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Foreign Direct Investment and the Socio-economic Cohesion of the European Union: Experiences of the New Member Countries

Abstract

International economic integration can worsen the situation of so called problem regions within the integrated area, i.e. less developed regions or undergoing structural transformation or located in peripheries. The aim of this chapter is to discuss the role of foreign direct investment (FDI) flowing into the new member states in economic and social cohesion of the enlarged Union and to answer a question whether it enhances or impedes the cohesion of the EU. This problem has several aspects and it could be examined at the European, national and regional levels. This chapter focuses on FDI flows into the new member states and their regions, with special reference to Poland, Hungary, the Czech Republic and Slovakia.

The enlargement of the EU brought about an unprecedented widening of economic and social disparities within the Union which must be treated as a challenge that the enlarged EU faces. Although the impact of FDI on the socio-economic cohesion of the EU 15 examined at the European level seemed to be limited, the enlarged EU can benefit from FDI inflows stimulating the development of all the new Member States.

The impact of FDI on the socio-economic cohesion of the enlarged EU examined at the national and regional levels is controversial. FDI seems to stimulate disparities between regions of the EU and within these regions. FDI tends to be located in the most dynamic regions of host countries which consequently makes catching up processes of lagging regions even more difficult.

1. Introduction

International economic integration can worsen the situation of so called problem regions within the integrated area, i.e. less developed regions or undergoing structural transformation or located in peripheries. Economic and social cohesion of the integrated area can be endangered especially when huge disparities in GDP per capita, employment and unemployment rates exist between member countries and their regions. Economic cohesion is measured by comparison of GDP per capita between member countries and their regions. Social cohesion is evaluated on the base of differences in employment and unemployment rates and according to the distribution of incomes in the integrated area.

The aim of this paper is to discuss the role of foreign direct investment (FDI) flowing into the new member states in economic and social cohesion of the enlarged Union and to answer a question whether it enhances or impede the cohesion of the EU. This problem has several aspects and it could be examined at the European, national and regional levels. This paper focuses on FDI flows into the new member states and their regions, with special reference to Poland, Hungary, the Czech Republic and Slovakia.

The main tasks of the paper are as follows:

(1)the presentation of aims and achievements of the EU cohesion policy;

(2)the description of challenges of the last enlargement for economic and social cohesion of the EU;

(3)the examination of theoretical aspects of the impact FDI on economic and social cohesion of the integrated area;

(4) the analysis of country and regional distribution of FDI flows into the enlarged Union, with special reference to the new member states;

(5)the evaluation of the impact of FDI on economic and social cohesion of the enlarged Union.

2. The aims and achievements of the EU cohesion policy

The observation of the European integration processes confirms the necessity of carrying out the common policy in order to enhance its cohesion. The general aim of the economic and social cohesion policy is to compensate a potentially negative influence of integration processes on development at national and regional levels. Three priority objectives of this policy have been formulated for the period 2000-2006. These are:

- to promote the development and structural adjustment of regions whose development is lagging behind;
- to support the economic and social conversion of areas experiencing structural difficulties;
- to support the adaptation and modernization of education, training and employment policies and systems in regions not eligible under Objective 1.

According to the evaluation of the European Commission, some progress is observed in the field of economic and social cohesion of the EU. Disparities in incomes and employment across the EU have narrowed over the past decade, especially since the mid-1990s. Despite the narrowing of disparities, large differences have remained even in old Member States. The enlarged EU faces new challenges that are clearly perceived by the EU institutions (European Commission, 2003, 2004). These are: unprecedented widening of economic disparities within the Union, the geographical shift in the pattern of disparities, a less advantageous employment situation. Average GDP per capita in the new Member States is under half the average in the EU 15 and the rate of employment is only 56% whereas this rate amounts to 64% in the EU 15. Some 92% of the people in the new Member States live in regions with GDP per capita below 75% of the EU25 average and over two-thirds in regions where it is under half the average. Some 15% of the total population face the risk of poverty, defined as income below 60% of the median in the country where they live (Third report 2004).

On the other hand, some factors demonstrate the economic potential of the enlarged Union. The GDP growth in new Member States has been around 1½ % a year above the EU average since the mid-1990s. Their labor force is relatively well educated.

3. Foreign direct investment and the economic and the social cohesion of an integrated area – theoretical aspects

The role of FDI in the development of host countries as well as the role of traditional and modern location factors are widely discussed (Dunning 1977, 1979, 1988, Agarwal 1980, UNCTAD 1999, 1999a, 2001). The recipient countries of FDI inflows, especially less developed, expect that foreign investment inflow will accelerate the GDP growth, strengthen the export from these countries and the competitiveness of the whole economies and regions, create new jobs and generate and transfer technology to their economies. Some expectation related to regional development is also formulated. FDI can potentially play a key role in reducing regional disparities in economic performance not only as a source of income and jobs but also as means of transferring technology and know-how to lagging regions. However, the attractiveness of so called problem regions for foreign investors is questionable. Foreign investors tend to invest in the most developed regions possessing comparative advantages that strongly attract them.

Nowadays, decisions about the location of FDI are determined not only by traditional location factors like market size, costs of labor force, transport costs but also by new factors related to globalization and integration processes. The location of transnational corporations' activities increasingly reflects three developments: policy liberalization, technical progress and evolving corporate strategies (UNCTAD 2001). Some new location factors like technology and innovations, agglomeration benefits, clusters and deregulation in the integrated area start playing a growing role. The integration process influence foreign investors' decisions about the location of FDI (Yannopoulos, 1990, Molle 1990, Cantwell 1987). The deepening and widening of European integration processes encourage both newcomers to invest in the EU and already set up investors to seek an optimum location within the integrated area. It gives an impulse to changes of geographical/regional patterns of FDI within the integrated area because the integration can enhance some existing comparative advantages of member countries and their regions or create some new advantages or reduce the existing ones.

4. Country and regional distribution of FDI flows into the European Union

The strength of the impact of FDI on the socio-economic cohesion of the EU depends on:

- the scale of FDI flows into the EU as a whole integrated area;
- the geographical distribution of FDI flows among member states;
- the regional distribution within particular member countries;
- the quantity and the quality of jobs created in host countries and their regions.

Data show that the EU as a whole remains a major recipient of FDI inflows, although it has experienced a sharp decline of these inflows after 2001. The annual FDI inflows into the EU fell from a record USD 671.4 billion in

2000 to USD 295.2 billion in 2003, i.e. more than twice. The decline of FDI inflows into particular member countries was uneven.

The analysis of the country distribution of FDI inflows into the EzU confirms that geographical distribution patterns were changing in the years 1992-2003 (see Table 1).

Table 1. Country distribution of FDI inflows, by the EU members, 1992-2003 (%)

Specification	1992-1997 (average)	1999	2000	2003
The EU 15	100.0	100.0	100.0	100.0
Austria	2.4	0,6	1.3	2.3
Belgium and Luxembourg	11.7	25,0	13.2	..
- Belgium	..	..	..	10.0
- Luxembourg	..	..	..	29.7
Denmark	2.7	3.5	5.0	0.9
Finland	1.2	1.0	1.2	0.9
France	20.6	9.7	6.4	15.9
Germany	6.3	11.7	29.5	4.4
Greece	1.1	0.1	0.7	0.01
Ireland	1.8	3.8	3.8	8.6
Italy	3.7	1.4	2.0	5.6
Netherlands	10.4	8.6	9.5	6.7
Portugal	1.6	0.3	1.0	0.3
Spain	9.0	3.3	5.6	8.7
Sweden	7.1	12.7	3.5	1.1
United Kingdom	20.3	18.3	17.7	4.9

Source: UNCTAD and own calculations.

There was a group of countries that experienced a growing share in the total FDI inflows. In 2003, these were Luxembourg (29.7%), Ireland (8.6%) and Italy (5.6%). The share of other countries was decreasing, although it was still relatively high. For example, the share of France amounted to 15.9% and Spain - 8.7%. The United Kingdom, an important recipient country in the past, lost its dominant position. The share of the UK fell from average 20.3% in 1992-1997 to only 4.9% in 2003. Cohesion countries (Ireland, Spain, Portugal and Greece) received together 17.6% of the total FDI flowing into the EU in 2003 while the average share of these countries amounted to 13.5% in the 90ies. A slight shift of FDI flows into cohesion countries was observed but only one country, Ireland, attracted large–scale inflows and its share was steadily growing. Spain, after a period of a decreasing share, regained the position from the 90. The shares of Greece and Portugal in the total FDI inflows to the EU were changing but in 2003 their shares were lower than previously. The role of FDI in the economies of the cohesion countries was also uneven. Inward FDI stocks as percentage of GDP in these countries amounted to: 129.7% in the case of Ireland, 36.3% in Portugal, 27.4% in Spain and only 9.8% in Greece (UNCTAD 2004).

The impact of FDI on the socio-economic cohesion of the EU examined at the European level seems to be limited. Among the Cohesion Countries, only the development of Ireland strongly relies on the foreign direct investors' involvement and shows spectacular progress.

The available data on the regional location of inward investment within member countries suggest that FDI inflows have tended to go disproportionately to the economically stronger regions and relatively little went to lagging regions. In Ireland, FDI were mostly located in the eastern part of the country, in Dublin and the surrounding area. In Spain, around 70% of FDI inflows in the years 1999-2001 went to Madrid and further 14% to Cantaluna, while Objective 1 regions accounted for well under 10%. In Germany, investment was concentrated in a limited number of Lander. More than 70% of all inward FDI inflows in the years 1998-2000 were located in three western Lander (Nordreihn-Westphalia, Hesse and Baden-Wurttemburg) and further 17% in Bayern and Hamburg. By contrast, the 5 Objective 1 regions in the east of the country accounted for only just over 2% of the total inflows between them. In Italy, where the data relate to employment in foreign-owned enterprises rather than FDI inflows, the majority of investment was located in the north of the country and under 4% of employment in foreign-owned companies was in the southern Objective 1 regions in 2000 (European Commission, 2004).

The above quoted data illustrate difficulties which host countries face to attract FDI into lagging regions. It is worth noting that the same difficulties encounter both developed and cohesion countries.

The accession countries from Central and Eastern Europe - now eight new Member States - received a small portion of global FDI inflows in the 90. It was only 2.6% in the years 1992-1997. This share rose to 3.9% in 1999 but it fell again to 2% in 2003. In absolute terms, the annual FDI inflows in 2003 amounted to only 56% of those in 2000. The perspective of membership of the EU was not a strong enough factor attracting FDI into these countries when some negatives trends occurred in the world economy.

The country distribution of FDI inflows shows relatively high concentration of FDI inflows in three new Member States. Poland, the Czech Republic and Hungary received more than 80% of total FDI inflows into CEE new Member States (see Table 2).

Table 2. Country distribution of FDI inflows, by selected new Member States, 1992-2003 (%)

Specification	1992-1997 (average)	1999	2000	2003
Eight CEE accession countries	100.0	100.0	100.0	100.0
Czech Republic	16.2	34.0	24.5	22.5
Estonia	2.2	1.6	1.9	7.8
Hungary	36.4	17.8	13.6	21.6
Latvia	2.9	1.9	2.0	3.1
Lithuania	1.3	2.6	1.9	1.6
Poland	36.0	39.2	46.0	36.9
Slovakia	2.9	2.3	9.5	5.0
Slovenia	2.1	0.6	0.7	1.6

Source: UNCTAD and own calculations.

Data on inward FDI stocks as a percentage of GDP of all the analyzed countries indicate that the role of FDI in their development was growing and relatively intense (see Table 3). The highest indicators are noticed in the case of Estonia, Hungary and the Czech Republic. But the development of other countries has relied on FDI to a large extent. An exemption was Slovenia with the lowest indicator.

Table 3. Inward FDI stock as percentage of GDP of selected new Member States, 1990-2003

Country	1990	2000	2003
Czech Republic	3.9	42.1	48.0
Estonia	..	51.4	77.6
Hungary	1.7	49.3	51.8
Latvia	..	29.1	35.1
Lithuania	..	20.9	27.2
Poland	0.2	20.6	24.9
Slovakia	0.5	18.5	31.5
Slovenia	3.4	15.3	15.6

Source: UNCTAD.

Given this, it may be concluded that FDI could be an important factor of enhancing the socio-economic cohesion of the enlarged EU at the European level if countries are treated as regions of the EU.

Within the new Member States, the available data indicate a relatively high degree of concentration of FDI in and around capital cities, as in Cohesion countries (see Table 4). In Hungary, over two-thirds of inward investment in 2001 was located in Budapest region (European Commission, 2004, p. 99). The region of Central Hungary where the capital city is located is characterized by the highest GDP per capita. It amounted to 204% of national average in Budapest and 158% in Budapest region. This region creates about 44% of the total Hungarian GDP (HCSO 2001). In the Czech Republic, 60% of inward FDI went to Prague and the surrounding region in 2001 (Stredni Cechy) and in the same year, in Slovakia, about 63% of FDI was located in Bratislava (European Commission, 2004, p.99). In Poland, the same tendency was observed. The capital city region (Mazowieckie) accounted for 56% of inward FDI in 2003. Some other voivodships like Wielkopolskie with a larger city Poznań, Małopolskie with Kraków, Śląskie with Katowice and Dolnośląskie with Wrocław attracted another 30% of the total inward FDI in Poland (GUS 2004 and own calculations).

Table 4. Distribution of inward FDI by NUTS 2 region in selected new Member States (% of country totals)

The Czech Republic	2001	Hungary	2001	Slovakia	2001
Praha	49,3	Kozep-Magyarorszag	67.7	Bratislavsky	63.2
Stredni Cechy	10,7	Kozep-Dunantul	9.4	Vychodne Slovensko	18.8
Jihozapad	7.6	Nyugat-Dunantul	7.5	Zapadne Slovensko	10.3
Severozapad	8.2	Eszak- Magyarorszag	6.2	Stredne Slovensko	7.7
Severovychod	6.2	Del-Alfold	4.0		
Stredni Morava	5.2	Del-Dunantul	1.8		
Moravskoslezko	4.0				

Source: A new Partnership for Cohesion. Convergence, Competitiveness, Cooperation. Third Report on Economic and Social Cohesion European Commission, February 2004, p.111.

The attractiveness of the rest of Poland and particularly lagging regions in the east and the east-north of Poland was much lower (see Table 5).

Table 5. Distribution of inward FDI by NUTS 2 region in Poland, 2003 (% of country totals)

Mazowieckie	56.0
Wielkopolskie	8.8
Małopolskie	8.2
Śląskie	7.3
Dolnośląskie	5.3
Pomorskie	2.2
Łódzkie	2.1
Świętokrzyskie	2.1
Podkarpackie	1.6
Zachodniopomorskie	1.3
Lubuskie	1.3
Opolskie	1.2
Kujawsko-pomorskie	1.0
Warmińsko-mazurskie	0.8
Lubelskie	0.5
Podlaskie	0.2

Source: GUS and own calculations.

The above quoted data indicate that FDI located within the new Member States increases disparities between their regions. Foreign direct investors prefer locating capital in the most developed regions of these countries as well as in Cohesion countries of the EU 15. This accelerates the GDP growth in the already better developed regions. FDI creates additional jobs and incomes in these regions. Wages and salaries offered by firms with foreign participation are usually higher than in domestic firms. It stimulates social disparities between regions within the new Member States. Social disparities can also increase within regions where FDI is located because firms with foreign participation differentiate wages and salaries among different groups of workers in a much stronger way than domestic ones.

The analysis of the social and economic cohesion of the EU carried out at the national and regional levels indicates that FDI inflows have been attracted to the most developed regions and this accelerates their development. Hence, catching up processes of lagging regions within the integrated area require additional effort and financial sources. This brings about some difficulties in formulating policies towards foreign investors in the new Member States. The problem is how to attract foreign investors to less developed regions when they naturally tend to locate their investment in the most dynamic regions.

5. Conclusions

(1)The aim of the social and economic cohesion policy at the European level is to compensate a potentially negative impact of integration processes on development at national and regional levels.

(2)The problem of the socio-economic cohesion of the EU has several dimensions, i.e. European, national and regional ones.

(3)Some progress was observed in the field of the social and economic cohesion of the EU 15. Disparities in incomes and employment across the EU 15 have narrowed over the last decade; nevertheless, large differences in GDP per capita and in social indicators still exist.

(4)The enlargement of the EU brought about an unprecedented widening of economic and social disparities within the Union which must be treated as a challenge that the enlarged EU faces.

(5)The role of FDI as a factor influencing the socio-economic cohesion of the enlarged EU is a subject of discussion. The deepening and widening of European integration processes encourage both newcomers to invest in the EU and already set up investors to seek an optimum location within the integrated area.

(6)Although the impact of FDI on the socio-economic cohesion of the EU 15 examined at the European level seemed to be limited, the enlarged EU can benefit from FDI inflows stimulating the development of all the new Member States.

(7)The impact of FDI on the socio-economic cohesion of the enlarged EU examined at the national and regional levels is controversial. FDI seems to stimulate disparities between regions of the EU and within these regions. FDI tends to be located in the most dynamic regions of host countries which consequently makes catching up processes of lagging regions even more difficult.

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