

ENDOGENOUS DEVELOPMENT: THE NEW CHALLENGE FOR CENTRAL EUROPEAN INDUSTRY

Gabor Lux

*Hungarian Academy of Sciences, Centre for Economic and Regional Studies, Institute for
Regional Studies*

Abstract: This paper examines the applicability of the concept of endogenous regional development to Central European post-socialist countries. Endogenous development emerged in response to the pressures of the global economy in Western Europe, and focuses on exploiting locally rooted competitive advantages that can counteract the cost advantages of less developed economies, providing a “high road” of socio-economic development. In Central Europe, industrial restructuring has mainly followed a development path based on Foreign Direct Investment, which has reinvigorated competitiveness, but now faces the need to go beyond low costs, and counteract the unfavourable effects of external capital dependency. The paper identifies two different paths to encourage endogenous development, drawing attention to their institutional background and the expected consequences on territorial development.

Keywords: endogenous development, industry, reindustrialisation, Foreign Direct Investment, regional policy, capital accumulation

ENDOGENOUS DEVELOPMENT IN THE MODERN SPACE ECONOMY

In the previous decades, the realities of increasing competition and the rescaling of the modern space economy have pushed even the most developed European economies to reconsider their development strategies. The pressures of “unlimited globalisation” have been brought about by advances in transportation and infocommunication technologies; massive worldwide deregulation; the appearance of several new players in global economic integration; and the constantly improving permeability of national borders. Foreign Direct Investment (FDI) flows, mainly controlled by transnational corporations (TNCs), increasingly shape the development prospects of states and regions; except for a handful of key players on the world stage, they face adaptation pressures which are impossible to avoid without the threat of marginalisation.

A process of rescaling takes place, leading to increased concentration in global centres (Faragó 2010). The new winners of worldwide agglomeration processes are the “ideal” locations of space; globalised city-regions which serve as frameworks of agglomeration economies (Gordon – McCann 2000), and fulfil both hub and gateway roles in the distribution of transcontinental flows (Taylor 1997; Derudder et al. 2003; Erdősi 2003; Sassen 2006; Gál

2010). Their strengths, founded upon a spatially limited system of location advantages, enable them to collect the most advanced functions of the post-Fordist economy: knowledge-intensive business services (KIBS), the most advanced innovative technologies, command and control functions in both the commercial and public sector. The highest value added economic branches show high concentration in these “world cities” (Audretsch 1998). In comparison, medium-sized metropolitan areas linked to the world city network tend to specialise in a narrower set of activities, from finance (Frankfurt, Zürich) to fashion and culture (Milano). Their examples are presented as idealised case studies in economic development, often converted into development recipes without taking into account their unique situation and capabilities.

In industrial development, low barriers of entry in mass production have resulted in massive competition from newly industrialised countries (NICs), challenging traditional industrial heartlands in Europe and North America. Freeman (2008) writes of “the great doubling” of the world’s labour force from 1.46 to 2.93 billion people since the 1990s, and draws attention to the resulting change in the global capital/labour balance, which has decreased to 61% under the same span. Emerging economies, particularly from East Asia, benefiting from state-led development policies (Gereffi 1995), have undergone significant upgrading from peripheral actors to global players, both through the attraction of TNC sites, and support for their own “national champions”. Both TNCs and national champions possess special advantages when it comes to worldwide competitive strategies: they can optimise the factor intensity, knowledge content and added value of their activities on the global scale. This unique “bird’s eye view” enables them to pay taxes in tax heavens; locate their labour-intensive production on low-cost sites while exploiting high-skilled labour, innovative activities and management close to the global centres; and sell their products to advanced economies as well as the broadening global middle class. Economies of scale and a powerful bargaining position grant them a similar place as global centres, with which they exist in symbiosis.

In contrast, “minor cities”, urban centres without sufficient critical mass find themselves facing a precarious situation, manifested in losing ground to global champions, and a dilemma between strong specialisation and a flexible economic structure (Lux 2015). Even advanced economies in Western Europe and North America feel the resulting development challenges. Unlimited competition results in downwards convergence towards a relatively low “global average” and exerts a burden on welfare states (Kilicaslan – Taymaz 2008; Milberg – Winkler 2010). Wage stagnation, long-term job displacement and labour market insecurity, coupled

with a structural shift towards post-Fordism and the crisis of traditional industrial regions, have led to the erosion of previously secure medium-skilled jobs, in both blue- and white-collar professions. The phenomenon of the “disappearing middle” has been noted as a severe problem by numerous authors (Goos – Manning 2007; Acemoglu – Autor 2010; Tüzemen – Willis 2013), and lead to the search for effective development strategies representing a “high road” of global competitiveness, characterised by a high level of social spending, employee skills, innovation and (consequently) productivity (Milberg – Houston 1999).

In regional policy, the spatial interpretation of high road development has encouraged an entire set of development policies, a “new consensus” of regional development which relies on the collaboration of territorially embedded public and private networks to foster learning and innovation (Humphrey – Schmitz 2002), as well as the development of learning ability, the skill to adapt to new circumstances and accumulate valuable knowledge in the learning region framework (Páger 2013a). *Endogenous development* stresses the exploitation of locally rooted, hard to reproduce location advantages, primarily unique skills and knowledge to achieve competitiveness in a selected industrial or tertiary niche. The central tenets of this development approach are a combination of the following concerns:

- resource concentration and the exploitation of agglomeration advantages enabling less dense regions to achieve the advantages found in metropolitan city-regions;
- increasing the regional embeddedness of production through an upgrading process;
- empowering local small and medium-sized enterprises (SMEs) and their networks;
- and preserving social cohesion and the welfare state.

The concrete expression of the philosophy can be seen through a variety of instruments and concentrated development units: regional clusters and industrial districts, growth poles, regional innovation systems and learning regions etc. These concepts are all interrelated, inasmuch as they attempt to encourage local resource accumulation, and the generation of spillovers or multiplier effects that starts from a concentrated location, and integrates a broader region into a production network. This “district” or “cluster” idea is mainly applied to the development of SME networks, but similar strategies are also employed to achieve a higher embeddedness of TNCs within the local economy, creating “sticky places in slippery space” (Markusen 1996) that can anchor mobile capital within a specific location by supplying particularly attractive location advantages. Instead of competitive SMEs, this variety relies on upgrading within global value chains, trying to capture the higher-end segments of production (Humphrey – Schmitz 2002; Milberg – Winkler 2010; Szalavetz 2013) Endogenous development has become a standard approach of EU development policy,

although it is often used haphazardly without regard to local capabilities, historical antecedents or institutional development – with varied amounts of success.

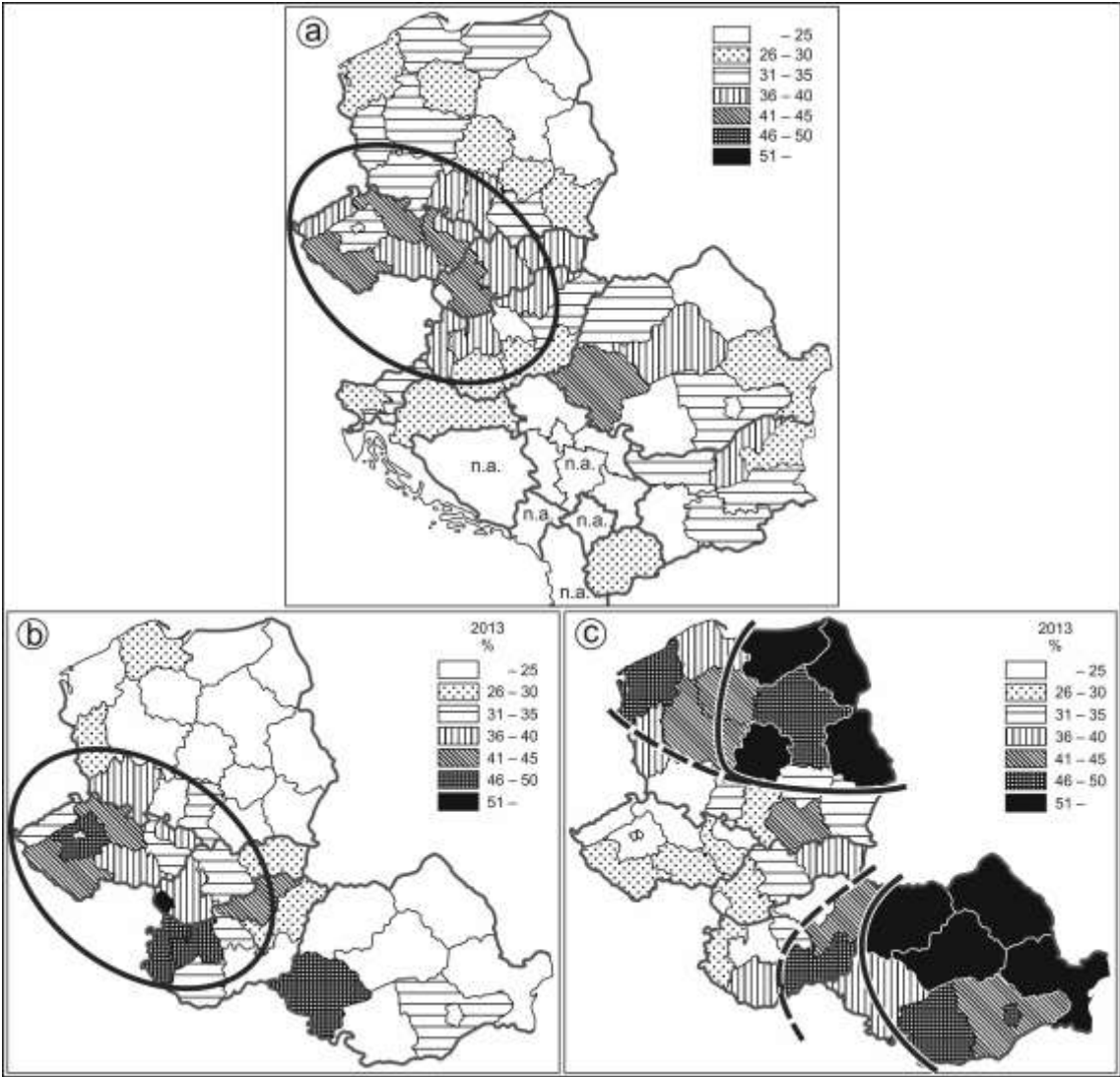
In the last decade, even the success stories of endogenous development have been facing new challenges. Cost-based competition has increased from post-socialist and Far Eastern emerging economies, while SMEs networks without effective niche strategies are increasingly disrupted by TNCs, which have entered and captured markets traditionally dominated by local enterprises. Transnational private governance has introduced TNC-friendly legislation through the EU, representing Anglo-Saxon competitive philosophies in contrast to the continental model (Nölke 2011). There has also been a cultural change with weakening informal ties, less integrated firm networks and changing populations, particularly visible in Italian industrial districts (Parrilli 2009). The result is the weakening of the environment which have allowed endogenous development models to succeed, the lower embeddedness of local companies, and the restructuring of company networks into more hierarchical, centrally or even externally controlled formations.

THE LIMITS OF FDI-DRIVEN INDUSTRIAL RESTRUCTURING IN CENTRAL EUROPE

In post-socialist Central Europe, socio-economic and political transformation has resulted in contradictory industrialisation processes: the decline of pre-1990 industrial structures (similar to, but more severe than the crisis of “Old Industrial Regions” in western economies) coincided with the new wave of European and global integration. Absent effective and well-financed state policies, this change has been overwhelmingly market-driven, and dominated by the location preferences of Foreign Direct Investment. Authors have described the results as “dual economies”, characterised by deep imbalances between the capitalisation, knowledge base, market position, and other vital characteristics of foreign and domestic corporations (Barta 2005; Havlik 2005; Kiss 2007a). In the Visegrad-4 group, services have become the leading source of employment, but outside capital cities and their agglomerations, industry plays the dominant role in territorial differentiation (Lux 2010; Kuttor – Hegyi-Kéri 2012). The space-shaping role of FDI has been strongest in what could be described as *Central Europe’s manufacturing core*, where the combination of beneficial productive legacies and new investments have created a favourable environment for the development of manufacturing industry (Figure 1a). This area encompasses Czechia, Western Slovakia, South-Western Poland, North-Western Hungary, and is closely linked to the production

systems established in Germany, Austria and Northern Italy. There are, however, other relevant differences: the industries of the core (machine industry and electronics) and the peripheries (traditional light and food industries) form relatively clear spatial divisions, both types contributing to competitiveness in their own way (Figure 1b-c).

Figure 1: The spatial structures of Central European industry in 2013 (%)



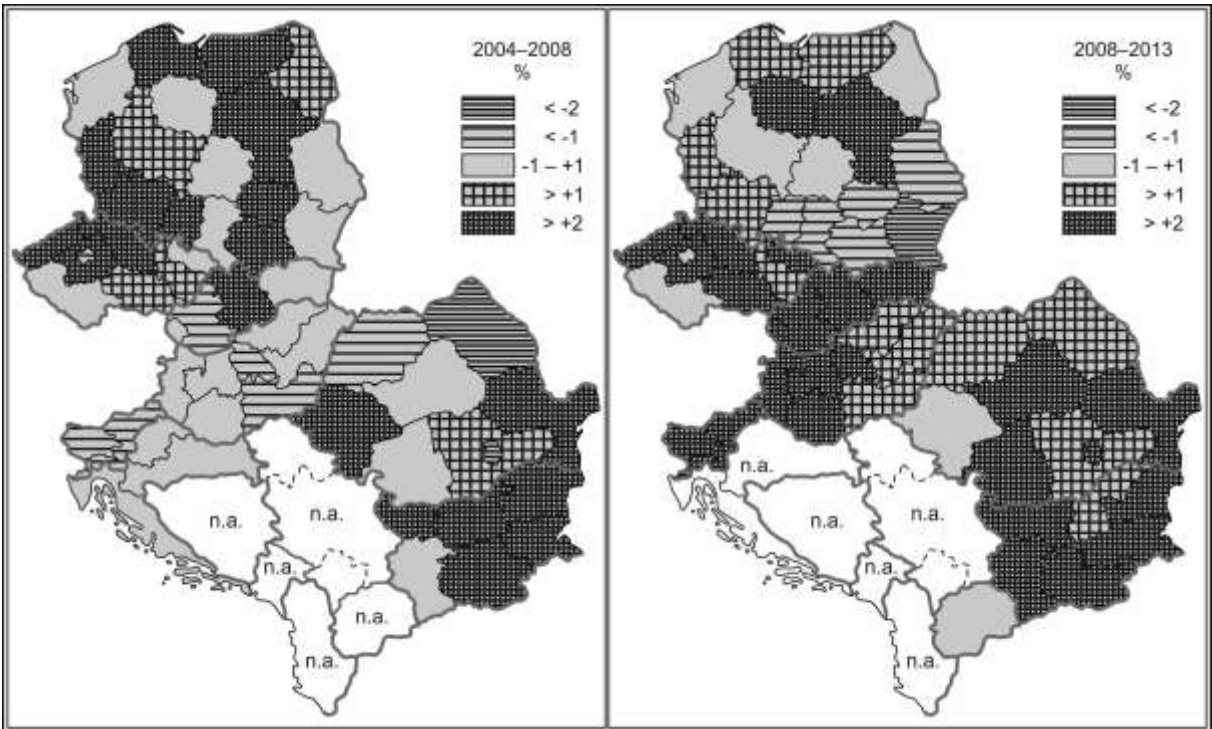
Legend: a) The share of industry and construction in total employment; b) The share of machine and electronics industry in industrial employment; c) The share of light and food industries in industrial employment.

Source: Author’s calculations based on data from EUROSTAT.

These development patterns are evidence of Central Europe’s deepening integration into continental economic networks, gradually surpassing a simple core-periphery model. German companies and the supply networks of the automotive industry play a particularly strong role

in establishing a division of labour where post-socialist states mainly become hosts to medium-skilled jobs and business activities (Molnár 2012; Krzywdzinski 2014; Wójtowicz – Rachwał 2014).¹ There is evidence of upgrading processes in competitive industrial branches, resulting in increasing factor intensity, i.e. moving from labour-intensive production to more specialised, capital- and knowledge-intensive roles, which now extend to a limited capacity of R&D centres (Pavlínek 2012). Simultaneously, supply networks have also increased the territorial embeddedness of FDI plants, although, outside Poland’s robust domestic supply sector, most of these suppliers are themselves based on foreign capital.

Figure 2: The dynamic of industrial employment in the accession and crisis period (%)



Source: Author’s calculations based on data from EUROSTAT.

The European economic crisis did not fundamentally alter the FDI-based development trajectory. Although export-driven industry was the short-term loser of the initial shock, leading to swift corporate downscaling and massive redundancies, this was followed by a rebound of exports, while the contraction of domestic markets – except Poland – had a lasting, but less significant negative effect (Barta – Lócsei 2011, Lengyel 2014). The post-crisis world has seen new investments by TNCs, leading to continuing internationalisation; in fact, as

¹ It is hard not to consider this issue from the perspective of Western Europe’s disappearing middle, even if the main beneficiaries of the process have been found in the Far East.

Lengyel demonstrates, foreign ownership in Hungarian manufacturing increased from 62% of Gross Value Added in 2008 to 73% in 2011. Partially in a bid to follow the successful German example, countries in Central Europe undertook industry-friendly structural reforms. Even more than in the accession period, the prevailing trend in the space economy is reindustrialisation (Figure 2).

While the FDI-based development model can be considered an overall success story, there are two important qualifiers that bear mentioning. First, the territorial unevenness of restructuring has been a factor in the increase of regional differences: a limited number of regions have benefited from high capital inflows and modernisation, while those missing out have often experienced destructive de-industrialisation, a loss of productive capacities without new industries or competitive services to replace them. Second, the development process is underpinned by strong external capital dependency, which is now starting to pose problems at the development phase where cost-based competitive advantages are no longer sufficient, and companies and regions need to explore “high-road” strategies to maintain or improve their positions. Indeed, the whole Central European development path fits into what Nölke – Vliegthart (2009), extending the varieties of capitalism debate in comparative economics, dubs the “*dependent market economy*” (DME) model. In contrast to the less regulated liberal market economies (LMEs, e.g. the US), as well as their coordinated counterparts (CMEs, e.g. Germany), DMEs’ competitiveness is tied to “*a specific type of comparative advantage that is not based on radical innovation (LMEs) or incremental innovation (CMEs), but rather on an assembly platform for semistandardised industrial goods*” (p. 679).

Therefore, the same success factors underpinning Central Europe’s current industrial competitiveness can hinder its further upgrading, and in some ways they are antithetical to endogenous development paths.² TNCs show *different firm behaviour* on home markets and near their subsidiaries: the most valuable segments of the value chain are kept close to corporate centres in developed economies, and the associated production functions on the peripheries receive much less attention. There are notable risks associated with *capital movements*: production sites engage in intense competition for the reinvestment of company profits, which can be easily repatriated or moved to other sites according to corporate strategies. Although there have been comparatively fewer examples of delocalisation in Central Europe’s economies before the crisis than in Western Europe (Kiss 2007b), labour-intensive light industries, and more recently electronics are starting to feel the pressures from

² As Humphrey – Schmitz (2002) have shown, this has happened to numerous Western European assembly sites.

Eastern European and Far Eastern competitors. Even in successful regions, the expansion of manufacturing, especially the effect of mega-investments, can result in *crowding-out and congestion effects*, occupying the product and labour markets of local companies, and taking over their development niches.³

Most importantly, low-road competitiveness and external dependency poses *long-term disadvantages for the accumulation of financial, human, and maybe even social capital*. In comparison with the LME and CME development models, dependent market economies are heavily reliant on external capital, a problem that can be considered a “historical” weakness of Central Europe, especially after periodic “transformation losses” caused by frequent regime changes (Gál 2013). Low-income competitiveness leads to a development trap: it hinders the formation of new, well-capitalised domestic enterprises, while encouraging skilled workers to move westwards in pursuit of higher wages – leading to long-term human capital loss in Central Europe, and undermining the potential sources of qualitative improvement. The structures of dependency are self-reinforcing, a vicious circle: they maintain the duality of industry, and can lock regions and enterprises into static development paths, eventually making them succumb to economic crises and low-cost competitors.

REINTEGRATING SPACE: PATHWAYS TOWARDS ENDOGENOUS DEVELOPMENT

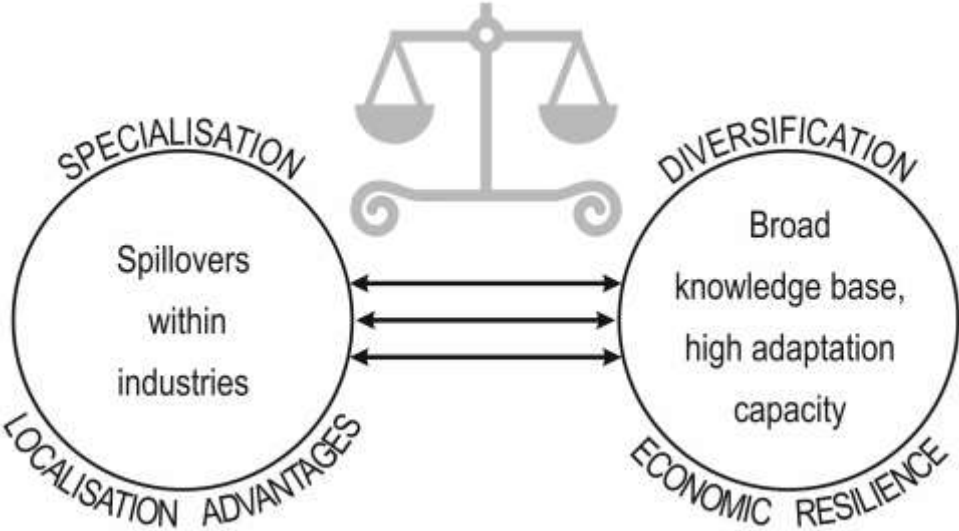
Beyond the European crisis, and taking into account the lessons of global integration learned in Western European economies, endogenous development should be considered in the Central European context as a means of fostering high-road industrial development, particularly as a growth model for non-metropolitan regions. FDI will continue to play a strong role in shaping industrial production, but domestic entrepreneurship, particularly medium-sized companies in supply networks or high-value added product niches should also be supported. This should also be supplemented by a limited number of large national champions that can integrate their own SME networks.

Endogenous development has particular importance due to the transforming sources of competitiveness, which, in high-road development, are becoming increasingly localised, tied to a specific place or region. Instead of individual factors such as cost-advantages or geographic proximity, industrial competitiveness becomes based on “packages” of multiple

³ As seen in Italian industrial districts, particularly in the South (Menghinello – De Propriis – Driffield 2010).

location advantages, which are reproduced in the local/regional context of companies, education institutions, local government and society. Identifying and exploiting local capabilities and building on them becomes the focus of regional development, in order to build territorially embedded competitive advantages which go beyond low wages. This can mean building on pre-existing economic potential (such as the modernisation or conversion of existing industries) or the mobilisation of previously unexploited resources (such as strengthening the knowledge transfer role of universities).

Figure 3: Specialisation and diversification in endogenous development.



Source: Author’s construction

Two general philosophies of endogenous industrial development can be distinguished: the direct and the indirect reindustrialisation pathway (Figure 3).

- *Direct reindustrialisation* deals with the improvement of the local or regional business environment. Through the logic of resource concentration, there is an attempt at building industrial districts and regional clusters in order to capture and bundle (concentrate) localisation advantages, encouraging endogenous capital accumulation or attracting external investments. The final aim is to achieve the *re-specialisation* of the city or region, creating a production system that can generate sufficient spillovers to draw in multiple enterprises and remain competitive in the global environment.
- *Indirect reindustrialisation* builds on the innovative development of the local factor supply, particularly skills, knowledge and learning ability, increasing the general adaptation capability of society, institutions and economic actors. This philosophy is

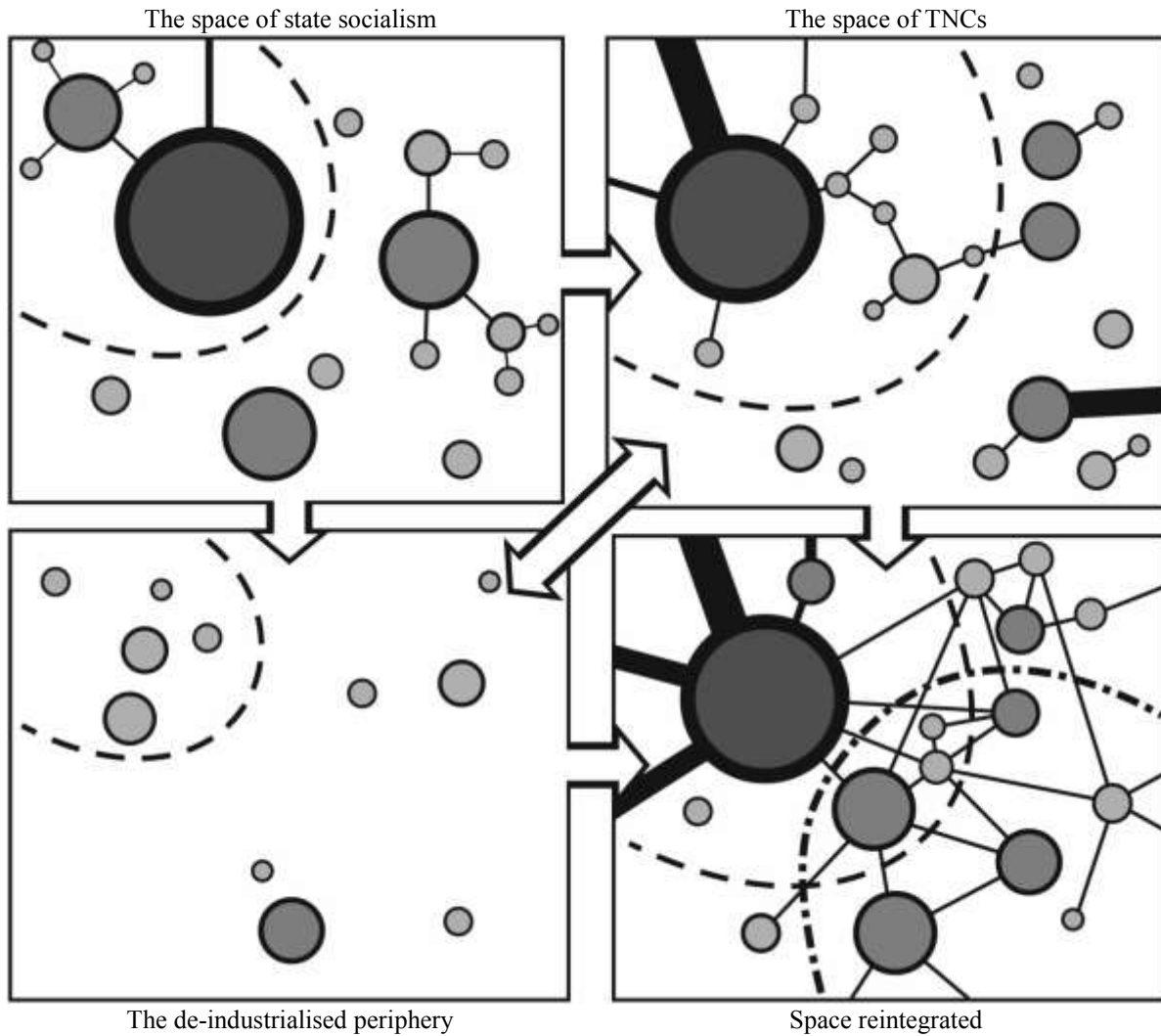
based on the concept of economic *diversification*, the continuous exploration of alternative growth paths, and results in improved economic resilience.

The alternative philosophies are complementary, and ideally, should be pursued together, but they represent a hard choice for non-metropolitan cities and peripheral regions, since they are too small, and have too few resources to maintain both diverse and specialised economic profiles which are found in metropolitan regions. A balance is possible, but hard to achieve, especially due to the shortage of domestic capital.

Further dilemmas lie in the institutional systems of Central European states. The region has long traditions of centralisation and top-down bureaucratic control, with weak bottom-up organisation and development cooperation – although Poland has developed a relatively competent planning system on the regional level (Mezei – Schmidt 2013; Páger 2013b). With weak local governance, there is instead a “planning vacuum” which is filled by actors from central governments or the European Union, who in turn develop plans according to their own ideas and interests (Horváth 2010; Pálné Kovács 2010). In recent years, there has been evidence that the self-organisation of local business elites can help to fill this gap, since senior company managers and the staff of development organisations have accumulated sufficient knowledge in this area (Lux 2015). There is a need to find effective institutional solutions to manage development cooperation, whether the resulting form is a relatively informal *development coalition* oriented on specific, narrowly defined development tasks, or a formalised *neo-corporatist* model of interest articulation following the Austrian or German model, and managing long-term restructuring processes.⁴ The former solution may be sufficient for direct reindustrialisation, but more indirect development tasks, which need long-term resource expenditure without short-term payoff, should be conducted under a more formal model of development cooperation.

⁴ In Hungary, this form of interest articulation could be filled by chambers of commerce and industry, which have long traditions in coordinating development activity (Póla 2007).

Figure 4: The transformation and reintegration of post-socialist space



Source: Author's construction

The long-term objective of endogenous development can be seen as *the reintegration of socio-economic space* through building strong, locally embedded production networks. An abstract depiction can be seen in Figure 4.

- Under state socialism, space was dominated by large, vertically integrated, companies under strong central control, which had few horizontal links to other local companies, although they developed their own local skill base, and accumulated valuable knowledge in their production networks. Smaller companies generally also existed in an isolated state, since they did not engage in traditionally understood competitive economic behaviour, although they, too, contained certain productive traditions.
- The market selection of transition had divided industrial space. The less successful regions of the periphery underwent de-industrialisation, and they saw the disintegration of production networks, as well as de-skilling with the loss of corporate

know-how. Large state-owned companies have lost their capital, either through complete disappearance or radical downsizing. “Creative destruction” was not followed by meaningful rebuilding. Instead, the resulting periphery lost both its capital and labour due to transformation losses or out-migration. It is “homogenous” in the sense that it can only offer the same set of resources to investors: basic infrastructure and cheap, mostly unskilled labour – too unskilled for higher value-added activities, often too expensive for “low-road” competitive strategies due to competition from low-cost countries. Without specialisation, peripheries don’t experience network development, and cannot offer the advantages of industrial specialisation to potential investors and local enterprises. These regions are best described as non-competitive, and need publically assisted reindustrialisation strategies to move out of their disadvantageous position, either through FDI-based or endogenous development.

- As described previously, the more successful regions ruled by TNCs has seen restructuring towards competitive assembly functions, with some upgrading towards higher value-added functions and “high-road competitiveness”, but limited by the external dependency of the regional supply networks. Their linkages are often oriented outwards, with weak connections between locally operating economic units that do not have supplier relationships. These regions are starting to face the pressures of low-cost global competitors, and must adapt through effective upgrading strategies in order to forestall the decline or loss of their current industrial base.
- Consequently, endogenous development is a strategy to achieve a reintegrated space economy: the building of strong local networks (mostly clusters, industrial districts and innovation systems) which can provide sufficient added value for both TNCs and domestic enterprises. The key of these networks is the density and diverse directions of their connections, which can break one-sided dependent relationships, and help to establish these regions as competitive players in the European and global context.

Altogether, endogenous development and the reintegration of space achieve three different, but closely connected goals:

- it encourages re-specialisation in industrial regions which have lost their previous focus;
- it makes it possible to transcend the limitations of FDI-based competitiveness and the DME development model;
- finally, it opens opportunities towards “high-road” growth paths, and the incremental improvement of socio-economic conditions.

There is no guarantee that endogenous development can prevent the emergence of “the disappearing middle” problem, or offer full protection from global competitive pressures: but, hopefully, it can help us learn to adapt – that is, to learn better learning.

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