Managing globalization by managing Central and Eastern Europe: The EU's backyard as threat and opportunity

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Abstract:

Globalization has been the source of many worries in Europe. Over the past decade, European voters and politicians have increasingly demanded that the EU "manage" globalization instead of just passively receiving it. But managing the new member states of Central and Eastern Europe (CEE) emerged as an important precursor for managing globalization more broadly. Poor areas next door often appear as both threat and opportunity to richer areas like the old EU-15. Some EU-15 actors – mostly corporations, but also many European liberals – saw in the CEE region a chance for new markets, new workers, and new investment opportunities for the core EU-15 economies. They tried to codify new conditions of production and sale that they thought beneficial. But other EU-15 actors worried openly about competition from CEE on capital, labor, and product markets or about the cost of fiscal transfers to the much poor peoples of CEE. The fearful – mostly EU-15 states and the EU itself but sometimes firms headquartered in the EU-15 – acted to try to minimize these potential threats. I show that, as a broad proposition, actors motivated by the threats seem to have shaped conditions more than those motivated by opportunity. I present data from financial flows, trade in goods and services, and labor migration to make this central point. I conclude with four paradoxes and some speculations on how this pattern may change with the financial crisis of 2008-09.

Southeast Asia begins 70 kilometers east of Berlin

--German trade union official, 1993

You think we don't know what you say? East Europe…where you pick up masterpiece for string of beads...And what we spend on meal for you is tip. And you can buy our whole machine tool industry for thirty second ad on NBC

--David Edgar, "Pentecost"

This paper is concerned with the Eastern enlargements of the EU in 2004 (by ten states) and 2007 (two more) and how these enlargements fit with Europe's broader efforts to manage globalization. A substantial literature focuses on EU efforts to manage the behavior of economic rivals, but how does the EU manage *prospective* members who are not yet major economic rivals? Managing Central and Eastern Europe (CEE) seems a prerequisite for managing globalization, and it is also an important issue in its own right. As the two epigraphs suggest, poor areas next door often inspire both feelings of threat and opportunity in rich areas (and the EU-15 are very rich indeed). The threat notion captures the worry (often on the part of the very same actors in the old EU-15) that competition from the region might actually threaten them.

One core question about CEE mirrors Europe's core question about globalization: are potential new economic partners more of an opportunity or more of a threat to us? This paper will argue that the CEE states have emerged as a clear opportunity for the EU, and that one reason for this is because the EU and its then-15 member states took them seriously as a potential economic threat almost from the very outset. I show that potential threats, when they emerged, were attenuated, weakened, and managed, often in ways that put the EU at the very center of the politics between the Western and Eastern parts of Europe. I also show that actors from the old EU-15 often used the EU to increase their business opportunities in CEE.

This is a novel claim, and it may have broader relevance since several authors – many among those optimistic about the EU as a rising power – have made the claim that the EU will increasingly impact a very large sphere of geographically proximate countries (McCormick 2006; Schnabel 2005; Reid 2004).[1] It seems useful, then, to look back on the EU's engagement with CEE as a source of clues about how the EU deals with economically weaker states whose proximity can be both an opportunity and a threat to its member states.

To do so, I investigate the three most commonly cited areas of globalization, namely flows of capital, labor, and goods and services. In my account, actors from the EU's 15 pre-2004 "old member states" (OMS) plus EU officials are the managers, while the 12 new member states (NMS) are the managed. I focus my attention on the period from the collapse of communism to the onset of the financial crisis in late 2008, the effects of which are too new for inclusion in the current paper. My core intuition is that managing global challenges begins by managing one's own backyard. To the extent there is a perception that much lower costs lie in close geographic proximity, this should induce some actors to try to exploit that and some to restrict it. I show that this is exactly what happened since 1990.

CEE sparked two primary responses among West European economic and political actors: a feeling of threat and one of opportunity. Some actors – mostly corporations, but also many European liberals – saw a chance for new markets, new workers, and new investment possibilities for the core OMS economies. The underlying logic was that OMS actors could use the physical, human, and legal assets of the CEE region to diversify (generally not abandon) their own economic model.[2] On the other hand, many OMS firms, labor unions, and not a few OMS politicians worried openly about competition from CEE on capital, labor, and product markets or the cost of fiscal transfers to the much poorer region. They sought to defend OMS economies against threats emanating from CEE by proposing barriers to immigration and trade and measures to moderate the amount of investment that flowed from OMS to NMS sites.

Broadly, my argument is that OMS actors have exercised remarkable amounts of control over the economic transformation process in CEE. That is, OMS actors have used the EU to manage the NMS. They have done so in ways that provided new opportunities but while carefully managing threats. Sometimes, this has involved very conventional EU tools – such as trade agreements – so that the outcome is not surprising. In other cases, however, the EU has acted creatively to manage flows of both capital and labor with new instruments. None of this is to deny that CEE actors – including national governments – were crucial to the economic reforms of post-communism, a prominent theme in my other work (Jacoby 2004; 2006). But given the relative neglect of the topic, it seems important to focus more light on some of the EU's less understood policies towards CEE.[3]

OMS private actors hit the ground early in CEE, and their effects have generally predated an active interest by the EU in the regulatory system of CEE economies. But where private actors have had relatively decentralized policies, the EU, while coming late to the table, enjoyed substantial leverage, especially during the run-up to enlargement. In broad terms, the EU (and some of its member states) have sought to displace private practices geared toward exploiting new opportunities with more defensive "fear-driven" policies as the dominant management approach in the region. I elaborate this central point through materials drawn from a growing secondary literature and from my own decade of research into these issues. I begin with an account of FDI, followed by immigration and trade.

Capital Investment: Promoting Opportunity, Attenuating Threats

In capital, the EU was fairly quiet in the face of early postcommunist investment debates but asserted key OMS interests against perceived threats that arose late in the transformation. Immediately after communism collapsed, many OMS corporate managers saw investment in CEE as a chance to build a low-wage platform to complement or replace high-cost OMS production, exploiting new conditions that would make their firms more fit for global competition. This paper's first epigraph – that Southeast Asia begins 70 kilometers east of Berlin – captures the sense of many actors that CEE was a natural low cost region no matter what political actions were taken there. Yet, it is incorrect to imagine that capital flowed quickly and easily into CEE. Almost all CEE states started out strongly protective of their national capital stock, partly for reasons crystallized in the second epigraph, taken from a character in David Edgar's brilliant 1995 stage play, "Pentecost."

Ironically, just as Edgar was writing in the mid-1990s, FDI saw its first real surge into the region. Even at that time, however, more than twice as many CEE respondents told pollsters that "Foreigners should not be allowed to own land in (respondent's country)" as in the OECD states (69% versus 33%) (Bandelj 2008: 55). Yet by 2004 FDI as a percentage of GDP was 39% in CEE – almost twice the world average. In banking, the picture was even more stark, as more than half the CEE financial sector was in foreign hands by the end of 2004, as opposed to an OECD average closer to 20% (Epstein 2008: 70-72). Clearly, something changed.

This market did not emerge spontaneously but was fostered by three sets of policies driven by, respectively the IFIs, transnational corporations (TNCs), and the CEE states themselves. First, when CEE governments had initial reservations about selling state firms to OMS investors, the Western-dominated IFIs that played a role in encouraging privatization could point to the EU's "free movement of capital" as a component of eventual membership. So while the EU itself had little involvement in the basic design of privatization programs, its famous Annual Reports often mentioned specific targets of privatization and encouraged the various CEE governments to sell properties for whom the most plausible buyers were generally from the OMS. Given the fame and later influence of Czech "voucher privatization," it is worth remembering that the conservative ODS government initially strongly resisted selling the perceived jewels of the Czech economy into foreign hands (Appel 2006). Drahokoupil shows that the EU "narrowed the space for attempts at promoting domestic accumulation" (2008a: 26). And multivariate regressions of the determinants of openings to FDI flows across all postcommunist states show large and significant "EU effects" (Bandelj 2008: 84-85).[4] Though hardly the central actor in privatization, the EU thus broadly sought to increase investment opportunities in CEE.

TNCs were a second source of policy innovation. Far from merely responding to CEE states' privatization tenders to buy and revitalize aging communist firms, many TNCs were willing to make expensive greenfield investments. A detailed study of seven major greenfield projects – six from OMS firms and a seventh from Kia – confirms that far from taking conditions as given, TNCs launched structured bidding wars among potential investment locations. When BMW announced plans to build a major car plant, it called upon prospective locations to answer over seventy questions about the conditions of investment there. It received proposals from about 150 locations in CEE. It also hired a CEE-based consulting firm, Svoboda & Partner, to encourage localities to put their best fiscal foot forward. One Svoboda official recalled, "We would knock on the closed doors of various [Czech] authorities, trying to persuade them that the state had to make a real effort. It was not enough to offer land; it was necessary to fulfill even the unexpressed wishes and expectations of the car-maker" (quoted in Drahokoupil 2008b: 204).

The third source of policy innovation has been the states of CEE. In the hunt for investment capital, they have often offered very lucrative investment incentives targeted at foreign investors (Drahokoupil 2008a; 2008b; O'Dwyer and Kovalcik 2007; Ellison 2007). Where large car firms are arguably policymakers[5], many smaller OMS investors are policy takers, and good general conditions are meant to lure them east. In that sense, we can imagine CEE policymakers solving the collective action problems of small OMS investors, who are the ultimate drivers in this scenario even if they are too dispersed to press their case. The basket of policies includes tax cuts for foreign investors, a simplified tax code, tax holidays, land grants, loose restrictions on labor relations, and even long-term commitments to reduced social spending as a credible commitment to sustained low taxes. Clearly a function of aggressive governments seeking to lure hard-to-identify potential investors, these policies have proliferated in some CEE states and not others.

These policies were coterminous with a second boom in FDI in the early part of the 2000s. But then a backlash against hyper-liberal policies ensued.[6] The backlash was led by actors worried about an OMS competitive disadvantage and by EU officials keen to prevent behavior that might undermine the legitimacy of the single market project. Some sought to prevent capital from flowing from the OMS to the NMS by pressuring CEE states to raise standards quickly so that CEE tax rates soon approximated those on capital in the OMS and to end or reduce very attractive tax holidays. This reaction came despite the fact that OMS states have not seen major capital outflows to CEE (except, perhaps, from Austria and, even then, major Austrian banks were reaping well over half of their profits in CEE markets by 2005).[7]

In this reaction, the leading instrument of OMS actors has been the EU, with its detailed single market *acquis* and reasonably well-developed enforcement mechanisms.[8] As a leading target of FDI, Hungary's policies have come in for particular scrutiny.[9] OMS corporate tax rates have come down markedly in recent years, at least partly in response to CEE tax competition, a development generally welcomed by managers.[10] On the other hand, the EU screening process stripped the NMS of some potentially useful national tools for managing the political economy – tools that were judged by the Commission to be in contradiction to the *acquis* (Ellison 2007; Appel 2006; Gabrisch and Werner 1999). Some tax tools were outlawed altogether as violations of the state aids section of the *acquis*; others were simply trimmed substantially, such as the length and extent of tax holidays. The backlash led to some very interesting dilemmas. For example, when the EU tried to void favorable conditions between Slovakia and US Steel, the American company successfully resisted, and the EU felt obliged to write the exception into the Slovakian accession treaty. In most cases, however, the EU was pushing to remove or limit concessions won by OMS-based actors in CEE.[11]

On balance, however, while the EU can clearly limit state aids to firms, OMS actors actually have relatively few tools to constrain the corporate tax policies of CEE states. CEE states not only know this but are also often allied with well-informed and powerful OMS firms poised to defend this policy discretion.[12] And on the controversial 'flat taxes' in six EU member states (Estonia, Latvia, Lithuania, Slovakia, Romania, and Bulgaria), only in Bulgarian did the choice for the flat tax come after EU membership, with the Baltic states moving already in the mid-1990s. Broadly, smaller and poorer CEE countries may have been attracted the flat tax as a tool to draw FDI that was flowing primarily to Poland, the Czech Republic and Hungary, and the OMS could do little to stop them.[13] At the same time, however, FDI allows OMS societies new options. Without fundamentally changing their own national models of capitalism – a deeply contentious process with uncertain economic results – many large and small OMS firms are able to do things complementary to (not alternative to) production at home. Suzanne Berger notes that some OMS firms (her examples are drawn from Italian textiles) tend to use CEE investment for new business and expansion while their core business stays in the home location.[14] Bandelj (2008) shows that investment opportunities in CEE allows OMS firms to alter the "make versus buy" decision in many cases.

In short, CEE is both a platform for OMS business expansion and also a pressure valve to diminish tension over OMS domestic regulations on the grounds that investors can escape some regulations by going to CEE. CEE politicians play to both sides of this: they offer preferential terms for OMS investment, defend those deals against skeptical EU Commission officials, and hope to use the resulting investment to catch up to OMS standards.

Labor Migration: Varieties of Anxieties

If the capital movement case revealed a structural advantage for OMS actors who saw opportunity in CEE, the labor case reveals an advantage for those OMS actors who felt threatened. Moreover, the capital side showed substantial diversity across the region, suggesting that if the CEE states are being managed, they are not all responding in the same way. The labor case adds the important dimension that OMS vary significantly in what they want from CEE, and the differences among the varieties of European capitalism seem even more manifest here than was true in capital movements.

In explaining this variation, geography clearly matters in the case of labor. Germany and Austria had quite poor member states on their immediate border while none of the other OMS did.[15] Their politicians judged the potential for migration flows very differently than did politicians in, say, the UK. As a general matter, the OMS have both a tradition of very low labor mobility internally and a de facto “low-skill bias” in their immigration policy (put differently, the lack of a common immigration policy). This scenario obviously brings somewhat fewer economic benefits to the OMS than would high mobility and a high-skill bias, but it also exacerbates the political tensions that surround immigration. In comparative perspective, moreover, Europe is more skeptical towards low-skilled immigrants than is the US since it has a more generous welfare state (Brücker and von Weizsäcker 2007: 248).

While some OMS actors placed priority on getting access to labor (especially skilled labor) from CEE, others focused on walling off immigration from CEE. Initially, it seemed as if the primary management here would involve the Commission walking the CEE states through a welter of well-established (if patchwork) regulations regarding free movement of persons, which had become a core principle of the single market in both theory and deed by the 1990s (Grabbe 2006: chapters 6 and 7). But technocratic debate over mutual recognition of things like professional certificates was soon swamped in the late 1990s by the high politics of member states. Germany and Austria, in particular raised strong objections to immediate free movement of CEE workers. In Austria, the temporary work of CEE migrants was often likened in the coarse public debate to prostitution, as the places where day laborers waited for work in Vienna was called the "Arbeitsstrich" – roughly the "work brothel." Between 2000 and 2004, the number of residents of the accession states living in the OMS increased from 700,000 to over 900,000. At that stage, gross monthly wages in the immediately acceding CEE countries generally ranged from less than 15% of German wages (Latvia and Lithuania) to about 30% (Hungary and the Czech Republic) (Zimmerman (2007).[16]

Faced with severe pressure from Germany and Austria, the EU was ultimately obliged to negotiate the right of individual OMS to limit entry for up to seven years after membership. Once the possibility was opened, twelve of the fifteen OMS took advantage of it – all but the UK, Ireland, and Sweden. To many observers, this majority position seemed politically comprehensible, but economically (and morally) shortsighted.[17] The

Commission unsuccessfully advocated more openness to CEE immigration. Frits Bolkestein, Internal Market Commissioner, was blunt about the defensiveness of the temporary walls: "In a healthy economy it is better to prepare for competition than to draw up new barriers" (Grabbe 2006: 146). In the event, Polish immigration to Germany barely budged with enlargement, though there seems little doubt that many Poles who emigrated to the UK might otherwise have gone to Germany.[18]

Among the handful of now-emerging empirical studies, Zimmerman (2007) reports that despite its significant miscalculation in the number of arriving immigrants, there is no evidence of declining native wages in the UK, Ireland, or Sweden "even in the sectors with the largest share of new immigrants." There is also little evidence of a growth in "welfare tourism" (Bawer 2006). Since enlargement, Irish unemployment has trended very slightly downward while UK and Swedish unemployment has trended slightly upward (Zimmerman 2007). Interestingly, the public perception of immigration (share who agree that "immigration is good for the country's economy") has tracked these disparate political decisions. In both the UK and Ireland, the share of respondents who answer agree with the statement rose in the wake of enlargement. In both Germany and Austria, the share fell (Zimmerman 2007).

In keeping with these heightened anxieties, Austria and Germany have already renewed their immigration bans and announced their intention to sustain these bans through 2009 (Austria) and 2011 (Germany). Meanwhile, Greece, Spain, Portugal, and Finland lifted the bans entirely after the first period, while Belgium, Denmark, France, Italy, the Netherlands, and Luxembourg have modified the restrictions, especially in sectors with tight labor markets. In short, anxiety over immigration has varied substantially across OMS, but the broad picture is that most of the OMS used the EU to develop new instruments (time-limited immigration bans on citizens of fellow member states) to buy time for adjustment to challenges from CEE.

Trade Patterns: Buying More Time

In trade, the EU initially used protectionism, treating the postcommunist states like it would other nonmembers. Controlling access to its market is, of course, one of the key assets enjoyed by the EU in efforts to manage globalization on behalf of its members. Not long into the postcommunist transformation, however, the EU began negotiating the so-called Europe Agreements (EAs) with the CEE states. While most observers saw the EAs as a substitute for offering the CEEs any perspective on quick membership, the EAs did contain much more favourable trade provisions than were available otherwise.[19] Giving up on pure protectionism, however, meant moving to a somewhat more subtle mix of management strategies.

As outright protectionism gave way to the carefully managed trade of the EAs, for example, the OMS determination to avoid competition in sensitive sectors was evident right from the outset.[20] On the surface, the series of bilateral deals between the EU and the CEE states seemed tilted towards the latter: Europe would remove its trade barriers within five years, while the CEE states would get ten years to comply. The fine print, however, contained exclusions for virtually every product where the CEE states were competitive, including iron, steel, some chemicals, and several agricultural products (Mayhew 1998). This asymmetry bought the EU-15 time to respond to areas of CEE comparative advantage. An obvious OMS response was to buy heavily in those areas. By the time general openness arrived, a surge in EU-15 FDI after 1995 (described above) left many key assets in OMS hands. As OMS-CEE trade deepened, it did so in ways that substantially softened the blow to EU-15 economies. In recent scholarship, a fairly vivid picture has emerged of trade developments up to enlargement. Collectively the picture is of a CEE economy profoundly dependent on that of the EU-15.

First, Baldone, Sdogati, and Tajoli (2007) show that CEE states' revealed comparative advantage is likely much lower than previously thought. Using an EU data set based on firm registration of intermediate goods flows (the firms received tax breaks in exchange for registering these transactions), the authors decompose trade statistics in a way that takes account of two facts: first, that many products that originate in non-EU countries go through at least one phase of their production in the EU (called "inward processing trade" or IPT); and second, that many products that originate in the EU undergo a phase of production outside the EU ("outward processing trade" or OPT). A key part EU OPT revolved around CEE, as German and Austrian firms temporarily exported to CEE and then re-imported the goods for final finishing.[21] EU countries' OPT shares were virtually always highest with the CEE states, rather than with American or Asian states who were their leading read partners and with whom their IPT shares were highest.[22] On the other hand, CEE states had a fairly trivial position as temporary exporters to the EU, accounting for only about 2% of total IPT in the EU. This shows that trade in semi-finished goods was essentially a one-way street. It also shows that apparent CEE strength in exports was, in some sectors, derivative of German and Austrian production that conventional trade statistics counted as CEE trade even though most of its value added occurred elsewhere. Finally, it means that CEE comparative advantage is generally overstated in most existing trade data sets.

A slightly different indicator of dependency in CEE economies takes off from the distinction between two basic forms of intra-industry trade (IIT). Vertical IIT occurs when developed countries control all the highest value-added parts of the product cycle, while horizontal IIT characterizes peer-to-peer trading regimes of differentiated products of roughly equivalent value-added. Concerned that the CEEs would be on the tail end of a vertical regime, Gabrisch and Werner (1999) wondered how Visegrad locations could achieve more horizontal IIT relationships. Their data showed that while IIT was on rise in CEE in he late 1990s, it was towards mass-production goods (142-43). Vertical ("bad") IIT as a percentage of total IIT was between 89-95% in 1993. Gabrisch and Werner's comparison figures show that VIIT was substantially higher than in EU-15 states (1999: 147).

The same data also showed that relative unit values (essentially, within sector variation in price-quality measures for EU-15 and Visegrad production) showed consistently large gaps in favour of the EU-15 in most of the 30 sectors that were liberalized most quickly. In only six of the 30 sectors were Visegrad producers more competitive (146-47). Finally, in the few cases of CEE advantage in price-quality ratios, less than 10% are in "high-quality" imports.[23] The bottom line is that even growing IIT involving CEE has not produced much economic convergence. Instead, Visegrad states are specializing in areas of "standard goods of labor- and scale-intensive production" (148). This certainly can raise CEE incomes, but it does so in way that seems less likely to pose a fundamental challenge to OMS models of production, which I have argued is the essence of managed globalization in the context of enlargement.

My tentative interpretation of these results is that the OMS have managed the trade aspects of integration with CEE pretty successfully from their perspective. They have diversified OMS production by investing in CEE but without (so far) provoking any major backlash against enlargement.[24] Recall that most estimates of the economic consequences of enlargement for the EU-15 tended to stress increased trade from a larger single market as the most substantial likely effect (far larger than either the common external tariff or even labor migration from NMS to OMS). But this generalization also hid large sectoral variations. While some sectors showed little potential for increased trade as a result of enlargement, several others did, led by big potential trade increases in agriculture (+249%), textiles and leather (134%), trade services (113%), non metallic minerals (107%), food processing (94%), transport equipment (94%), electronic equipment (79%), fabricated metal products (56%), and machinery (37%) (Lejour, de Mooij, and Nahuis 2004: 226).

As noted above, OMS firms could also insist on steps to open CEE markets while protecting themselves from competition from CEE. Several pieces of evidence show that OMS firms have had this concern. For example, though illegal under EU law, many OMS investors imposed "vertical restraint agreements" prohibiting their own CEE affiliates from using technology transferred to them for any production activities outside the framework of their joint-venture agreement with their OMS partners (Lorentzen and Mollgard 2000). Moreover, Volkswagen (legally) limited reimports to the OMS of its Skoda products out of fear of cannibalizing its VW brands there.[25] My claim here has been that the OMS management strategy bought time and essentially attenuated the potential for unwanted competition that did occur.

So far, CEE producers have posed few really stiff competitive challenges to OMS producers. There are two factors behind this pattern. First, the trade strategy just described meant that potential direct competitive challenges from CEE mostly could be managed by EU rules and policies. Second, global liquidity was so high that ample investment capital could flow to CEE without thinning the capital base of the OMS. This "win-win" pattern is easiest to see in the auto sector, where very clear upgrading did take place in CEE (already by 1999, CEE producers had caught up to EU-15 producers in unit values in autos) (Sceponovic 2009: 6). Even as CEE producers increased employment and exports of both high- and low-value added production in the auto sector, the sector also showed stable or growing production in Southern Europe (especially Spain) and Germany (Sceponovic 2009).

While the first factor dampened CEE growth into high value-added markets, the second promoted such growth. Both of these factors have now changed, however. First, the OMS regulatory strategy depended very heavily on the CEEs' non-member status, which ended in 2004. Should CEE-based firms – aided by propitious tax, investment, and labor market policies in CEE – launch new challenges, it is harder to see how this pattern could be repeated. Second, the financial crisis has manifested as a liquidity crisis. Lending is way down as are risk appetites. This has had devastating effects on CEE exports, which are off 30% year-on-year in several CEE economies during 2009.

Conclusion: Paradoxes of Dependent Economies

This paper has argued that the OMS were highly risk averse during the Eastern enlargement and that this risk aversion is linked not merely to the increasingly well-understood process of membership conditionality but also to a less-noticed (and older) effort by the OMS to manage globalization. Their management efforts allowed OMS actors to exploit investment opportunities in CEE but without exposing OMS economies to large increases in migration or trade pressure in sectors where CEE had comparative advantage. In finance, the EU eventually stripped CEE states of some of the tools they had been using to attract foreign capital, and the EU paved the way for the OMS to put up barriers to labor mobility and to delay trade opening in sensitive sectors until FDI patterns increased OMS influence.

Several paradoxes emerge from this story. First, even though CEE states have been thoroughly managed by the OMS, the result still has broadly been perceived as a win-win situation, at least in the short run. Even though the OMS states won all the key disagreements during enlargement – over agriculture funding, the size of the structural funds, the time to membership, the stretching of the *acquis* – the large gap in living standards between OMS and NMS means that even smaller concessions have been meaningful to the CEE states. Moreover, their status as potential and then actual EU members has helped lower CEE borrowing costs, which translated into a long consumption boom. In most places, employment, growth, and investment have been up while inflation has been down – at least until recently. The financial crisis of late 2008, however, may further cement CEE interest in joint EU policies even if costs are asymmetric. While most CEE states have taken a cautious approach to future Eurozone membership, it has not escaped notice that those states that did join – Slovenia, Slovakia, Malta, and Cyprus – enjoyed a certain insulation from the currency fluctuations that roiled markets in late 2008, hammering even states like Iceland, let alone Hungary and Latvia.[26]

A second paradox is that where Meunier and Abdelal (2010) show that the EU was more able to affect global rules in the area of capital regulations than in trade, the CEE cases show roughly the opposite pattern: the OMS governments more easily managed the trade aspects of enlargement than the FDI aspect, where they often resented many CEEs' hyper-liberal policies designed to attract investment. These liberal policies emerged from an implicit coalition between CEE reformers and OMS investors (Jacoby 2006). This coalition around finance was much harder for the OMS to control, but it also generated conditions under which the later move to free trade would be much less disruptive, since OMS actors soon came to own the CEE firms exporting (or re-importing as in the above data) to the OMS. Broadly, this pattern underscores again how powerful is the EU's gatekeeping leverage granted by virtue of the large internal market to which it controls access. By contrast, the EU has far fewer instruments to limit the outflow of capital from the OMS.

The question is how well the EU deploys its leverage. In global trade talks, the EU has often fared poorly of late, seemingly handcuffed by its commitment to multilateralism. In the current banking crisis, the EU seems often to have failed to exploit widespread disenchantment with American finance practices to play a central role in developing new global financial regulations (or even get its own house remotely in order) (Véron 2009; Newman 2009). And even in its own Neighborhood Policy, the EU has struggled to use economic leverage alone (without membership conditionality) to prompt deep reforms in "deep" Eastern Europe or the wider Mediterranean areas (Vachudova 2008). However, in CEE the EU did play its trade cards adroitly and to the clear benefit of OMS actors. Now that the CEE states are full members (a situation that has often led to substantially improved conditions for previous waves of EU entrants), they can defend themselves far better. Yet what if access to consumption financing narrows and investment capital does flow out of CEE during a protracted economic downturn? Will the CEE states, even as full members, find that they have left behind their status as geo-strategic buffer states for the USSR only to emerge as economic buffer states for the old EU?

A third paradox is that some level of liberal "threat" from CEE may actually be welcomed by generally conservative and risk averse OMS governments. Initially, OMS firms' efforts to attract generous investment subsidies seemed to empower CEE states with whom these firms often worked very closely. OMS states and the EU often protested about the potential for social dumping and unfair tax competition. But these complaints have grown quieter, and part of the reason for this may be because CEE liberalism helps solve a collective action problem of OMS firms and reduces their demands on OMS governments. Many OMS corporations – not least large German firms – chafe at domestic regulations and are genuinely interested in using production abroad not just to cut costs but to put reform pressure on their home governments. Yet the ability to lower their costs in the short-run by investing in CEE, may rather dampen their fervor for OMS reforms that might lower their home costs in the long-run. In that sense, CEE investment seems to have functioned as a "pressure valve" that, when released, somewhat deflates the pressure for domestic reform, something that might, for example, have threatened to tear apart the CDU-SPD grand coalition that governed Germany until fall 2009. Post-election interviews in the German Ministry for Economics suggest no enthusiasm for re-opening the contentious debate over "tax dumping" in the NMS.[27]

A fourth paradox is that when EU membership was achieved, the resulting "safety" seems to have led the NMS to adopt some very risky new behaviors. This behavior is the subject of another paper, but some of its roots seem already to be clear enough. On the one hand, the very fact of prospective and then actual EU membership dramatically lowered borrowing costs for NMS actors, but this was especially true to the extent that borrowing was denominated in foreign currencies like the Euro or Swiss franc. Some of this debt was no doubt justifiable in the context of consumer prices that were converging on OMS levels quite a bit faster than were wages. Nevertheless, when domestic currencies crashed in the fall of 2007, debt service became a crushing burden for both private and public actors. To this economic logic, we must also add an important note about politics that may well lie at the heart of this risky behavior: NMS politicians of all stripes have been faced with relentlessly dissatisfied electorates, resulting in high electoral volatility, party death and exit, and high government turnover (Bertoa and Mair 2009; Bunce 2006). In this context, the incentives are hard to resist for politicians to pursue policies with benefits in the here and now and costs that will be born by the next government, almost certainly not by them.

What lies ahead? With the global economy in turmoil, it is exceedingly difficult to say. One hunch is that variations across European economic systems will become even more important. We already know that even the Europe of the EU-15 contained up to four fairly coherent economic models: 1) Nordic SMEs; 2) Continental SMEs; 3) LMEs; and 4) a southern European model (Pontusson 2005). A useful line of future research would ask the extent to which countries from each part of the typology have and sustain a distinct relationship with CEE. For example, Germany is, by some distance, the largest investor in CEE. On the other hand, the UK – which is well ahead of Germany and second only to the US in global FDI outflows – has been only a bit player in CEE, accounting for less than 5% of total FDI, except in Bulgaria (11%) and Lithuania (7%) (Bandelj 2008: 106-10). One hypothesis consistent with this data would be that the LMEs have the least to gain from CEE (since their economies are already more liberal) and that they therefore invest less in CEE. A corollary might, however, be that LMEs have allowed more immigration from CEE, suggesting they want something different, but not that they are less interested in CEE. In other words, the OMS may use regionalization differently: Britain hosts CEE workers, while Germany prefers to invest there instead.[28]

Variation in OMS objectives must also be matched analytically with substantial variation in CEE capacities, a crucial theme that space limitations have largely precluded in this paper. Greskovits (2006) shows that behind broadly liberal policy regimes very different economic structures are still being reproduced. Distinguishing capital intensive and non intensive production regimes as well as skilled versus less skilled production produces a typology with four combinations: capital intensive-low skilled (e.g., mining, Bulgaria), capital intensive-high skilled (e.g. autos, Slovakia), non capital intensive-low skilled (e.g., textiles, Romania), and non capital intensive-high skilled (e.g., electronics, Hungary). Surely, these sectors will respond differently to the turmoil ahead, with the auto sector already in very difficult times. It is far from certain that the OMS can still use

EU instruments to manage the NMS now that they are all members, but given the history sketched above and the rough times ahead, it seems beyond a doubt that they will give it a try.

[1] For example, Leonard (2006: 145-6) lists 82 non-member European, African, and Asian, states in an emerging "Eurosphere."

[2] This logic applies both to firms – which have a model of production – and to nations in the sense of national models of capitalism.

[3] For important exceptions, see (Gowan 1995; Böröcz 2001; Zielonka 2006; Böröcz 2010).

[4] This finding is based on a dummy for prospective membership. On the other hand, formal EU investment treaties seem not to explain much variation (Bandelj 2008: 123).

[5] Audi recently was able to resist Hungarian efforts to impose a 4% "solidarity tax" on foreign capital and ultimately scuttle the whole measure (Ellison 2007: 25).

[6] To be clear, my claim is not that liberal policies definitely attracted investment capital and jobs. Even when the Baltic states moved to the kind of hyper-liberalism just described, this did not redirect FDI away from the four "Visegrad" states that had already been the main beneficiaries of the first FDI boom (see Bohle and Greskovits 2007: 457-59). My point is that the policy basket under discussion scared key OMS actors with visions of the proverbial "race to the bottom."

[7] Epstein 2008. Occasionally, CEEs states have pushed back. For example, Estonia has annoyed the EU by holding to a 0% tax on reinvested corporate profits (profits distributed as dividends are taxed at 23%). The EU has been critical, but Estonian politicians point out the policy contravenes no regulations.

[8] The CEE states appear to have been conscientious about passing EU legislation and resolving disputes with the EU subsequent to membership (Sedelmeier 2008).

[9] For example, Volkswagen accounted for about 15% of both Czech and Slovakian exports in recent years (Pavlínek 2004).

[10] A 2006 EU report found that corporate tax rates declines in 22 out of 25 EU states between 1995 and 2004. Weighted for country size, the average rate drop was from 43% to 33% (European Commission, 2006: 82-84).

[11] Foreign ownership (usually by OMS-based investors) was a clear advantage when CEE states sought temporary "derogations" that allowed them to set aside parts of the *acquis* for a limited time (Van Aken 2008).

[12] Former Estonian Prime Minister Juhan Parts spoke for many when he said, "Estonia views any move to QMV on tax and social security as not acceptable." *BBN Estonia*, October 6, 2003.

[13] For a subtle, but inconclusive, analysis along these lines, see Aligica and Evans (2009: 185-203).

[14] Even here, however, Berger (2005) stresses the low productivity in CEE sites like Romania, while noting that firms there are often obliged to build much of their own infrastructure. Such hidden costs cut heavily into anticipated benefits. See also (Sammarra and Belussi 2006).

[15] Greece did by 2007, but not 2004 when the core policy space was contested.

[16] Slovenia was an outlier at just over 50%. Bulgaria and Romania (2007 accession) were under 10% of German wages.

[17] To be sure, Germany and Austria have the highest shares of non-nationals among their working age populations (about 10% – though few from the NMS).

[18] The UK received far more immigrants than they anticipated (according to the BBC, 600,000 total rather than the Home Office's estimate of 13,000 per year (e.g. roughly 50,000 since May 2004), with Poland, by far, the biggest sender).

[19] For the EAs, see (Sedelmeier 2005). Vachudova (2005: chapter 4) shows that the rather stingy EU trade concessions in the EAs stimulated CEE states to seek full EU membership.

[20] The logic again being that it is far easier to mobilize actors to defend current benefits (market shares) than to pursue new rewards (through FDI).

[21] In the years the study was conducted – 1990-2003 – the CEEs were non-EU countries.

[22] Note further that OPT to the CEE states is undoubtedly higher than these figures suggest because after 1997, EU trade agreements with the CEEs removed most of the tariffs and other barriers that led firms to register intermediate goods trade.

[23] Mykhnenko (2007: 373) found that even CEE states with very different growth levels still showed similar comparative advantages in global markets, namely, low and medium technology exports and resource-based manufacturing exports.

[24] This claim is easier with the Lisbon Treaty finally ratified. That said, I am not aware of solid data linking prior French, Dutch, or Irish rejection of the Constitutional or Lisbon treaties to frustration over enlargement.

[25] I thank Bob Hancké for this information.

[26] For the Hungarian case, see Szlanko (2008); for the Latvian case, see Raudseps (2008).

[27] Interview with Hansjög Schaal, German Ministry of Economics, Berlin, Sept. 2009.

[28] Consistent with this proposition, Ireland has virtually no CEE investment. On the other hand, Sweden – which also opened its labor markets from the start of enlargement – was actually the fifth largest investor in CEE.

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