE COHESION POLICY IN EASTERN EUROPE

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Gergő Medve-Bálint and Dorothee Bohle

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# **MORE INTEGRATED BUT ALSO MORE DIVIDED: INTENDED AND UNINTENDED CONSEQUENCES OF FOREIGN DIRECT INVESTMENT AND THE COHESION POLICY IN EASTERN EUROPE**

**Gergő Medve-Bálint and Dorothee Bohle**

## **Abstract**

By examining the intended and unintended consequences of Foreign Direct Investment (FDI) inflows and Cohesion Policy, this paper offers a critical assessment of the European Union (EU)'s economic integration capacity in the Eastern European member states. We argue that although both foreign investments and EU funds have contributed to overall economic growth and facilitated integration to the core European and global markets, they also had divisive consequences in economic and spatial terms. First, we show that FDI, which the EU has actively promoted in Eastern Europe, has produced dual economies in which some privileged, FDI-based, competitive sectors thrive along with less prosperous, domestically-owned ones. Moreover, FDI has also been the main driver of rising territorial disparities because the bulk of foreign investments have been realized in the most developed regions. Second, we demonstrate that although the funds of the Cohesion Policy have enhanced economic growth, they have failed to deliver on their original goal of reducing territorial inequality. This is because – similar to FDI – EU funds tend to accumulate in the wealthiest Eastern regions. We argue that this is partly the consequence of the recent shift in the Cohesion Policy which has been captured by the economic governance agenda of the EU: instead of supporting the backward regions, the policy now aims to promote growth and competitiveness everywhere with less emphasis on cohesion. We conclude that European integration in general and FDI and Cohesion Policy in particular have produced externally more integrated but internally more divided economies in Eastern Europe.

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## 1. Introduction

The European Union (EU) has facilitated the economic integration of East Central Europe (ECE) primarily through two distinct instruments. First, an indirect tool of the EU has been the promotion of Foreign Direct Investment (FDI), which, by assisting economic upgrading and structural change, was expected to contribute to growth and competitiveness in ECE. Second, the most visible instrument has been the Cohesion Policy, which distributes funds across the member states with the objective of enhancing territorial cohesion and competitiveness. In this paper, we seek to examine the effects of FDI and Cohesion Policy on ECE. By identifying the unintended negative consequences of both policies, we aim to provide a critical assessment of the EU's economic integration capacity.

First, we argue that economic integration through FDI has reoriented ECE countries towards Western markets. Foreign investments have produced highly internationalized economies with a dual character: export-oriented, competitive, FDI-based sectors thrive side by side with sectors dominated by domestically owned, small and medium-sized companies. The strong presence of FDI in ECE has made these economies dependent on foreign investors and vulnerable to external economic shocks. At the same time, foreign investors rely on the cheap, high-skilled Eastern labor to boost their competitiveness. In this respect, the economic relationship between East and West can be characterized as asymmetrical interdependence. FDI has not only enhanced economic growth, but also contributed to rising regional disparities – thus, it is divisive both spatially and economically.

Second, with respect to the Cohesion Policy, EU funds have contributed to the Eastern members' GDP but failed to deliver on their initially stated goals. On the one hand, the participation in EU-funded projects did not empower local and regional authorities but rather strengthened central administrations at the expense of subnational units. On the other hand, the more advanced ECE regions have been more successful in securing the funds than the backward regions. It follows that the funds did not reduce internal territorial disparities in ECE.

Foreign capital and EU funds therefore had mixed consequences on the economies of ECE. Overall, both FDI and Cohesion Policy have assisted economic growth and enhanced the integration of these countries into the European and global markets. However, both FDI and EU funds have produced or reproduced important spatial asymmetries, which are unintended side-effects that contradict the original policy objectives. For this reason, we conclude that these integrative measures of the EU have produced externally more integrated but internally more divided economies in ECE.

The structure of the paper is as follows. The first section analyzes how the EU has promoted foreign capital inflows into ECE and also seeks to identify sectoral and territorial trends in FDI. The following part highlights the recent shifts in the Cohesion Policy and traces how these changes have affected the territorial-administrative structures of the Eastern members. In addition, it also analyzes the regional distribution of the funds in the previous programming period (2007-13). The final section concludes and outlines potential directions for further research.

## 2. Integrating ECE through Foreign Direct Investment

FDI represents an external, private source of finance committed to making long-run productive investments in the target country. Foreign investors establish important links between the domestic and the external markets by which they facilitate the economic integration of the host country into the global markets. This is the reason why FDI has played a prominent role integrating ECE and Western Europe and has also been one of the main drivers of economic restructuring and upgrading in ECE. In the following pages, we discuss how the EU has promoted foreign investments into ECE and also highlight the main sectoral and territorial consequences of foreign capital penetration into these countries.

### 2.1 *FDI as a driver of economic integration in ECE*

In the early 1990s, Eastern European post-communist governments faced a dual challenge of laying the institutional foundations of a democratic political system and establishing market economies integrated into the Western European and global markets. FDI was expected to serve these goals as it was supposed to bring many benefits to the domestic economies such as higher economic growth, new jobs (Alguacil et al. 2008; Pickles/Smith 2005), intensified foreign trade and technological upgrading (Bradshaw 2005), knowledge, and technological and managerial spillover to local enterprises (Rugraff 2008).

These expected benefits may paint too rosy a picture of FDI. Yet, external advisors to ECE governments emphasized that attracting foreign capital was an element of democratic consolidation (Pinder 1993) and the condition for successful economic restructuring and catch-up with the advanced capitalist countries (Bandelj 2008). The rise of FDI has therefore become a political issue and an indicator of commitment to market reforms (Bandelj 2008).

However, following the regime change, most post-communist governments adopted a rather opposing stance towards foreign investors. They did so because in the first decade of transition, FDI came primarily through privatization - thus, there was a price to pay for the inflow of external capital: the sale of the 'family silver' - mostly uncompetitive state-owned enterprises on the cheap. In addition, opening the gate wide open to FDI became politically risky in light of the first experiences with foreign investors who, in order to increase efficiency of production, often engaged in layoffs. Moreover, shielding domestic businesses from foreign competition was another strong argument for excluding or at least restricting the entry of foreign businesses into the domestic economy. With few exceptions, Eastern European governments adopted privatization schemes that either privileged insiders or restricted foreign involvement (Beblavy/Marcincin 2000; Bohle/Greskovits 2001; Sass 2003; Vachudova 2005).

Nevertheless, Hungary and Estonia chose a different road. Hungary opened up to FDI early on because the government needed instant cash revenues to finance its record-high and further deteriorating public debt (Bohle/Greskovits 2012; Mihályi 2001). Already before the regime change, Hungarian laws allowed foreign companies to develop partnership with domestic ones. This liberal FDI policy therefore finds its roots in the 1980s (Szanyi 1998). In contrast, Estonian governments considered FDI as a key step to establishing national

independence because it facilitated the breakdown of state-owned enterprises especially in the industrial sector, which employed primarily Russian labor. As Bohle and Greskovits (2012) argue, FDI formed part of a nation-building project in Estonia, while in Hungary it was a tool for debt consolidation and economic restructuring.

## 2.2 *Shaping FDI inflows to ECE: the EU's role*

By the mid-1990s all ECE countries had applied for EU membership, which gave the EU considerable regulatory influence over them: with the launch of the enlargement process, the external regulatory dimension of transition gained much greater salience (Bruszt 2002). This allowed for a more active promotion of foreign investments by the EU in Eastern Europe, which represented a key element of 'backyard management' (Jacoby 2010). Through FDI, Western European firms entered new markets and by relying on low-cost Eastern labor, they could also benefit from efficiency gains.

The European Commission engaged in a thorough investigation of the applicant countries' economic, political, and social background in order to assess the progress towards fulfilling the Copenhagen criteria, which set the basic requirements for EU membership. The country opinions, prepared for the 1997 Luxembourg European Council by the Commission, demonstrate how eager the EU was to promote FDI inflows to ECE.

In these documents, the European Commission assessed the economic situation of the applicants based on "the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union".<sup>1</sup> The documents reveal that the EU tried to establish large-scale privatization of state-owned assets through FDI as a condition of membership.

Only Hungary and Estonia received positive evaluations from the Commission while it criticized every other Eastern candidate for their slow privatization process and low involvement of foreign investors. While the Estonian document suggested that "the continuation of foreign direct investment is crucial to the Estonian economy" (European Commission 1997: 36), the Hungarian opinion clearly revealed what the Commission expected from foreign capital:

*"Foreign direct investment has been playing a large role in the Hungarian restructuring process, at times even contributing to the development of new industries [...]. This is particularly important since FDI flows typically constitute an efficient way to transfer technology to the enterprise affected as well as to the rest of the economy through demonstration and spillover effects. FDI can also be expected to help Hungarian industry adapt to the requirements of the acquis" (European Commission 1997: 36).*

The preaching of the Commission in these documents served as guidelines for future policies. Soon, all the Eastern candidates complied with these demands because by the end of the 1990s, ECE governments

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1 The Copenhagen criteria are available at [http://ec.europa.eu/economy\\_finance/international/enlargement/criteria/index\\_en.htm](http://ec.europa.eu/economy_finance/international/enlargement/criteria/index_en.htm), accessed 22 July 2016.



were replaced by coalitions that supported the speeding up of privatization and the opening to foreign investors. Bandelj (2010) explains this shift with the frequent interactions between EU-elites and post-communist decision-makers who eventually became convinced that promoting foreign investments would be a desirable economic strategy. Although this aspect is certainly relevant, the take-it-or-leave-it character of EU accession forced the applicants to comply with EU requirements regardless of whether the domestic governments shared those norms or not.

As Medve-Bálint (2014, 2015b) argues, even though the EU had no legally binding tool to prescribe foreign involvement in the economies of the Eastern European countries, by applying quasi-legal instruments and exercising considerable pressure on them, it succeeded in triggering a liberal shift in investment policies and by the end of the 1990s, all the post-communist applicants opened up to foreign capital. In fact, the 2000s marked an era of investment competition, during which Eastern European governments offered increasingly generous investment incentives to foreign investors (Drahokoupil 2008a, 2008b).

The emerging ‘bidding war’ among ECE countries violated EU competition policy regulations. Ironically, the promotion of FDI in ECE generated EU intervention in defense of EU laws (for more details see Blauberger 2009; Medve-Bálint 2014, 2015b) but the discussion of this aspect is beyond the scope of the current work. Nevertheless, it highlights the EU’s leading role in triggering FDI-friendly policies in ECE as it created an enabling regulatory environment for the economic integration of ECE through FDI.

### 2.3 *Temporal trends of FDI in ECE*

While in the first decade of transition foreign capital inflows to ECE countries remained low, there has been a boom in FDI inflows after 2000 (Figure 1). Between 2000 and 2007, total foreign capital stock in ECE grew from 107 billion USD to 624 billion USD.<sup>2</sup> Although the 2007-08 global financial and economic crises caused a setback in investment activity, total FDI stock climbed to 730 billion USD by 2014. This represents nearly three percent of the world’s total foreign investment stock.<sup>3</sup>

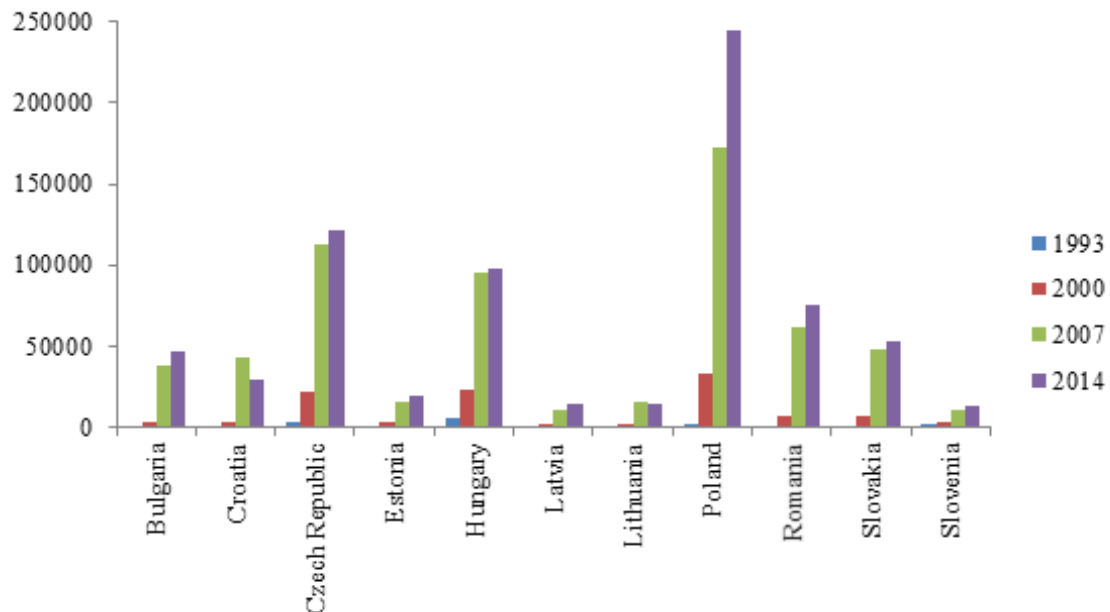
In spite of this impressive overall performance, the distribution of FDI across ECE is uneven. The imbalance is partly the consequence of the differences in the size of the domestic economies. The four countries with the largest nominal GDP (Czech Republic, Hungary, Poland, and Romania) have accumulated 74 percent of the total FDI stock invested in Eastern Europe. Poland, the biggest economy, is by far the greatest recipient as well, followed by the Czech Republic, Hungary, and Romania.

The differences in nominal FDI stock, however, do not reveal the differences in each country’s attractiveness to foreign investment. Even though Poland has secured the highest foreign capital stock in ECE, in per capita terms, its performance is among the poorest (Figure 2). In this respect, Estonia, the Czech Republic, Hungary, and Slovakia are leading, while Romania and Lithuania are the least endowed with foreign investment.

2 Calculating total FDI stock in constant dollars, the growth becomes somewhat smaller but not less impressive: expressed in constant 2005 USD, total FDI stock in Eastern Europe in 2007 (587 billion USD) was nearly five times greater than in 2000 (121 billion USD). Source: the authors’ own calculations based on UNCTAD data.

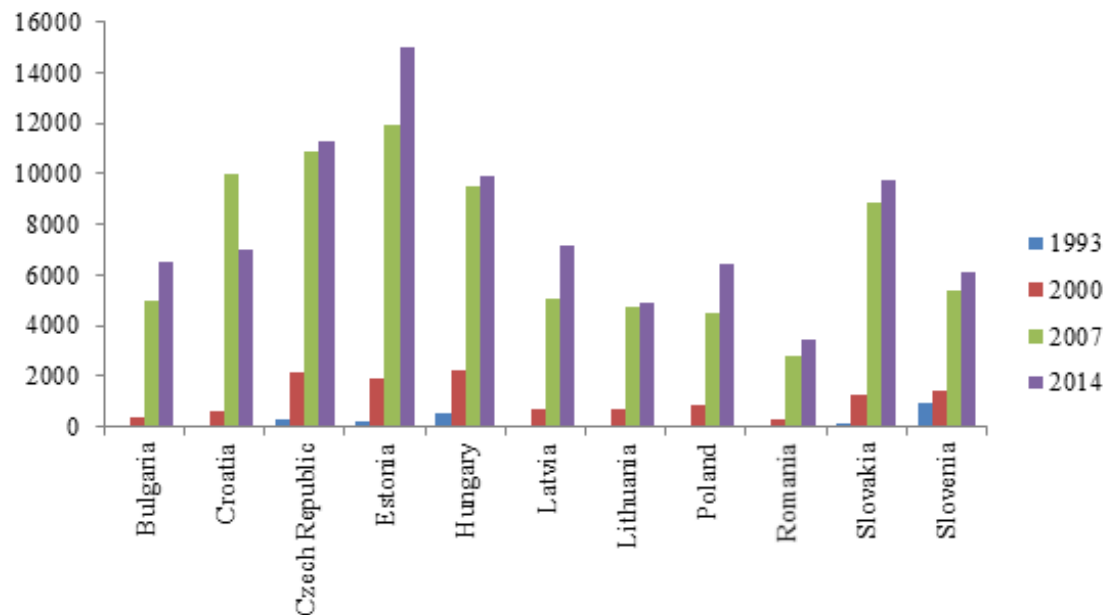
3 Source: Authors’ calculations based on UNCTAD data.

Figure 1: Total FDI stock in ECE in millions of USD (1993-2014)



Source: UNCTAD.

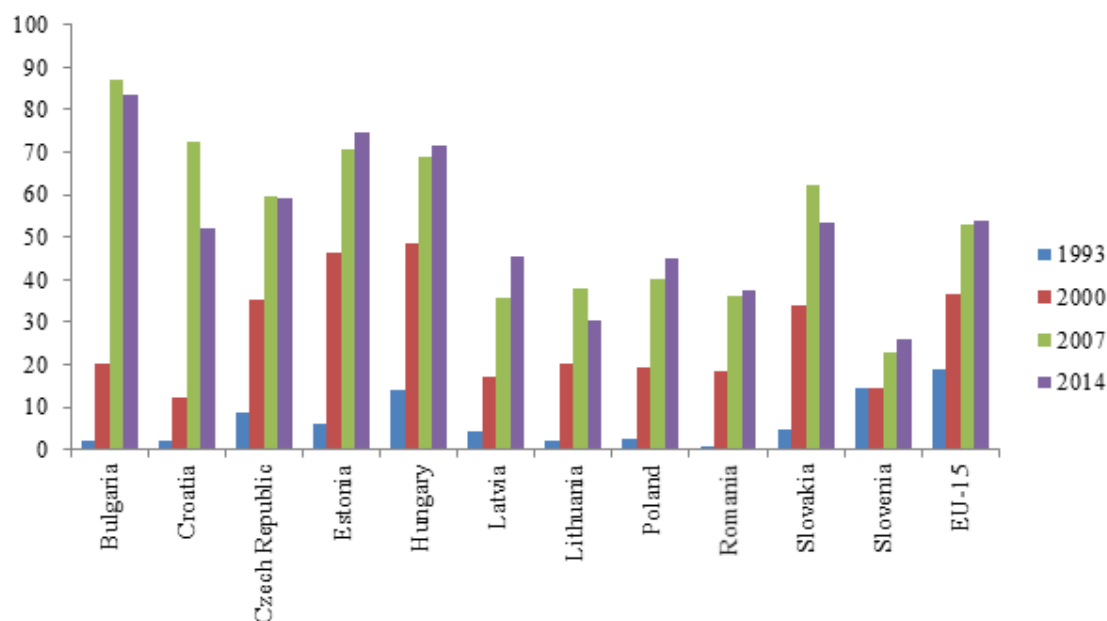
Figure 2: Total FDI stock per capita in ECE in USD (1993-2014)



Source: UNCTAD.

Taking the EU-15<sup>4</sup> as a benchmark, the per capita FDI stock in Eastern Europe falls behind the Western European levels. In 2014, FDI per capita in the EU-15 reached 24,931 USD whereas the Eastern European figure stood at 7,954 USD.<sup>5</sup> This suggests that foreign capital inflows to Eastern Europe did not reach their saturation point and there remains some potential for further foreign investments into the region. Nevertheless, the Eastern countries match Western figures in terms of the role foreign capital plays in their economies. As Figure 3 shows, total FDI stock as a percentage of GDP is beyond 40 percent in all but two ECE countries.

Figure 3: Total FDI stock as a percentage of GDP in ECE (1993-2014)



Note: EU-15 figures calculated without Luxembourg.

Source: UNCTAD.

As Table 1 shows, the lion's share of total FDI stock invested in ECE comes from the EU-15, which are responsible for more than half of total investments. In this respect, Slovenia demonstrates the highest share with 78 percent of total FDI stock coming from the EU-15, while Latvia has the lowest figure of 53 percent. The data portrayed in Table 1 suggest that the primary investors in Eastern Europe are companies registered in the European Union. This brings further evidence for the argument that FDI has been one of the key channels of ECE's economic integration with the West.

4 Without Luxembourg, as the country enjoys a special status of a tax haven and, for this reason, is a target of extraordinary FDI inflows that are neither the consequence of the size nor the performance of the domestic economy.

5 Cross-country variation in FDI per capita in Western Europe is also considerable. In this respect, the Eastern EU members are more homogenous because their FDI per capita varies to a smaller extent: the difference between the lowest (Romania: 3,453 USD in 2014) and the highest (Estonia: 15,032 USD) per capita figures is less than fivefold, while in the EU-15, Ireland has 43 times more per capita FDI stock than Greece. The low Greek per capita FDI stock is not a consequence of the deep economic crisis. Even in 2007, when FDI per capita in Greece reached a record high level, it stood at 4,809 USD. Data source: UNCTAD.

Regarding the other investors, the roles of Cyprus and Luxembourg are noteworthy. These EU members are known for their liberal tax policies that make them particularly attractive to enterprises seeking tax avoidance (Gravelle 2009). For the same reason, outward FDI activity from Cyprus and Luxembourg is remarkably high also because this is a way of shielding the identity of the original investors. For instance, Cyprus is a landing place for Russian outward investments that are then further invested in European host countries (Pelto et al. 2004; Tepavcevic 2014), including ECE.

In ECE, Bulgaria, the Czech Republic, Hungary, and Poland are potentially most exposed to these types of investments as the share of Cypriot and Luxembourgian FDI stock is the highest there. Bulgaria, Croatia, Lithuania, and Poland are also the main targets for investors coming from other well-known tax havens. Without conducting further investigation, one may only speculate about the quality of these investments. They may represent a source of FDI which does not necessarily serve economic catch-up and upgrading.

*Table 1: Share of selected country groups from total FDI stock (2014)*

	Total FDI stock in 2014 (millions of USD)	Share (%) of EU countries	Share (%) of EU-15 countries <sup>a</sup>	Share (%) of Cyprus and Luxembourg	Share (%) of offshore tax havens <sup>b</sup>
Bulgaria	49 815	81.44	63.81	10.17	4.61
Czech Republic	136 001	87.39	72.29	9.76	0.17
Estonia	19 351	81.35	71.41	4.83	0.46
Croatia	31 946	91.79	65.95	6.27	1.67
Latvia	13 577	72.05	52.92	8.52	1.10
Lithuania	15 796	78.08	53.70	4.27	2.19
Hungary	102 519	76.46	60.57	14.96	0.22
Poland	235 111	87.71	72.81	13.55	1.97
Romania	77 732	88.60	77.73	6.86	0.61
Slovenia	15 469	87.05	78.18	2.96	0.86
Slovakia	55 816	90.67	69.21	8.51	0.74

<sup>a</sup> Without Luxembourg

<sup>b</sup> FDI from Andorra, Gibraltar, Guernsey, Isle of Man, Jersey, Lichtenstein, Monaco, Bermuda, Seychelles, Belize, Panama, the Caribbean region and Oceania

Source: Authors' calculations based on Bilateral FDI Statistics 2014, UNCTAD.

The above figures suggest that a quarter of a century after the collapse of communism, ECE economies are as much internationalized as the Western European ones.<sup>6</sup> However, the rapid internationalization of these markets raises concerns about the sustainability of the ECE model. Foreign capital plays such a dominant role in ECE that some authors consider them as dependent market economies (Nölke/Vliegenthart 2009) or FDI-based market economies (Myant/Drahokoupil 2011). Given the speed of transformation during which foreign investors have taken a leading role in ECE, Šćepanović (2013) refers to their pathways as a hyper-integrationist development model, in which foreign capital inflows inhibit the growth of domestic economic capabilities.

Being dependent on foreign capital increases the risk of exposure to external economic shocks. Indeed, the global financial and economic crisis took a heavy toll on the Eastern European countries but recovery from the economic downturn was relatively fast and FDI seemed to facilitate rather than hinder this process (Myant/Drahokoupil 2012; Smith/Swain 2010). Foreign investments therefore represent a mixed blessing. On the one hand, they contribute to the integration of the Eastern economies to global markets: they develop competitive, export-oriented productive or service sectors and upgrade those to international standards; and generate economic growth. On the other hand, excessive reliance on foreign capital increases the domestic economy's vulnerability to external economic shocks and FDI may also hinder the development of domestically-owned sectors (crowding-out effect).

Another controversial factor related to FDI inflows is the race-to-the bottom effect which follows from the competition for investments. This is manifested in the gradual decrease in corporate income taxes, the deterioration of industrial relations, and welfare state retrenchment (Bohle 2009). These effects are also conditional on the sectoral composition of FDI (Bohle/Greskovits 2006). Thus, they may vary in degree but are present to a certain extent in each ECE economy. The next section thus examines the sectoral aspects of FDI in ECE.

## 2.4 *The sectoral distribution of FDI in ECE*

The share of foreign-owned companies from the total production value of specific economic sectors is a suitable indicator for estimating the role of foreign investors in the different segments of the ECE economies. This measure shows the percentage of the total production value which is produced by foreign-owned companies. Table 2 shows the latest of these figures for the Eastern European EU members.<sup>7</sup> It reveals that foreign-owned production is the most significant in Hungary and Slovakia, where, respectively, 57 and 60 percent of the total production value of the economy is produced by foreign companies. In the Czech Republic, Estonia, and Romania, foreign-owned companies are responsible for nearly half of the total production value. These figures give further support for the claim that ECE economies are strongly dependent on foreign capital and foreign-owned production.

6 Slovenia is a notable exception to this rule. The country has remained the least open to FDI and it did so intentionally. The Slovene neo-corporatist model – unique in the region – is based on a tripartite coordination among the state, labor, and employers which requires a delicate balancing of interests (Bohle/Greskovits 2012). Foreign investments in strategic domestic sectors, which were already competitive in the Western market, would have ruined this balance and it was not in the interest of either labor or company managers to let foreigners take a greater share in the domestic economy (for more on this, see Crowley/Stanojević 2011).

7 The financial and insurance sectors are not included in the calculations.

In spite of the overall dependence on FDI, the sectoral level of internationalization varies across ECE. In this respect, the manufacturing, wholesale and info-communication sectors are the most dominated by foreign investors, while construction, transportation, accommodation, and food services are the least penetrated by them. This is consistent with earlier findings about the preferred sectoral targets of FDI (Bandelj 2008; Bohle/Greskovits 2012; Drahokoupil 2008a). The Baltic states attracted investments mainly into services and the financial sector, while the others have excelled in securing manufacturing investments.

*Table 2: Share (%) of foreign-owned affiliates from total production value by economic sectors (2012)*

	Total business economy <sup>a</sup>	Manufacturing	Construction	Wholesale and retail trade	Transportation and storage	Accommodation and food service activities	Information and communication
Bulgaria	39.07	53.83	14.36	28.36	20.35	18.07	51.39
Czech Republic	47.50	66.44	17.51	38.52	28.80	20.48	62.28
Estonia	47.59	59.72	20.83	45.74	31.90	33.89	75.67
Croatia	27.42	27.64	10.15	27.57	n.a	15.43	57.39
Latvia	26.68	31.58	9.50	43.23	16.02	30.58	38.84
Lithuania	39.29	57.89	13.94	28.94	15.47	13.47	58.48
Hungary	57.50	69.26	18.89	48.97	30.50	26.03	71.48
Poland	37.69	46.11	23.69	41.71	20.33	23.39	57.42
Romania	47.00	62.03	19.79	40.89	20.33	15.91	68.36
Slovenia	23.48	32.55	6.87	29.38	14.91	8.77	29.75
Slovakia	60.04	81.91	24.27	28.23	27.80	10.09	58.45

<sup>a</sup> Without financial and insurance activities

Source: Authors' calculations based on EUROSTAT FATS database.

A closer look at the manufacturing sector (Table 3) reveals that foreign businesses have captured nearly every sub-segment and in some cases the presence of domestic enterprises is negligible. The computer, electronic, and optical products industry<sup>8</sup> and especially the automotive industry are the ones where foreign firms have conquered the entire market. These sectors are also the most competitive and export-oriented. Yet, their high level of internationalization also suffers from certain important drawbacks.

<sup>8</sup> With the exception of Lithuania and Slovenia.

Table 3: Share (%) of foreign-owned affiliates from total production value in the manufacturing sector (2012)

	Food products and beverages	Textiles, wearing apparel and leather products	Wood, paper and furniture	Chemicals and chemical products	Computer, electronic and optical products and electronic equipment	Motor vehicles, trailers and semi-trailers
Bulgaria	34.15	40.59	30.38	52.53	49.97	88.35
Czech Republic	38.99	35.32	54.64	63.23	82.97	94.93
Estonia	50.60	64.44	35.48	66.76	93.62	78.88
Croatia	22.23	62.68	13.28	27.17	49.89	78.44
Latvia	27.67	61.95	28.93	11.80	85.18	n.a
Lithuania	25.18	39.91	50.34	59.08	30.16	82.18
Hungary	49.11	64.93	58.27	58.55	95.30	96.33
Poland	39.30	31.73	64.36	31.58	74.88	89.67
Romania	41.70	53.84	61.97	50.95	76.75	95.43
Slovenia	10.81	50.41	27.89	41.58	32.32	59.31
Slovakia	50.30	68.55	50.77	67.31	92.65	99.39

Source: Authors' own calculations based on EUROSTAT FATS database.

As Pavlínek (2015) argues, the Eastern European FDI-based automotive industry is an example of an 'integrated peripheral market' in which production takes place mostly in routine assembly operations that represent the low-value added segment of the value chain with weak or nonexistent R&D functions. Furthermore, domestic businesses benefit from spillovers only to a limited extent and remain subordinate to foreign partners. The same applies to service investments where the main attraction of the region lies in its cheap, relatively high-skilled workforce (Capik and Drahoukoupil 2011; Gál 2014; Sass 2011).

Dependence on FDI is not as one-sided as the above observations would suggest. This is because foreign companies have relied on investments into ECE to increase their competitiveness on global markets. Econometric evidence also suggests that ECE serves as an extended market for Western Europe and the level of economic interconnectedness between the two sides of the continent is high (Prettner/Prettner 2014). Taking this into account, the relationship between the Eastern members and the EU-15 can rather be characterized as asymmetrical economic interdependence.

## 2.5 *The territorial aspects of FDI in ECE*

Having introduced FDI trends in ECE as well as the sectoral aspects, the territorial dimension of foreign investment also needs to be discussed, especially given that the spatial distribution of FDI in ECE corresponds to the predictions of mainstream economic theories. Location theories (Hirschman 1958; Myrdal 1957), endogenous growth theory (Lucas 1988; Romer 1986), and new economic geography (Krugman 1991) contend that economic activity will concentrate in central places because of the so-called agglomeration effects. This leads to uneven spatial distribution of capital, labor, knowledge, and technology.

The uneven distribution of FDI in ECE clearly follows this pattern in that only a handful of regions have become the targets of foreign investors. While foreign investments have contributed to the economic catch-up and integration of these economies into the global markets, in spatial terms this process has been highly selective. The metropolitan regions and those that already had a relatively strong and diverse industrial base were able to secure most of the foreign capital inflows. As several scholars have shown, this is a uniform trend across ECE (Brown et al. 2007; Chidlow et al. 2009; Dornean/Oanea 2015; Hunya 2014; Smętkowski 2013).

The uneven territorial distribution of foreign investment has also contributed to growing regional disparities because FDI has primarily entered the prosperous, leading regions which have become well-integrated into global markets. Conversely, those areas that have not succeeded in attracting considerable FDI remained backward. To put it differently, there is a strong association between the regional level of development and FDI: those regions that are more developed also tend to secure more foreign investments.

Figure 4 depicts this relationship for the NUTS 3 regions<sup>9</sup> of four Eastern European countries, the Czech Republic, Hungary, Poland, and Slovakia, which have been among the leading recipients of FDI and for which comparable data on regional foreign capital stock is available. The chart shows that the four capital city regions, which are also the most developed, have accumulated the highest per capita stock of FDI. The correlation coefficient between the two indicators is high and significant ( $r = 0.699$ ,  $N = 108$ ,  $p < 0.001$ ), which reinforces the claim that regions with greater foreign capital endowment indeed demonstrate higher levels of development. This also suggests that regions with substantial levels of foreign capital inflows have served as the growth poles of the Eastern EU members: the incremental convergence of country-level per capita GDP between East and West is thus largely driven by the outstanding growth performance of those few prosperous Eastern city regions that have attracted the bulk of FDI.

While in the last two decades predominantly rural and intermediate regions tended to exceed the growth of city regions in the EU-15, the opposite has been the case in ECE (Dijkstra et al. 2013). FDI has been a key factor in this process: metropolitan regions in the East not only receive more foreign investments, but also attract more diverse industries and especially higher-end services which embed them in

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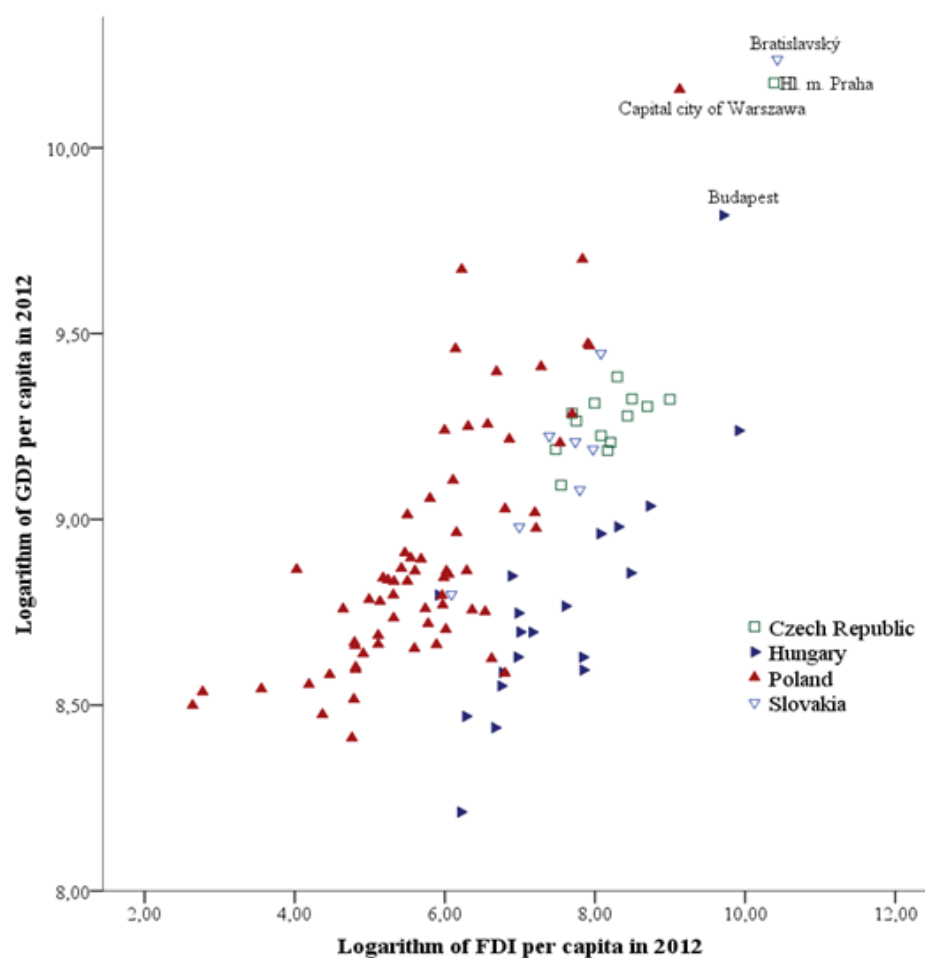
9 NUTS (Nomenclature of Territorial Units for Statistics) is the standardized territorial administrative system used in the EU. The NUTS 3 level refers to the county level administrative units.



international trade networks and, as a consequence, these regions experience higher growth rates than those with less or less diversified foreign capital (Dogaru et al. 2015).

This is not unique to ECE though: as Giannetti (2002) has shown, country-level convergence within the EU is driven by those regions which specialize in high-tech sectors, whereas those regions that do not upgrade their economies are lagging behind. In this sense, a simultaneous process of convergence and divergence shapes European economies. What is peculiar about ECE is that the location patterns of FDI drive this phenomenon.

Figure 4: The association between regional FDI stock per capita and GDP per capita in four Eastern European EU members (2012)



Source: Authors' own calculations based on data obtained from the national central banks and Eurostat.

Although after the economic and financial crisis of 2007-08 foreign capital inflows to Eastern Europe have dried up and are yet to recover, the territorial distribution of FDI has remained the same. Before the crisis, investments into complex manufacturing dominated, but since then a shift towards services has taken place. In spite of this change in the sectoral orientation of FDI, the same preferred regions continue to

receive most of the investments – metropolitan and city regions have managed to retain their privileged status (Medve-Bálint 2015a). Moreover, as Capello and Perucca (2015) demonstrate, the regions with a high presence of foreign investors may be more capable of adjusting to economic crises and experiencing a quick recovery. This also implies that the long-term economic prospects of the Eastern European regions crucially depend on their ability to attract FDI.

All things considered, it seems that two types of asymmetries characterize the integration of Eastern Europe into the EU and global markets. First, these countries and their economic performance have become dependent on FDI, although the competitiveness of EU-15 investors also benefited from the low-wage, high-skilled Eastern European workforce and the geographical proximity of these states to the core EU markets. Second, integration through FDI at the subnational level is asymmetrical: few leading regions secure the majority of foreign investments with which they establish a leading position relative to those areas that are unable to catch the attention of investors. This leads to sustained and growing regional disparities in the East, which highlights the significance of countervailing measures and regulatory interventions, such as the role of the most important direct integrative instrument of the EU, the Cohesion Policy.

### 3. Integration of ECE through the Cohesion Policy

The previous section has shown that the integration of ECE through FDI has produced two distinct asymmetries: first, ECE countries have become dependent on foreign capital inflows, while investors depend on the cheap and high-skilled Eastern European labor. Second, FDI has accumulated in the relatively well-developed regions. Thereby, it contributed to their superior growth performance and increased the developmental gaps between advanced and backward regions within the host countries. Growing regional disparities have thus gained political salience in ECE and in this context, the Cohesion Policy, whose central beneficiaries are the ECE countries,<sup>10</sup> lends itself for further analysis.

#### 3.1 *The objectives of the Cohesion Policy: an overview*

The Cohesion Policy is the most important direct integrative instrument of the European Union representing one third of the total budget. It has multiple goals, such as fostering development, good economic governance, competitiveness, and local democracy, as well as strengthening the identity and visibility of the EU at the local level. Nevertheless, its most important aim is to narrow the national and regional development gaps across the member states. Because of its regional orientation, the policy was also expected to strengthen subnational administrations against the central state.

Currently, the EU's Cohesion Policy "is one of, if not the, largest integrated development policy in the Western world, and one of the largest of such programmes anywhere in the world" (McCann/Varga 2015:

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10 In the 2014-20 programming period, the eleven Eastern member states, which in 2015 represented 20.3 percent of the EU's population, receive 50.4 percent of the total budget of the Cohesion Policy. *Source:* the authors' own calculations based on Eurostat data (population) and European Structural and Investment Funds Open Data Platform, available at <https://cohesiondata.ec.europa.eu/>, accessed 3 December 2015.

1255). The history of the policy goes back to the Treaty of Rome (1957), which laid down the main objectives of a European development policy. According to these founding principles, the policy should address economic, social, and territorial cohesion across the member states:

*“In order to promote its overall harmonious development, the Union shall develop and pursue its actions leading to the strengthening of its economic, social and territorial cohesion. In particular, the Union shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions.”* (Article 174 of the Treaty on the Functioning of the European Union)

The Treaty thus implies a territorially focused policy which is based on the principle of solidarity, meaning that financial resources from the more developed countries and regions are redistributed to the backward areas. While the Cohesion Policy seems to bear a strong normative element, it is also motivated by economic rationale. This is because market economies produce territorial imbalances if the flow of capital and labor is free.

In the first section on FDI, we already introduced the concept of agglomeration effects which implies that factors of production as well as innovation and know-how tend to concentrate at some privileged locations which will experience higher growth rates than other places (see for instance Krugman 1991; Lucas 1988; Myrdal 1957; Romer 1986). If the direction of flows remains persistent, then it leads to the spatial polarization of the economy. The creation of the European single market through the elimination of all barriers to the free flow of goods, labor, capital, and services released those spatially divisive forces which had been previously contained within national borders. European integration was expected to widen the gap between the most developed and less prosperous countries and regions.

In order to prevent divergence between core and periphery and to compensate for the negative territorial effects of integration, the Cohesion Policy became a key tool for the EU to address spatial imbalances. Funds targeting the most backward regions were expected to enhance their economic growth and assist them in catching up with the core areas (Allen 2010; Frisina 2008). Also, a Europe-wide development policy was an attempt to “match the territorial scale of the response with the source of the economic problems” (Begg 2010: 81). The Cohesion Policy has thus become an instrument to counterbalance the widening gap between the rich and the poor European regions.

However, it has not evolved in isolation from broader socio-economic goals that the EU has pursued. We argue that this has undermined some of the key initial objectives of the Cohesion Policy. First, the recent EU-wide emphasis on growth and competitiveness rather than redistribution and cohesion has downplayed the goals of territorial convergence and development. Second, the EU’s ‘competitive solidarity’ approach has also undermined the decentralization agenda and failed to empower the local level vis-à-vis the nation state. In the following pages, we show how these processes have taken place in ECE.

### 3.2 *Cohesion Policy and subnational authority in ECE*

In 1988, the reform of the Cohesion Policy introduced the partnership principle which stipulated that the European Commission and national and regional authorities had to coordinate the planning and implementation of the programs. The partnership principle provided the opportunity for subnational governments to actively participate in the design and implementation of the policy (Thielemann 2002). In this vein, the 1988 reforms were also “bound to affect territorial relations in the member states by empowering subnational authorities” (Hooghe 1996: 6).

In the 1990s and early 2000s, several scholars addressed the question as to whether the reformed Cohesion Policy would indeed weaken the national governments and bring about the rise of local and regional autonomy. From a multilevel governance perspective, it seemed that over time subnational actors would be able to challenge central governments and replace them as ‘gatekeepers’ in European affairs (Bache 1998). Others considered the Cohesion Policy as a signal for the emergence of a networked polity in which the distinction between state and non-state actors and the hierarchy among different levels of government would become blurred (Ansell 2000).

As the Western European examples showed, this ‘regional turn’ was far less notable and much more ambiguous than expected. Although institutional adjustment necessary for accessing the funds took place in every member state (Benz/Eberlein 1999), the subnational level gained strength only in those countries where regional institutional capacities were already strong for a meaningful participation in the policy (Bailey/Propriis 2002b). Domestic institutional capabilities thus became the key determinants of the degree of regionalization and in this respect, the outcome varied considerably across the member states (Börzel 2002). The 1988 reform of the Cohesion Policy has therefore led to diversified Europeanization of regional policies and state administrations in Western Europe, conditional on domestic institutional settings (Baudner/Bull 2013).

In the case of Eastern Europe, the EU had greater leverage over domestic outcomes because of the conditionality of enlargement. However, a uniformly binding rule on how territorial administration should be organized did not exist: the *acquis* was ‘thin’ on the institutional requirements for the implementation of the regional policy (Hughes et al. 2004) and there is no EU law on regionalization either. Although the European Commission was pushing for decentralization in the candidate countries, it had to acknowledge that “the decentralisation of responsibilities necessary for an effective regional policy is likely to be a lengthy process and the countries need to continue their efforts to establish the structures and procedures necessary for them to receive support from the EU Structural Funds” (European Commission 1999: 193).

Drawing on Western examples, some scholars warned that “regional institutional structures are unlikely to be sufficiently developed to enable the weakest regions to be active partners” in Eastern Europe (Bailey/Propriis 2002b: 424). The same authors also pointed out that the creation of adequate regional institutional capabilities would require time but this process had not been facilitated by pre-accession funds, which mostly focused on the national level thereby strengthening central administrations and

having little impact on the subnational level (Bailey/Propris 2002a). Yet, Bruszt and Vedres (2013) have provided convincing counter-evidence: by examining a sample of Eastern European regions, they found that deeper and more lasting experience with EU pre-accession assistance was associated with stronger post-accession developmental agency. Pre-accession capacity building at the regional level has – to a certain extent – produced the intended outcome and resulted in the external empowerment of local agents.

While initially the Commission insisted on territorial reforms, it shifted its agenda as the accession negotiations progressed. Instead of regionalization, the Commission began to place greater emphasis on the efficient use of funds, which required greater administrative capacity to spend the allocated budget. This eventually involved centralized fund management (Ferry/McMaster 2013; Grabbe 2001).

Why did the EC change its original approach? First, the Prodi Commission, which took office in 1999, shared the view that the weak administrative capacity of regional actors in Eastern Europe would seriously compromise the ability of these countries to effectively manage EU funds (Bailey/De Propris 2004). Second, the adoption of the Lisbon strategy in 2000 set new mid-term strategic goals for the EU, which also affected the Cohesion Policy. According to the Lisbon agenda, by 2010 the EU should have become “the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion” (European Parliament 2000). The strategy prescribed that EU funds should promote economic growth – thus, they needed to be spent efficiently. This is why efficient fund management became a key concern for the Commission. It “wanted centralized management of funds so as to maximize efficiency, streamlining and control of expenditures” (Hughes et al. 2004: 541).

The shift in the Commission’s approach reinforced the centralized decision-making systems in the Eastern member states, thus empowering central governments instead of regional administrations. The ECE countries therefore adopted centralized institutional arrangements which allowed for only a limited role of regions and localities in the design and implementation of the programs. The dominance of central administrations left local actors in a position of “learned helplessness” (Bruszt 2008). This legacy dates back to the communist times, which puts an ironic tone to the integration of Eastern member states into the multilevel governance system of the EU.

### 3.3 *The ‘Lisbonization’ of the Cohesion Policy*

The adoption of the Lisbon Agenda paved the way for the second shift in the Cohesion Policy because the EU began to promote growth and development in all territories (Bachtler/Wishlade 2011). This was consistent with the so-called place-based approach to regional development: instead of targeting the struggling regions, place-based policies aim at stimulating growth everywhere relying on endogenous growth potentials (Barca 2009; Ferry/McMaster 2013).

The economic crisis that pulled Europe into a deep recession in 2008 reinforced the above shift in the primary objectives. As the economic output of the member states went into freefall, EU funds served as a buffering against the crisis: the EU accelerated spending by relaxing some of the payment rules and granting

access to advanced payments. In this way, the funds represented a significant financial compensation for declining public consumption in the member states, particularly in ECE (Jacoby 2014). The crisis set the context for the negotiations about the next budget period (2014-20) and in these circumstances, the net contributors to the EU budget expressed concerns about the use of the funds.

While the UK insisted on reducing the budget for the Cohesion Policy, Germany argued for stricter spending rules and proposed the introduction of institutional conditionalities. At the same time, net beneficiary countries – mostly the Eastern European member states – and the Commission expressed a different view as they referred to the principle of solidarity and argued against the budget cuts. In essence, the fault lines emerged between net payers and net recipients (Bachtler et al. 2013). The former wanted to align the Cohesion Policy more with the economic governance agenda, which prescribes a stricter mechanism of EU-wide fiscal surveillance and demands greater fiscal discipline from the member states. The latter were especially concerned about keeping the national allocations at a similar level compared to the 2007-13 period.

Recent findings in the literature about the effects of EU funds supplied the net contributor countries with further arguments. Several authors have found that the domestic institutional environment limits the absorption capacity of a country or a region. To put it differently, EU funds may contribute to economic growth only in those areas that demonstrate a sufficiently high level of institutional capacity (Ederveen/de Groot/Nahuis 2006). This relationship has been demonstrated by other authors as well (see for instance Milio 2007) and generated a scholarly debate about whether institutional quality may be a conditioning factor for regional development (Rodríguez-Pose 2013).

In the context of the Cohesion Policy, a recent study (Rodríguez-Pose/Garcilazo 2015) confirmed that the quality of local and regional institutions is a key mediating factor for the growth-generating potential of the funds. The authors concluded that “in many of the regions receiving the bulk of Structural Funds, greater levels of cohesion expenditure would, in the best-case scenario, only lead to a marginal improvement in economic growth, unless the quality of the government is significantly improved” (Rodríguez-Pose/Garcilazo 2015: 1288). The scholarly literature reinforces the net payers’ view about stricter controls over spending and the introduction of institutional conditionalities. At the same time, the emphasis on promoting growth also implies a turn away from supporting the most backward areas, which, ironically enough, often demonstrate inferior institutional quality.

During the negotiations about the budget and the new rules of Cohesion Policy for the 2014-20 programming period, each member state agreed that there was a need to respond to the economic crisis, but net contributors and net recipients differed to a great extent about how this should take place. The turning point came when Poland, the greatest net recipient that takes 20 percent of the total 2014-20 budget, aligned with the net contributors.

According to a high-level diplomat who represented Poland at the negotiations, the primary goal of the Polish government was to save the policy. They also had to manage domestic expectations about the size

of the budget the country could get.<sup>11</sup> In this vein, Poland became a supporter of the proposed institutional conditionalities. Thereby, the most important net recipient made a strong and credible commitment to the reforms. This severely weakened the opposition of the other net recipients. In the end, the demands of the net payers were satisfied but, as compensation for the proposed measures, the total budget of the policy was cut only by five percent (in real terms) compared to the 2007-13 programming period.

As a consequence, since 2014 the Cohesion Policy has been closely aligned with the EU's economic governance agenda: fiscal discipline, efficient spending, and the stimulation of growth became the primary objectives. The new institutional criteria for the payments include three main dimensions. First, the so-called ex-ante conditionalities contain both thematic (related to a sector or policy that receives support) and general (public procurement or anti-discrimination requirements) conditions which need to be fulfilled by the end of 2016; otherwise the Commission will automatically suspend the payments. Second, the regulations have set ex-post conditionalities as well, which refer to performance targets that the funds should achieve. Third, there are country-specific macro-economic conditionalities regarding the member states' fiscal and economic policies, which make funding dependent on how closely they respect the economic governance rules (European Commission 2014).

All things considered, the institutional dimension and the objective of growth have made the territorial aspect and the principle of solidarity a secondary goal of the Cohesion Policy. In their analysis of the recent regulatory changes introduced for the 2014-20 programming period, Avdikos and Chardas (2016) argue that the reorientation of the policy's focus from cohesion to regional growth and competitiveness is likely to exacerbate existing regional disparities in economic performance and would augment territorial inequality. The authors refer to the 'Lisbonization' of the Cohesion Policy, by which it has been gradually tied to the economic governance agenda that has cemented the logic of austerity in the EU (Avdikos/Chardas 2016: 109).

In the ECE context, the requirement to spend the funds efficiently supplies central governments with a powerful argument against delegating administrative powers to the regional authorities. This is also manifested in the structure of the national operational programs for the 2014-20 programming period. Compared to 2007-13, only Poland has retained regional operational programs (ROP), while besides the sectoral programs, every other Eastern member state adopted a single, integrated regional operational program with centralized fund management. The change is most notable in the case of the Czech Republic, Hungary, and Slovakia, which completed separate ROPs for each NUTS 2 region in the previous period, but they have been replaced by a single ROP in the current programming cycle. In practice, this implies further centralization of fund management and even less involvement of the regional level into the decision-making system.

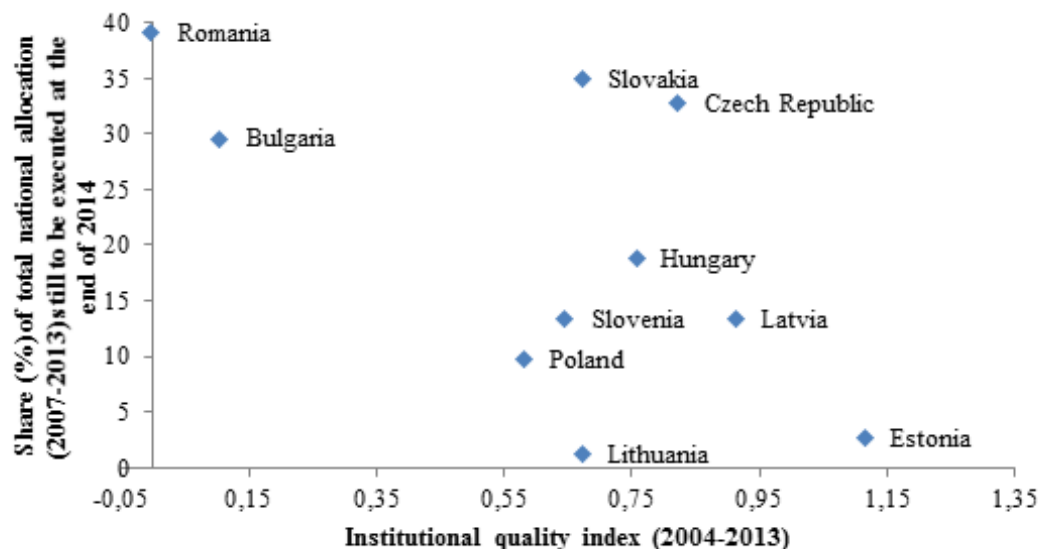
It remains to be seen though whether the stricter institutional conditionalities will be fulfilled or not and whether they will indeed serve the goal of economic growth. A recent study has found that conditionalities introduced in the former funding periods, such as the decommitment rule, the performance reserve, and

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11 Oral communication at a roundtable discussion on EU Cohesion Policy regulations (Brussels University Club, 14 October 2015).

the earmarking rules,<sup>12</sup> did not lead to more effective spending (Bachtler/Ferry 2015). In some instances, they rather increased the speed of committing the funds but adversely affected the quality of projects. These findings question the utility of the conditionalities and make it somewhat doubtful that an improved institutional environment would indeed result in more efficient spending.

Figure 5: Share of the total national allocation of the Cohesion Policy funds (2007-13) still to be executed at the end of 2014 and average quality of government (2004-13)



Source: Authors' calculations based on Worldwide Governance Indicators and European Commission 2015: 30.

Indeed, as Figure 5 suggests, beyond a certain level, the quality of government in ECE is not related to performance in spending the funds. The figure shows the share of the total 2007-13 national allocation that was not paid (still to be executed) at the end of 2014 and the average value of a composite indicator of institutional quality<sup>13</sup> in 2004-13. Data on the uncommitted funds also reflect the absorption capacity of the Eastern member states or, in other words, their spending ability. In principle, a higher share of unspent national allocation suggests lower efficiency in spending.

The chart shows that Bulgaria and Romania, the worst performers in terms of institutional quality, were among those Eastern countries that proved the slowest in spending the funds. This is also related to

12 The decommitment rule is also known as the n+2 rule, which was first introduced for the 2000-06 funding period. It stipulated that any funding awarded to a project had to be paid out within two years, otherwise the Commission would automatically decommit it. The performance reserve was also introduced in the 2000-06 programming cycle. It specified that four percent of the national allocations had to be kept back to subsequently reward the most successful programs within each member state. The earmarking rules were first applied in 2007-13. These rules prescribed that a certain proportion of the total expenditures had to be allocated to specific investment categories such as innovation, the knowledge economy, information and communication technology etc.

13 The quality of government index is the arithmetic mean of the Worldwide Governance Indicators of regulatory quality, government effectiveness, rule of law, and control of corruption (2004-13). Source: Worldwide Governance Indicators, available at <http://info.worldbank.org/governance/wgi/index.aspx#home>, accessed 26 July 2016.



the fact that in 2008, the European Commission decided to temporarily suspend the payments to these two countries because of the reportedly corrupted fund management (Spendzharova/Vachudova 2012). Nevertheless, the other ECE countries demonstrate huge variation in absorption capacity which does not correspond to their institutional quality. For instance, Lithuania and Slovakia are rather similar in this dimension but their spending rates are radically different: while Lithuania was the most efficient in committing the funds, Slovakia remained just slightly ahead of the weakest performer, Romania.

*Table 4: Cumulative national contributions to the EU budget and total payments to the Eastern member states from the Cohesion Policy since EU accession until 2014*

	Total payments to the member states (mn of EUR)	Total national contribution to the EU budget (mn of EUR)	Difference in total payments and total contributions (total net payments) in mn of EUR	Total per capita net payment in EUR	<b>Total net payment in percentage (%) of total GDP</b>
Bulgaria	4941	2698	2243	300	.72
Czech Republic	19811	12539	7271	701	.46
Estonia	4051	1422	2629	1965	1.55
Latvia	5074	1869	3206	1495	1.49
Lithuania	8801	2701	6100	1928	1.93
Hungary	23308	8631	14677	1466	1.37
Poland	70450	31203	39247	1030	1.07
Romania	11373	9372	2000	97	.19
Slovenia	4232	3278	954	470	.25
Slovakia	9208	5503	3705	688	.56

Note: In the cases of Bulgaria and Romania, the data refers to 2007-13, while for the other countries the time period is 2004-14. Croatia is not included because the country became an EU member in 2013, thus, only two years of budget data are available. Population data was calculated as the annual average population in the above time periods.

Source: Authors' calculations based on data from Eurostat (population and GDP) and EU budget data

In the context of the economic and financial crisis, the contribution of the EU funds to the national GDP of the ECE countries became a salient issue. As Table 4 shows, in both per capita terms and in terms of contribution to the GDP, the Baltic states and Hungary have been the greatest beneficiaries of the Cohesion Policy. In their case, the net balance of funds and national payments to the EU budget ranges from 1.37 to 1.95 percent of the GDP. This is notable by any measure. The per capita net payments in the case of these four countries are also outstanding compared to the other Eastern members. As for the low

performers, it is particularly striking that in per capita terms Bulgaria and Romania, the two poorest EU members, benefited the least from the funds.

These figures also reveal an almost irresolvable problem of the Cohesion Policy: the most backward member states are the least able to efficiently spend their national allocations, but they are in the greatest need for external financial resources for development. However, increasing their share in the Cohesion Policy budget (i.e. distributing more funds to them) may not generate further economic growth because of their inferior capacity to spend the funds. But, as discussed earlier, enhancing the quality of the domestic institutions may not deliver immediate results either.

In spite of these concerns, the positive balance of national contributions and payments suggest that, overall, each Eastern European member state has benefited from the funds. As an external source of income, Cohesion Policy has ‘topped up’ national GDP, which, especially during the years of the crisis, served as a buffer against deeper economic decline (Jacoby 2014). We thus do not question the overall contribution of the funds to economic growth in ECE and do not doubt the argument put forward by several scholars that EU membership has a substantial positive effect on per capita GDP (Campos et al. 2014). However, similar to Avdikos and Chardas (2016), we argue that the shifts in the regulatory framework of the Cohesion Policy may not serve the needs of the most backward Eastern regions. In other words, instead of lowering the internal developmental gaps, the funds may have maintained or even widened existing territorial disparities. In the next section, we demonstrate this empirically.

### 3.4 *Territorial disparities and EU funds in ECE*

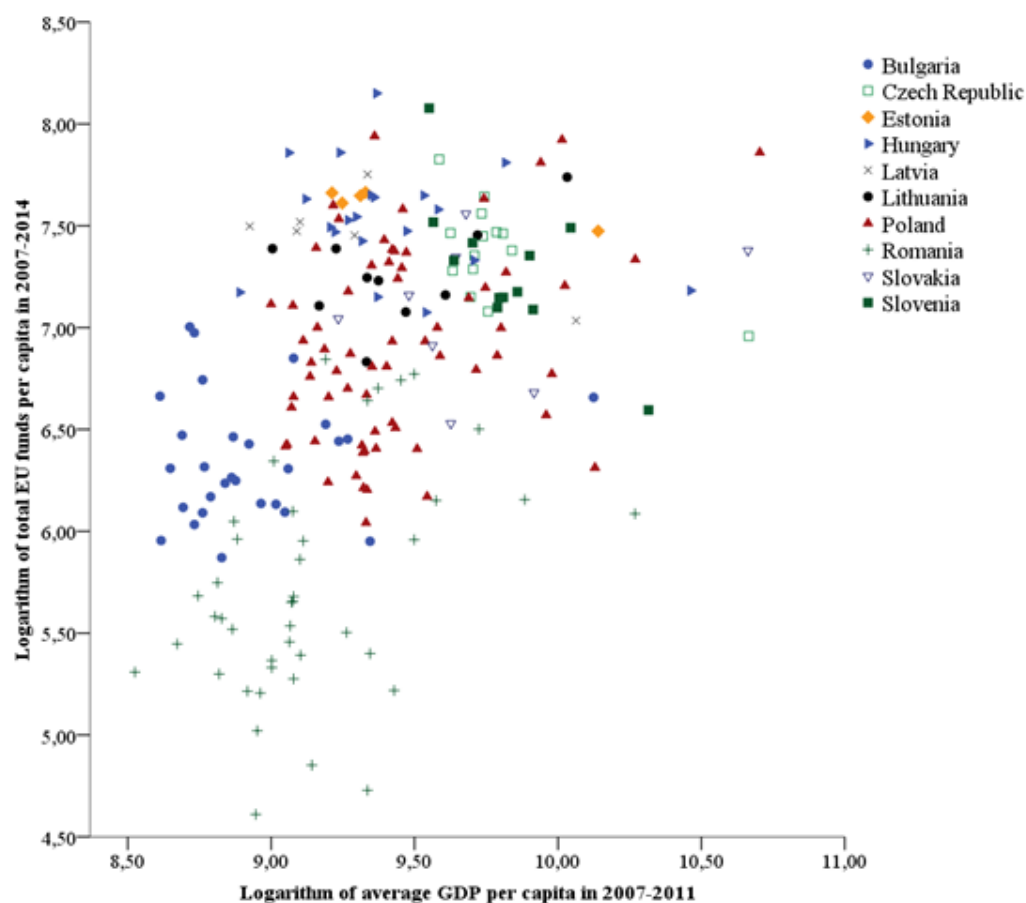
An investigation into the regional distribution of the 2007-13 EU funds in the Eastern member states provides evidence for the claim that the Cohesion Policy does not facilitate the catch-up of the poorest regions. In fact, the funds seem to reinforce existing territorial disparities both within and across ECE countries. Figure 6 shows the total EU funds per capita spent in the NUTS 3 regions of the Eastern member states until 2014 and their mean GDP per capita in 2007-11.<sup>14</sup> In order to produce a visually more appealing chart and also to reduce the positive skew in the data, the original values were logarithmically transformed.

The chart reveals a positive relationship between per capita funds and GDP, which is confirmed by the positive and significant correlation coefficient of the two indicators (0.467,  $p < 0.001$   $N = 211$ ). This suggests that more prosperous Eastern regions are likely to secure more EU funds per capita. On the one hand, this is related to the fact that the per capita national allocations for the two poorest countries with the poorest regions, Bulgaria and Romania, was below every other Eastern member state. Consequently, Bulgarian and Romanian NUTS 3 regions, on average, received the lowest EU support in the previous funding period. In this respect, the positive correlation between GDP and EU funds is partly driven by these two county cases. On the other hand, the distribution of the funds across the regions shows another particular feature: some of the relatively most prosperous areas have become the greatest beneficiaries of the Cohesion Policy while the least advanced ones are lagging behind.

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<sup>14</sup> In the Eurostat database, regional GDP figures for the NUTS 3 units are available only until 2011.

Figure 6: Regional GDP per capita and total EU funds per capita (2007-13 programming period) in the NUTS 3 regions of the Eastern EU member states



Source: Authors' calculations based on EU fund data provided by DG Urban and Regional Policy and Eurostat data.

A potential weakness of the data portrayed in Figure 6 is that it only accounts for expenditures from the European Regional Development Fund and the Cohesion Fund and does not include spending from the European Social Fund. However, a recent analysis (Medve-Bálint 2015b) of the territorial distribution of the EU funds in four ECE countries (Czech Republic, Hungary, Poland, and Slovakia), which accounted for the expenditures from each of these funding sources, has reached similar conclusions.

We have run a regression analysis to further establish the relationship between funds and regional GDP per capita and also to control for other potential economic factors that may play a role in fund distribution. The availability of comparable cross-regional data seriously limited the scope of those variables that we could include in the models. In addition to the main explanatory variable, GDP per capita, we considered the following indicators for testing our assumption: regional population, population density, and employment level.<sup>15</sup>

<sup>15</sup> Please consult the Appendix for the full description and operationalization of the variables.

We expect that as the regional number of inhabitants grows, the per capita amount of secured EU funds decreases simply because the region needs to absorb proportionally more financial support from a limited pool of resources to match the performance of lowly inhabited areas. There is a conditioning factor though: per capita funds may be positively associated with population density because, presumably, the metropolitan areas and city-regions, which demonstrate a high density of population, are able to attract more funds due to their superior capacity to generate own resources and the abundance of actors that are eligible for submitting project applications. Regarding employment, funds should target those areas that face challenges of unemployment, thus we expect that the higher the regional level of employment, the lower per capita funds the region receives. With our data, we may not capture this relationship because expenditures from the European Social Fund, which is the primary instrument to finance employment and human capital projects, are unavailable at the regional level.

We ran OLS regressions on the dataset of the 211 Eastern European NUTS 3 regions.<sup>16</sup> In each model, we included country dummies in order to control for the unobserved variables that produce cross-country variation in the dependent variable. The indicators of GDP per capita, population size, and population density were logarithmically transformed in order to normalize their distribution. The results are reported in Table 5.

*Table 5: Results of the OLS estimations. Dependent variable: total contracted EU funds per capita (2007-13) in the Eastern European NUTS 3 regions*

	Model 1		Model 2		Model 3		Model 4	
	B	SE	B	SE	B	SE	B	SE
Constant	3.255***	0.867	4.360***	1.266	3.820***	1.452	6.962***	0.884
GDP per capita	0.347***	0.096	0.464***	0.149	0.402**	0.180		
Not convergence region	-0.548***	0.165	-0.514***	0.150	-0.673***	0.203	-0.925***	0.247
Business density							0.006**	0.002
Population			-0.177**	0.066	-0.110	0.076	-0.118	0.083
Population density			0.006	0.054	-0.036	0.058	0.005	0.052
Employment level					0.007	0.006	0.007	0.005
Country fixed effects	yes		yes		yes		yes	
N	211		211		186		170	
F-value	55.83***		53.21***		55.34***		57.97***	
Root MSE	.404		.400		.403		.413	
R-squared	.72		.73		.75		.74	
Unstandardized coefficients, robust standard errors								
*** p < .01 ** p < .05								

<sup>16</sup> A multilevel linear model may better fit the data but given the low number of cases in the grouping variable (countries in which regions are nested), the application of this method would be statistically problematic.

In Model 1, we included only two explanatory variables besides the country dummies. The first one is regional GDP per capita, the second one is a dummy indicating whether the region was a convergence region or not in the 2007-13 programming cycle. Because convergence regions were eligible for the highest level of support, we expected that in those few that did not qualify for this category the per capita amount of contracted EU funds would be lower. The first model confirms our expectations because both explanatory factors show the expected relationship with the dependent variable and are significant as well.

In Model 2, we included the indicators of population and population density. These changes did not affect the sign and the significance of the GDP variable and the funding category dummy. While both population and population density demonstrate the expected sign, only population size is significant. In Model 3, we introduced the indicator of regional employment level. The reason why we treated it separately is that for some Polish regions and for all the Slovenian ones, employment data is unavailable. Thus, the number of cases in which the model is estimated is lower than in the first two instances. Even by adding employment to the regression, GDP per capita remains significant and shows a positive association with EU funds per capita. This simple modeling exercise has therefore confirmed that, on average, the richer Eastern European regions were able to secure more per capita funds than the backward ones.

As a robustness check for the results, in Model 4 we replaced the GDP indicator with an indicator of regional business density, which was calculated as the number of active enterprises per thousand active inhabitants. The correlation coefficient for business density and regional GDP per capita is high and significant ( $r = 0.757$ ,  $N = 195$ ,  $p < 0.001$ ) thus both indicators can be considered as proxies for the level of regional economic development. Indeed, business density turned significant in the model and shows a positive sign with the dependent variable.<sup>17</sup>

This provides further evidence for the argument that in Eastern Europe the richer regions tend to secure more EU funds than the poorer ones. Recent country studies analyzing the distribution of EU grants have reached similar conclusions (Bloom/Petrova 2013; Raagmaa et al. 2014).

However, if funds are typically absorbed by the relatively more prosperous areas while the most backward regions secure proportionally less resources, then EU funds may not decrease regional disparities, if they are able to trigger such effects at all. In other words, the territorial distribution of the funds in the Eastern member states may not contribute to the reduction of spatial inequalities, as it is suggested by Avdikos and Chardas (2016).

All things considered, the original objectives of the Cohesion Policy are not fulfilled in the case of the Eastern member states. On the one hand, instead of empowering the regional administrations, the management

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<sup>17</sup> Each model raises the issue of multi-collinearity because the indicators show moderate to strong correlation with each other (for the correlation matrix, please consult the Appendix). We do not consider it a problem though because in Model 3, which is the most important one for our purposes, GDP per capita has the highest Variance Inflation Factor ( $VIF = 4.28$ ), yet it shows a significant effect. Typically, multi-collinearity inflates the standard errors of the coefficients thus it may lead to Type II error, that is falsely concluding that there is no relationship between the explanatory and the dependent variable. In this case, our key explanatory variable, GDP per capita, remains significant in each of the specifications in spite of the presence of multi-collinearity.

and implementation of the funds have led to further centralization and the strengthening of the central state. On the other hand, funds seem to promote the development of the relatively more prosperous Eastern regions. Thus, the Cohesion Policy is unlikely to reduce regional disparities there. However, these outcomes are consistent with the recent shifts in the policy objectives, which were partly triggered by the economic and financial crisis and which place the emphasis on promoting economic growth in all the territories and on the efficient spending of the funds. Against this backdrop, the EU funds in the Eastern member states seem to satisfy the new orientation of the policy but this comes at a high price: the original objectives laid down in the Treaties have been sacrificed. Thus, the EU has partially undermined its own policy agenda.

#### **4. Conclusion**

In this work, we sought to critically assess the impact of Foreign Direct Investment and the Cohesion Policy on the Eastern European EU member states. We have shown that FDI has been a key component of economic integration in that the majority of foreign investments to Eastern Europe came from the EU-15. By now, the Eastern European economies are more internationalized than the old member states. However, FDI has produced some negative side-effects as well. First, the dependence on foreign capital has increased the vulnerability of these countries to external economic shocks. Second, most investments have entered the complex manufacturing and the financial, wholesale, and info-communication sectors in which domestic firms play only a minor role. Third, FDI has been spatially divisive: foreign investors have consistently preferred to set up their businesses in the most developed regions, thus reinforcing existing territorial disparities.

Regarding the Cohesion Policy, we argued that even though it has notably contributed to the GDP of the Eastern member states, the funds have failed to deliver on their original policy objectives. This is because the EU has recently shifted the focus of the policy from territorial cohesion to promoting economic growth and efficiency. The Cohesion Policy is now aligned with the EU's economic governance agenda and can be regarded as a financial compensation for the tightening rules on fiscal discipline. As an indirect consequence, the most prosperous Eastern regions have benefited more from the funds than the most backward ones. This implies that EU funds have reinforced rather than reduced regional disparities in Eastern Europe.

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## 6. Appendix

Figure 7: Histogram of total contracted EU funds per capita (2007-13)

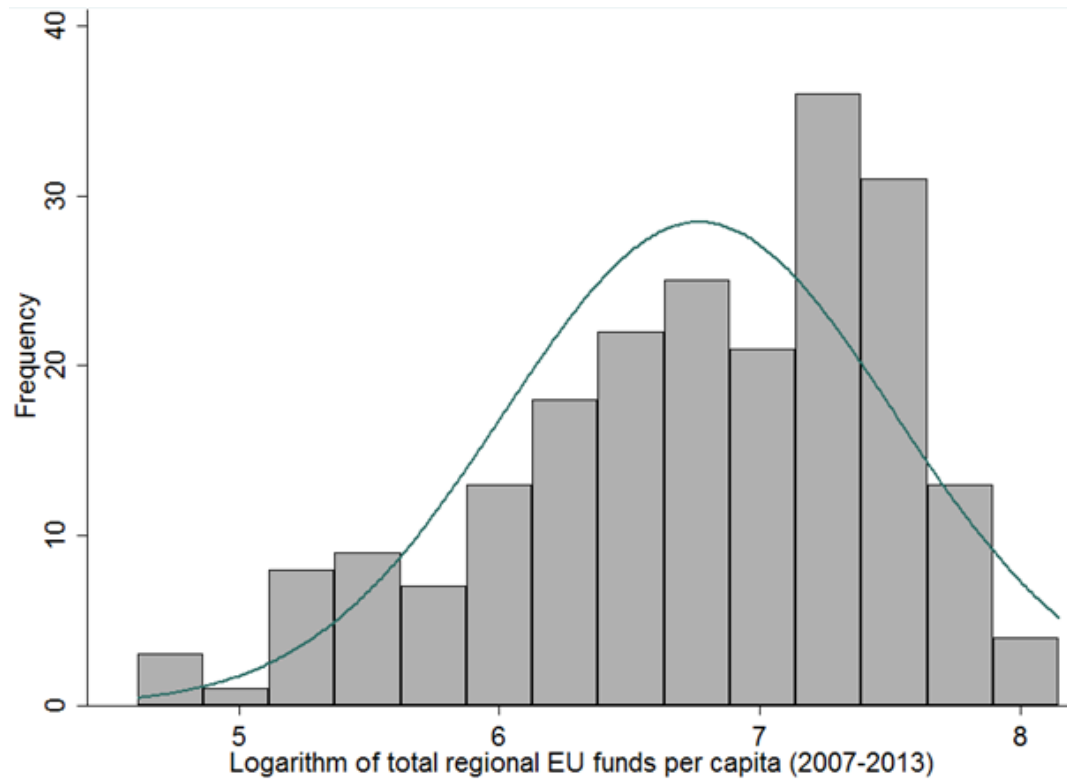


Table 6: List of variables included in the OLS regressions (original scales) – dependent variable: total contracted EU funds per capita (2007-13)

	MIN	MAX	Mean	SD	Source
GDP per capita – average regional GDP per capita (2007-11) in PPS	5,040	44,520	12,777	6,263	Eurostat
Business density – active enterprises per 1000 active inhabitants (2010)	12.57	254.43	72.27	36.98	Eurostat
Population – average regional population (2007-14)	44,254	1,927,263	477,733	285,599	Eurostat
Population density (2008)	13.8	8,499	261.3	778.9	Eurostat
Employment level – total persons employed as a percentage of active population (2008)	35.1	115.16 <sup>a</sup>	61.43	12.05	Eurostat
EU funds per capita – total contracted funds per capita in EUR (2007-13)	100.52	3,463.99	1,100.55	685,1	DG Regional and Urban Policy

<sup>a</sup> In the case of Budapest, Prague, and Sofia, the value exceeds 100, which is caused by the high number of commuting workers who are not included in the active resident population of these regions but are counted among the employed.

Table 7: Correlation coefficients of the independent variables included in the OLS regressions - dependent variable: total contracted EU funds per capita (2007-13)

	GDP per capita	Not conver- gence region	Population density	Population	Employ- ment level	Business density
GDP per capita	1					
Not convergence region	.33***	1				
Population density	.64***	.29***	1			
Population	.40***	.22**	.59***	1		
Employment level	.36***	.38***	.30***	.14	1	
Business density	.76***	.42***	.49***	.32***	.32***	1

\*\*\* p < .001; \*\* p < .01; \* p < .05





**"Maximizing the integration capacity of the European Union: Lessons of and prospects for enlargement and beyond"**

The 'big bang enlargement' of the European Union (EU) has nurtured vivid debates among both academics and practitioners about the consequences of 'an ever larger Union' for the EU's integration capacity. The research project MAXCAP will start with a critical analysis of the effects of the 2004-2007 enlargement on stability, democracy and prosperity of candidate countries, on the one hand, and the EU's institutions, on the other. We will then investigate how the EU can maximize its integration capacity for current and future enlargements. Featuring a nine-partner consortium of academic, policy, dissemination and management excellence, MAXCAP will create new and strengthen existing links within and between the academic and the policy world on matters relating to the current and future enlargement of the EU.