

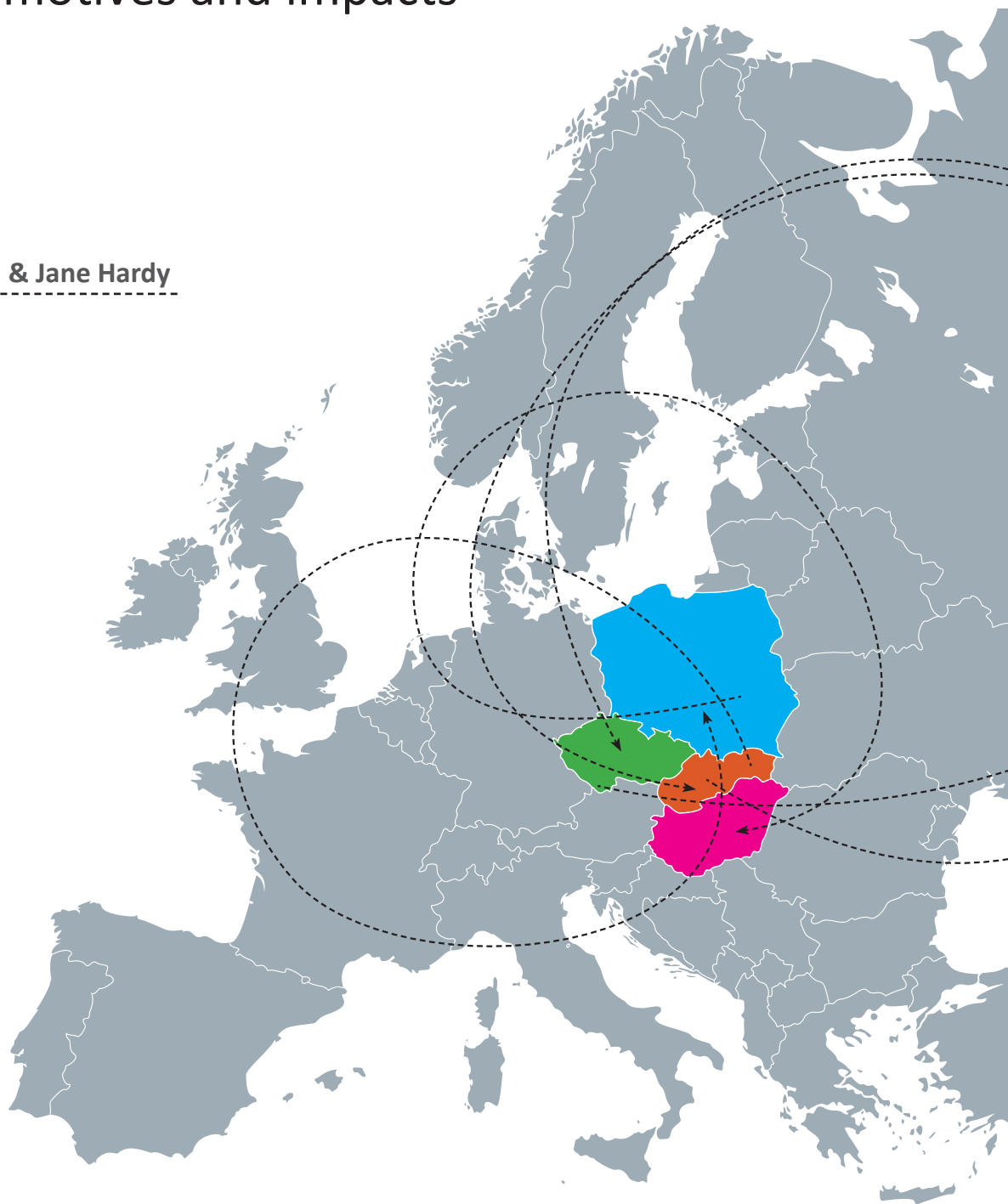
Business Service Foreign Direct Investment in Central and Eastern Europe

> trends, motives and impacts

Project Report

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February 2010



This report was prepared as part of the project *Foreign Direct Investment in Central and Eastern Europe: What Kind of Competitiveness for the Visegrad Four?* This was a joint project between the Economy and Society Trust and the Business School, University of Hertfordshire, UK. The project was funded by the International Visegrad Fund and the University of Hertfordshire and ran from 1 March 2007 to 28 February 2010.

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EXECUTIVE SUMMARY

From the beginning of the 1990s, V4 countries (Poland, the Czech Republic, Hungary and Slovakia) have attracted a significant amount of foreign investment. In the first decade of economic transformation these investments were mainly in the manufacturing sector, however, the importance of foreign direct investment in the service sector, and business services in particular, has been growing since 2000. More specifically, there has been a shift from market seeking horizontal business service investments to vertical business service investments as firms fragment their value chains and move one part of their operation to another destination in order to reduce costs.

The main aim of the project was to outline the current position of the V4 countries as destinations for foreign investment in business services, analyse the patterns of service sector investment, identify the motives for companies investing in the business service sector in the V4 countries and to consider the impacts of these investments. There are considerable problems with collecting data on business service investment and available statistics are supplemented with thirty in-depth interviews with foreign investors in V4 countries.

The findings of the research are that the attractiveness of the V4 region is based on the availability of skilled labour with strong language skills, low costs, favourable business and stable political environment, well developed infrastructure and geographical and cultural proximity to Western Europe. Although the labour costs are much higher than in many Asian countries, all the above mentioned factors significantly influence overall costs and make the V4 a feasible location for companies looking to establish a shared service or contact centre. It could be concluded that service investments are driven by the foreign investor's desire to gain access to skills and business environment comparable to home country conditions, while capturing some of the cost advantages.

The positive impacts of these business service investments were mainly felt in the labour market. These included expanding the range of skilled employment and good wages, working conditions and training. Further, knowledge spillovers to the local economy were evident as former employees moved to other companies or set up their own businesses. Impacts on local companies were negligible. Shared service centres exported nearly all of their services so were not in a competitor position. Horizontal business service investments served other large companies and FDIs on the domestic market in which domestic firms did not compete. However, major cities, which were the main destination for business service foreign investment, were beginning to 'overheat' and shortages of suitably skilled workers were developing in some places. Further, the multiplier effect through the use of local suppliers was very small.

In order to maintain competitive advantage the V4 economies need to ensure the continued availability of highly skilled workers and develop an education sector which responds flexibly to labour market needs. To encourage more spillovers the relationship between business service FDIs and local suppliers needs to be enhanced. The benefits of 'spin off' SMEs needs to be maximised by supporting innovative entrepreneurs in the IT sector. In order to prevent 'overheating' in the cities, policies to encourage the dispersion of business service investments could be considered. In order to underpin these recommendations institutional linkages between employers' organisations, foreign investors, government and higher education institutions need to be strengthened.

While the V4 countries often attempt to outbid each other with the amount of public support offered for the particular industrial FDI investments, the changing composition of FDI flows, means that countries find themselves competing on wider, structural basis. Growing interest from the business services sectors should induce the V4 to shift the policy emphasis from a single subsidy provision, to a more structural approach in education, infrastructure, and wider business environment.

1 INTRODUCTION

1|1 CONTEXT OF THE RESEARCH

Since the beginning of the transition to democratic market economies in the 1990s, the Visegrad (V4) countries (Poland, Czech Republic, Hungary and Slovakia) attracted a considerable amount of foreign direct investment (FDI), which in the first decade of the economic transition was mainly in the manufacturing sector. However, the share of business services in global service-related FDI grew from less than 20 % in the period 1989-1991 to 26 % by 2007. Therefore in line with shifts in global flows away from manufacturing towards services increased amounts of service-based FDI have been evident in V4 countries from 2000 onwards.

The increased share of service sector FDI has potentially both positive and negative effects for the receiving V4 economies. The impacts depend on number of factors, such as the level of development of the economy, the type of FDI and the strategy of the investor. Nevertheless, foreign investments in services are broadly believed to be an important engine of growth and foreign companies are expected to bring much needed capital, transfer technologies and managerial know-how and offer an expanded range of employment opportunities, including high quality work. Attracting service sector FDI has therefore become a key component of national inward investment strategies. In all the V4 countries government policies are aimed at attracting these types of investments by providing subsidies, services to the investor or adjusting policies according to the perceived advantages that the foreign investors see in particular locations.

Service sector FDI has been recently diverging from the traditionally dominant transport, communication, trade and financial intermediation sectors towards business services. This new wave of FDI can be explained, in part, by the fragmentation of activities made possible technology developments in the last decade, where processes within the service sector can be split up and relocated across national boundaries. Advances in information and communication technologies increased the tradability of services and the possibility to separate service processes and produce and consume them at different locations and times.

As a result of the changing composition of FDI, V4 countries have found themselves competing with other destination to attract business services with high value added activities having become one of the strategic objects for state intervention. The importance of service sector FDI in V4 countries is growing and all governments place attracting such investments high on their agenda. This project therefore focuses mainly on the specific determinants influencing an investor's choice of location and the impacts such investments have on the economy.

1|2 AIMS OF THE RESEARCH

The main aim of the project is to outline the current position of the V4 countries as destinations for service investments and account for differences among them.

- To analyse and identify the patterns/nature of business service investment in V4 countries
- To identify the motives of companies (re)locating business service activities in V4 countries
- To consider the cost and benefits of service sector foreign investment to V4 states and their regions
- To reflect on the policies aimed at attracting the service sector investments

----- 1|3 RESEARCH DESIGN

----- 1|3|1 Problems with data measurement

In order to analyse the patterns/extent of service sector investment and its impacts, indicators derived from service sector statistics, foreign direct investment, trade or employment data would provide an ideal base. However, there are various measurement and data problems.

1|3|1|1 A lack of clear definitions

→ Defining the service sector

Traditionally service activity was defined as intangible, non-storable output produced by human work, consumed at the moment of its production, requiring the physical proximity of producers and consumers. However, in practice it is becoming increasingly difficult to distinguish where the product ends and the service begins.

→ The lack of a generally accepted classification of services

Various names are used for describing the same or similar subsets of service activities (for example, professional services, knowledge services, knowledge-intensive services, knowledge-based services, business services, other business services, IT-related services, computer and business services) which hinders the possibilities for comparative analysis.

→ Categories used for the service sector are too aggregated

There is insufficient detail regarding the service activities included in each category, for example real estate, renting and business services are referred to as one category and it is not defined precisely which activities belong to business services. The insufficient breakdown of service sector categories applies to service sector statistics, FDI, trade and jobs data. Service data are presented in a far less detailed way than manufacturing; there are fewer categories each of which involves very different activities. For example, software services include customized software service, basic software coding or innovative-creative software development, so the activities range from simple menial to sophisticated research and development.

1|3|1|2 Data problems

→ Services FDI data

These are unreliable and vary greatly depending on the source of the statistics. Moreover, because the costs of setting up a service centre are negligible (the renting of business space, recruiting/training employees, buying equipment) the volume of services FDI does not reflect the real extent of service sector investment. Sometimes the number of service projects is taken into consideration, but due to the differing activities, labour requirements and the size of the service centres the number of projects as a measure is not representative.

→ Lack of detailed employee data

These are not available in most cases and there are no exact statistics on the number of jobs involved in different types of service activities. Labour data can also be misleading due to the problem differentiating between service and manufacturing sector activities.

→ Data on services export and import

This would be an indirect way of measuring the activities of foreign investors. However, reliable

services trade data are missing and available services trade data are incomplete and insufficiently detailed. It is more difficult to measure trade flows in services across borders due to the non-physical nature of services, and use of communication technologies. Further, some trade in services is not reported at all, while some is double-reported because of re-export.

1|3|2 Research method

→ Case study approach

The above mentioned shortcomings of data and measurement instruments limit an accurate statistical analysis. Determining the actual extent and patterns of service sector investment therefore requires a combination of quantitative and qualitative research. This project uses a case study approach as a way of gaining in-depth data. The companies chosen range from shared service to research and development centres, which enabled the deconstruction of service sector activities and their implications for V4 economies. In order to acquire information on all the aspects of investment, semi-structured interviews were chosen as the most appropriate data collection technique.

→ Sample

Between September 2007 and September 2009, 30 semi-structured in-depth interviews were undertaken with the senior managers of service related FDI in the four Visegrad countries. Six companies were interviewed in the Czech Republic, eight in Hungary, ten in Slovakia and six in Poland.

2 RESEARCH FINDINGS

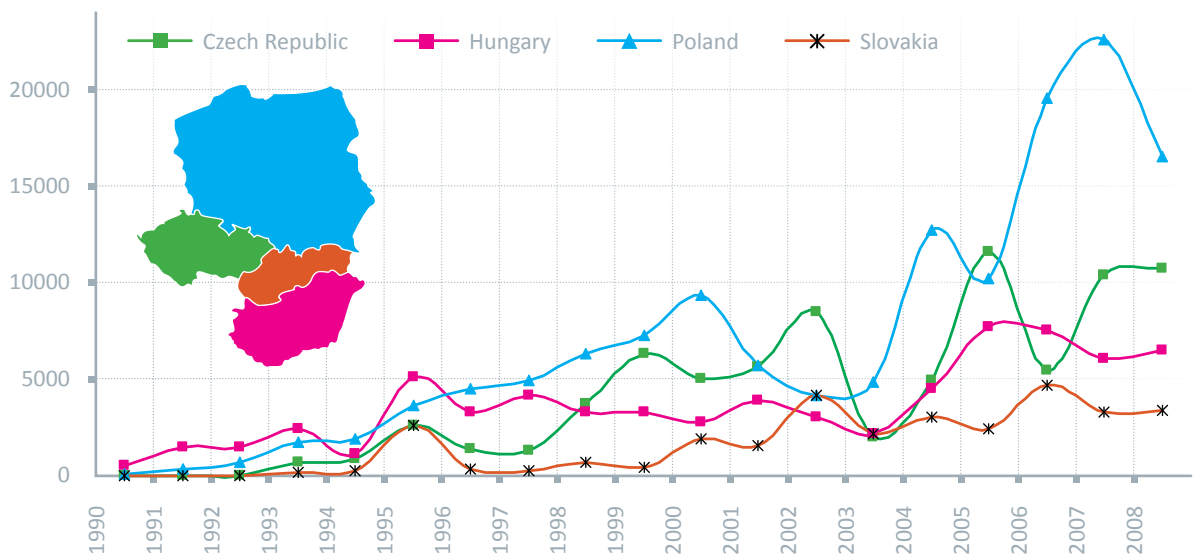
2|1 BROAD TRENDS

2|1|1 Foreign direct investment inflows

At the beginning of the 1990s, the Visegrad Four (V4) countries started to transform from centrally planned into market oriented economies and the inflow of foreign capital was seen as one of the key drivers of transition. The region offered a huge unsaturated market, cheap skilled labour, natural resources and privatization opportunities. However, foreign investors had to deal with political and economic instability, weak infrastructure and business environment, corruption as well as language and cultural barriers. As the previously closed economies gradually opened, improved their economic environment and policies were put in place to attract foreign investment, the V4 region started to become an increasingly popular destination for foreign investors seeking to expand into new markets or to enhance their efficiency and gain access to cheap resources.

The inflow of FDI into the V4 region was rising, but the geographical distribution (especially at the beginning of the 1990s) was quite uneven. The majority of investments went to the more politically stable and economically developed countries, such as Hungary, Czech Republic and Poland, which started earlier with rapid transformation, privatization and signed Association Agreements with the EU. Using these reforms Hungary and Poland were initially the most attractive for foreign investors, which was soon reflected in the volume of FDI inflow. The Czech Republic, however, swiftly caught up and in some respects exceeded the speed and the extent of the introduced reforms which resulted in increased competition within the V4 group. While the inflow of FDI to other V4 countries grew steadily, Slovakia's position weakened from 1994 onwards. As a result, Slovakia missed the investment boom in the 1990's, which was directed towards Central and Eastern European (CEE) countries at the beginning of the transformation process and - considering both quantitative and qualitative aspects of FDI - is still catching up with the other three V4 countries.

Figure 1 → Foreign direct investment inflow to V4 countries (1990-2008) | Source: WIR 2009

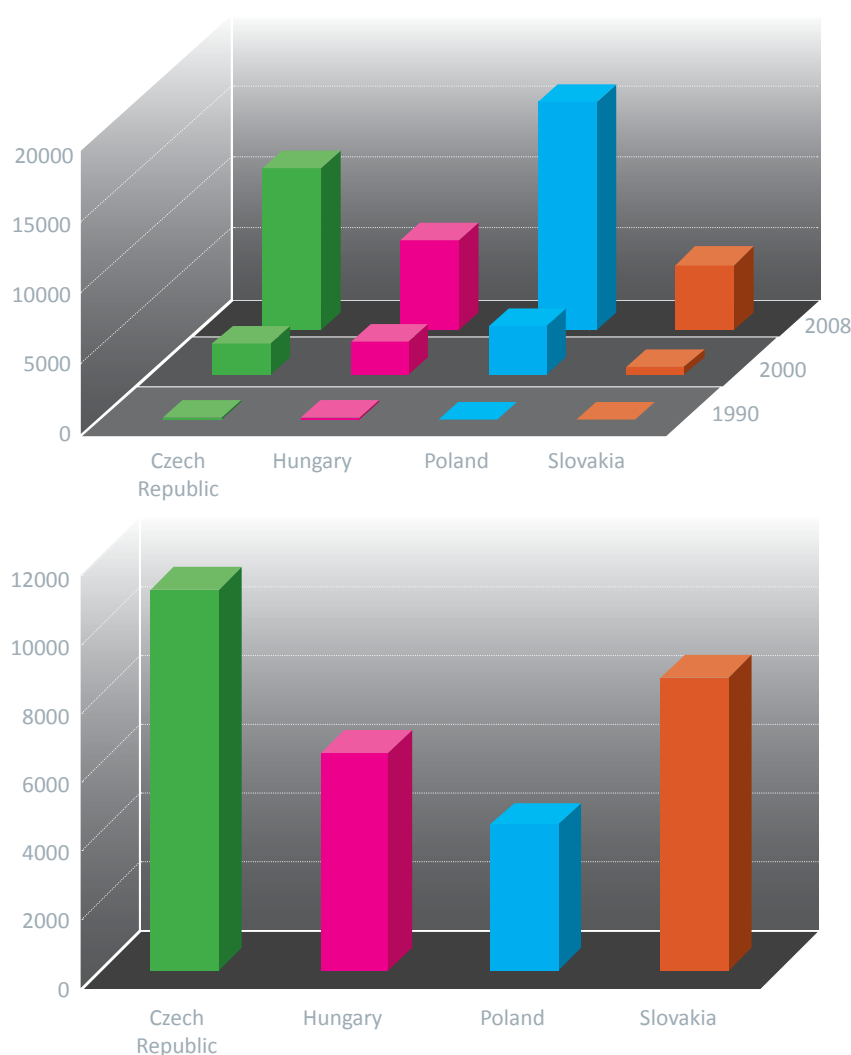


Until 1995, Hungary led the way in the V4 region - labour was inexpensive and the government was able to offer extremely attractive investment incentives. Radical reforms in Poland and the size of its market, however, soon increased Poland's attractiveness. Since 1996 Poland systematically attracted more foreign capital than the remaining three countries and with the exception of two years, regularly received the biggest share of FDI flows. In 2002 it was the Czech Republic which attracted the bulk of capital invested in the V4, and again in 2005 the Czech Republic attracted USD 2 million more than Poland owing to the privatisation of the domestic telecommunication operator.

Slovakia has attracted the least amount of investment among V4 economies during the whole transformation period, with the exception of years 1995, 2000 and 2002. Among the main reasons were the political development in Slovakia, legislative barriers to entry and weak business environment. The improved political and economic situation after 1999 started the steady increase of FDI, but after the major privatisation projects took place, the FDI inflow slowed down again.

Out of the total FDI inflow into V4 countries since the beginning of the transformation up to 2008, almost 43 % went to Poland, 25 % to the Czech Republic, 22 % to Hungary and 10 % to Slovakia, which is reflected also in the growth of FDI stock. However, the inward FDI stock per capita is highest in the Czech Republic and reaching USD 11 000 it is also the highest in the whole CEE region.

Figure 2 → FDI stock in V4 countries in Millions USD: in 1990, 2000, 2008; per capita | Source: WIR 2009



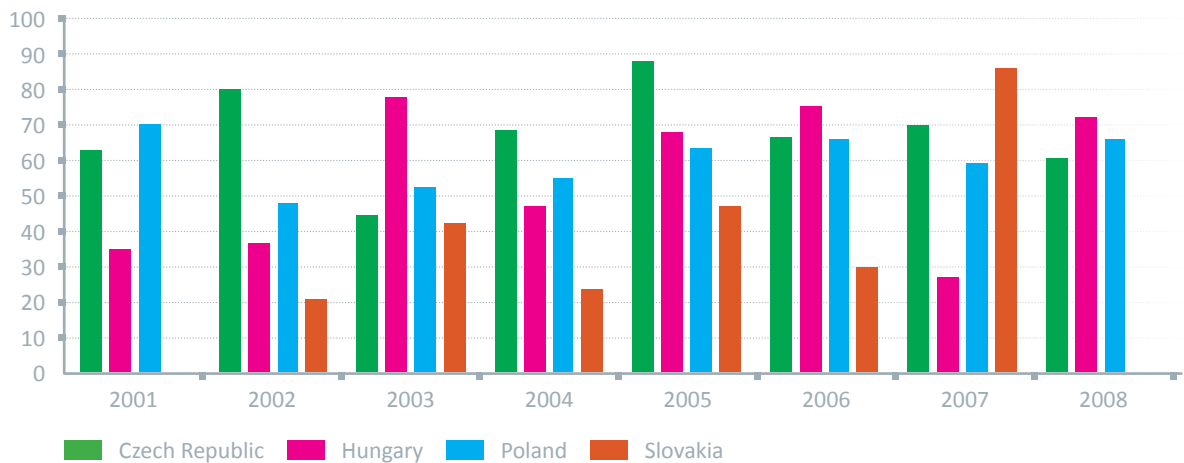
By the end of 2008 the total FDI inflow into V4 countries reached about USD 380 billion. Together with Russia, V4 countries are still the main FDI destinations in the CEE region gaining about 70 % of all the investments.

2|1|2 Foreign direct investment inflows in the service sector

There has been a worldwide structural shift towards service-based foreign direct investment. Between 1989 and 1991 the share of service sector FDI in total capital inflow amounted to just over 50 %, while twelve years later this figure had reached almost 60 %.

In line with international trends, the structure of FDI in V4 countries reoriented to the service sector. In the Czech Republic, Hungary and Poland, foreign investments in the service sector became dominant by the late 1990's, but this trend accelerated in 2000, when services-related FDI reached almost 60 % of total FDI in the region. Since 2000, the share of service sector FDI in total FDI flows was 70 % in Czech Republic, 55 % in Hungary, 60 % in Poland and 40 % in Slovakia. Overall, the tertiary sector received more than 60 % of the foreign capital inflows into the V4 region.

Figure 3 → The shares of services in FDI inflow in V4 countries
 Source: own calculations based on Eurostat data



The volumes of FDI inflows into the service sector have changed rapidly each year, especially in Czech Republic. In Poland and Slovakia a more stable growth of these investments can be observed. The decrease of service sector FDI in the Polish economy in 2008 is most probably a result of overall FDI inflow decline as many companies suspended their expansion plans due to the global financial crisis.

The increasing role of service sector FDI can also be illustrated indirectly by employment data. In all the V4 countries the service sector share in total employment has continually increased; most dramatically in Poland from 45 % in 1995 to almost 55 % in 2008. Slovakia and Hungary have the highest share of service sector employment, but are still lagging behind the EU 15 average which approaches 75 %.

Figure 4 → Service sector FDI inflows to V4 countries in Millions Euro | Source: Eurostat

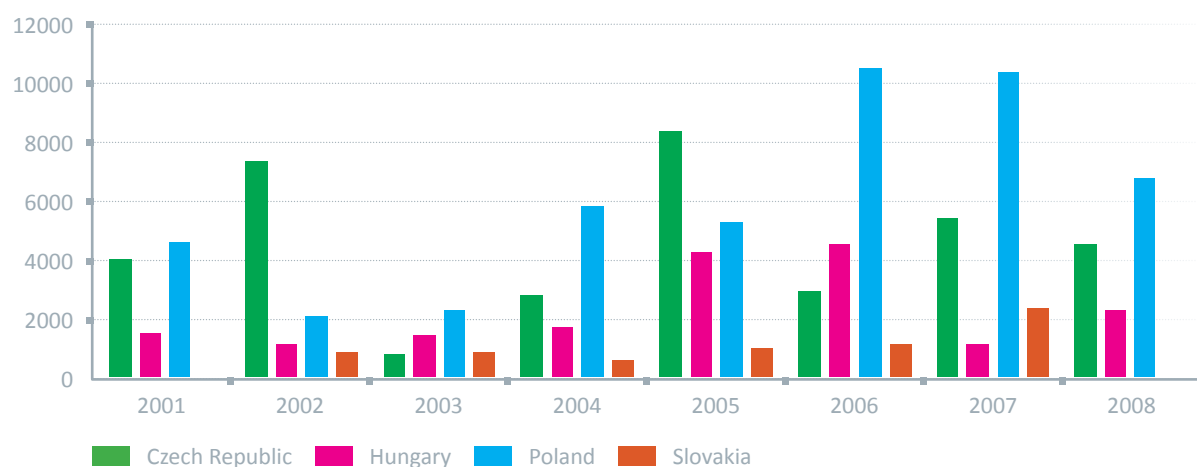
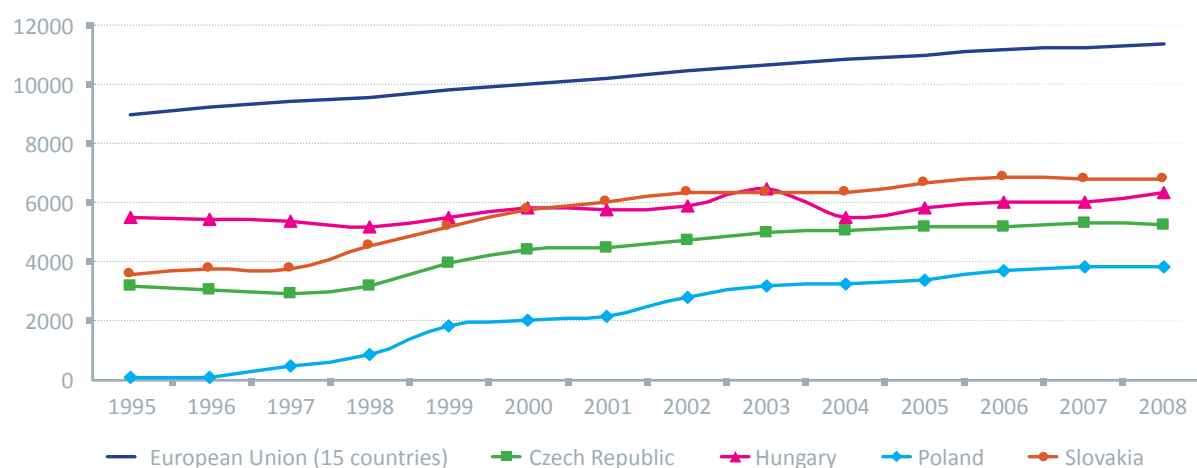


Figure 5 → The share of service sector in total employment | Source: Eurostat



2|1|3 Main developments in the service sector investments

→ Horizontal business service investments

From 1990 onwards new demand and a lack of competition in V4 countries constituted an opportunity for horizontal investments. These are defined as demand driven (or market seeking) investments where a company seeks to establish a subsidiary in a new market and provide the same services in this new market as it provides elsewhere. The main motivation behind this type of investment is to serve the local market, gain access to customers and get closer to competition as the services provided are usually not tradable and require market presence of the company. The most important factors influencing an investor's location decision are therefore related to specific market attributes.

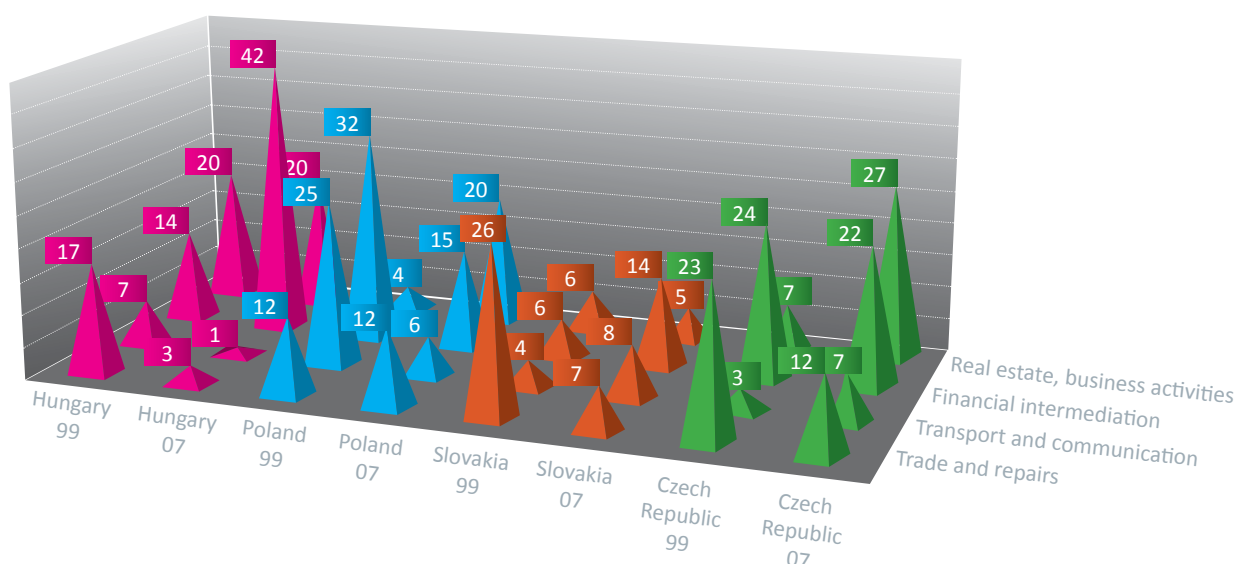
The establishment of a market economy required various (previously unavailable) services, for example banking and insurance services, auditing, legal counselling and business consulting. Such investments came into the V4 countries from 1990 onwards, when large international firms tried to gain first mover advantage and establish market share. In the first decade of transformation, the

majority of incoming service FDI was concentrated in trade, transport, communication, financial intermediation, real estate and business activities and other infrastructure services. Except trade, each out of these sectors received a huge amount of investment during this period as a result of privatization. In the wholesale and retail trade the inflow of FDI was mainly a result of supermarket chains entering the unsaturated market.

After 2000 the composition of FDI flows started to change. While the share of financial intermediation in the total FDI inflow has oscillated between 5-35 %, the share of trade, transport and communication has been continuously decreasing. Divergence from traditionally dominant FDI receiving service sectors was compensated by the increasing amount of investments into business activities, which can be observed especially in the case of the Czech Republic and Poland.

Figure 5 → Shares of selected service sectors in FDI inflow- 1999, 2007

Source: own calculations based on data from Czech, Hungarian, Polish and Slovak national Banks



→ Vertical business service investment

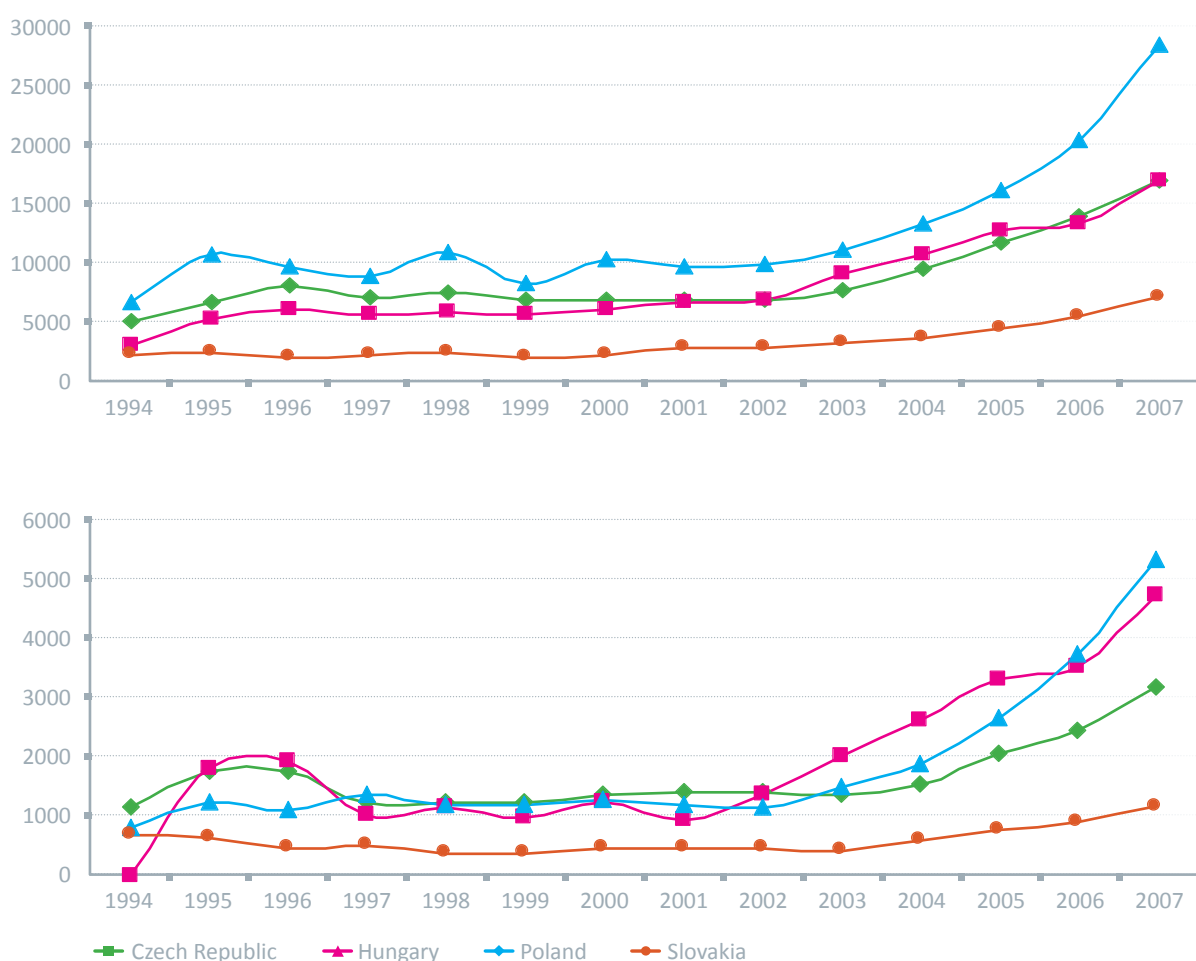
The increasing share of business services in the FDI flows reflects a global growth of vertical investments. This type of investment is defined as resource seeking investment as foreign investors seek to establish a subsidiary in a foreign country in order to gain access to inputs/resources, which are scarce or more expensive elsewhere. The company basically splits its activities by function and relocates certain parts of its operations to a subsidiary abroad. The main motivation behind this type of investment is cost reduction and the most important factors driving the location decision are cost and availability of factors of production. Foreign companies are relocating only particular service functions- usually administration (back office functions), finance, human resources, payroll services, logistics (corporate functions), customer care and content development (knowledge services and R&D). Such investments are commonly referred to as shared service (or contact) centres and take place within both service and manufacturing sectors. Shared service centres usually deal with back office and corporate functions supporting subsidiaries of the company abroad. Contact centres on the other hand deal with front office - customer facing - activities and serve the customers within a particular region or globally.

The share of V4 countries in the global business services FDI is less than 1 %. The region is lagging far behind Asia (mainly India) and Western Europe but it shows a growing potential and may attract a bulk of European companies which started later with the relocation of service activities. In Europe there are 1400-1500 services centres, of which 150-180 can be found in Central and Eastern Europe, mainly in the Czech Republic, Hungary and Poland, which have realised about 40-50 projects per country up to the present.

The first business service FDI projects in the V4 region involved mainly back-office functions (finance, invoicing), which are less complicated and do not involve direct contact with the client. As the next step, front office activities were transferred to the region and the process has been continuing with more added value and skill-intensive activities. While Poland, Hungary and Slovakia attract a wide range of service activities, the Czech Republic investments are mainly specialised in IT-related activities.

While market seeking investments usually concentrate in developed economies with strong market potential, the resource seeking investments are flowing to developing and transition economies which offer low costs. In case of vertical investment, where the motivation is primarily to take advantage of the local resources, not to serve the local market, the majority of the services produced are immediately exported. The growth of vertical investments in the service sector therefore results also in increased exports in services.

Figure 6 → Total Services exports; Other Business Services exports in USD Millions | Source: OECD



The export of services has grown significantly in the V4 region since 2002. In comparison to 1995 the level of services exports in 2007 tripled. The sectoral composition is comparable in all the four countries with travel, transport and business services having the highest share. In West European countries, this pattern is reversed with the share of travel and transport in exports much lower and the share of business services much higher than in the V4 countries. Out of these three sectors, the growth rate of business services export was most dynamic (around 20 % on average after 2002). Its share in total service exports was decreasing until 2002, but since then it started to increase steadily in all the V4 countries. This could be explained by the growth of export oriented vertical investments, but as not all the export is provided by service centres, the statistics can be misleading. Both the volume of business service exports and its share in total services exports is the highest in Hungary.

The majority of the V4 services export is directed towards the EU market (around 70 %), which means that the service centres are providing services mainly for their customers or subsidiaries within Europe.

Figure 7 → The structure of the services exports in V4 in 2007 | Source: own calculations based on OECD data

	CZ	HU	PL	SK
Total services	100	100	100	100
Transportation	29,4	19,2	32,1	31,9
Travel	38,7	27,7	36,8	28,7
Communication	3,4	2,9	1,8	3,6
Construction	1,8	2,3	5,6	1,7
Insurance services	0,1	0,1	0,1	0,3
Financial services	1,7	1,5	1,2	3,9
Computer and inform. services	4,6	4,2	2,3	3,0
Royalties and licence fees	0,2	5,4	0,4	2,1
Other business	18,7	27,8	18,8	16,8
Personal, cultural	1,1	8,1	0,7	4,6
Government	0,2	0,7	0,3	0,6
Services not allocated	0,1	0,0	0,0	2,8

2|2 MOTIVES FOR (RE)LOCATING TO V4 COUNTRIES

According to the interviewed companies, the region of Europe or Eastern Europe was identified first as a preferred investment location (long-list). The advantages and disadvantages of specific locations were considered helped to identify the shortlist, where the V4 countries usually ended up together with Romania and Bulgaria (or other Eastern European countries) and were then compared based on a wider set of factors. The following section discusses the reasons for the selection of V4 location.

2|2|1 Cost reduction

A primary aim for the (re)location of vertical investments in V4 economies was the possibility of cost reduction. The majority of shared service and contact centres were established after 2002. Previously countries operated the 'country model' where the activities of the service centres were located in the customer countries and executed locally for the local market, or local subsidiaries. Aiming primarily at cost reduction, the companies then identified activities that could be centralized and with the 'lift and shift' system moved them to another location. The choice of a particular location was influenced by factors other than cost.

The cost of labour was mentioned in the majority of the interviews. 50 % of companies in the Hungarian sample found that the price-quality ratio of skilled labour was best in Hungary. Although Slovakia is still the cheapest location among the V4 countries it is more expensive than Romania and Bulgaria, but the performance/costs ratio was reported as being better. With rising labour costs in Poland, Hungary, and the Czech Republic, lower-cost alternatives such as Slovakia, Bulgaria and Romania are becoming increasingly attractive, so the three V4 countries will have to compensate on the basis of highly skilled labour.

30 % of the companies saw other costs as one of the relevant factors, which made V4 countries attractive. This related particularly to the costs of infrastructure, operating costs and taxes. In the Hungarian sample the availability of office space at reasonable prices was underlined as a factor determining the choice of location.

2|2|2 'Knowledge advantage': Availability of qualified labour

While the cost of labour was mentioned in 60 % of the interviews, all the companies were concerned with its availability and quality. Technical and language skills were highlighted by almost all the companies, but the education level only by two of them. Services, particularly those associated with businesses, often depend on knowledge and information, so the skill level of the available workforce is therefore likely to be the principal differentiating factor among locations.

The availability and cost of educated and skilled labour was stated by all the interviewed companies as one of the most influential factors in their decision to invest in the V4 countries. The main concern was availability of a qualified workforce skilled in information technology or other technical fields and languages. Some companies also required excellent communication and interpersonal skills, but subject matter expertise in areas such as accounting or HRM was not that important.

V4 countries are considered to have a 'knowledge advantage' compared to other lower priced countries in terms of the knowledge of 'smaller' languages and a good supply of university

graduates in the required fields. Language requirements vary considerably, but usually English and other European languages are preferred, which underlines the market orientation of the investing companies. According to the interviewed managers, the analysed countries have a tradition of a relatively good education system, especially in fields like mathematics, engineering, IT, and although not outstanding, they also provide a relatively good education in economics and accounting.

In Poland the availability of graduates from technical disciplines, economics and finance coupled with large numbers of graduates from a variety of other higher education institutions and good level of foreign languages (English, Russian) was most valued. The Czech talent pool was considered well suited for the work in terms of relevant education as well as knowledge of at least one foreign language. Foreign companies in Slovakia especially appreciated language and technical skills. Several interviewed managers in Slovakia also stated that the English accent of Slovak people was the main determining factor, which decided in favour of Slovakia over Hungary and the Czech Republic. Hungary is considered to be the least good at languages, but besides English, companies mentioned German and smaller European languages, which were readily available in Hungary.

----- 2|2|3 Access to domestic markets

Horizontal investments started flowing into the V4 countries in the 1990s. Even though the political situation was unstable and business environment unfavourable, the emerging markets with its new demand for services attracted many foreign investors. Some were motivated by the possibility of gaining new customers; others came together with their clients, which they served globally. Therefore gaining access to the market and serving it locally is the main concern of horizontal investments.

One of the interviewed managers described the decision making process as follows:

At the beginning of the 1990s, demand for these new services was created and foreign companies therefore started coming. Even in 2000, 2001 the demand was higher than the companies could satisfy. More and more clients were interested in our services and majority of our competitors were entering or had already entered the market. Establishing a subsidiary was therefore a must. Motivation to set up a subsidiary in Slovakia was purely market (clients) driven and nothing else played any role in the decision making process. At that time there was not any investment stimuli scheme prepared and definitely not for this type of companies, as they would enter the market anyway.

It was clear from the interviews that competition played a significant role in the choice of location. The presence of competitors on the market indicated the market potential for new customers and created pressure on companies that were not serving their clients locally.

----- 2|2|4 Strategic location

The geographical location was identified as considerably influential with 40 % of companies preferring a location which has a strategic geographical position within the region and good accessibility to potential customers. V4 countries have the advantage of being in the centre of CEE region, close to Western Europe and other Middle East and Africa countries; therefore offer a variety of local languages and strategic location to serve a relatively large market. Being close to customers, the home country of the investor, other company centres and business metropolises was cited as important by 14 of the companies. Further some companies had a specific requirement to be within a time zone that would enable them to serve other than EMEA region and provide 24/7 support through their shared services centre.

2|2|5 Quality of infrastructure

The quality of infrastructure, especially information and communication infrastructure was cited as important by 50 % of the companies. Developed infrastructure is a precondition for most business service investments such as shared services or call centres. These tend to be technology-dependent requiring infrastructure and facilities such as telecommunication and power networks or fast internet connection. Similar to labour, the quality and availability of infrastructure was seen as being far more important than its cost.

2|2|6 Political and Business Environment

The importance of the political and economic environment was mentioned by 14 companies. This included political stability, progressive governments, tax and social reforms, membership of NATO, and good macroeconomic conditions. The regulatory environment of V4 countries is viewed as favourable, the rule of law is regarded as relatively strong and EU-membership is often quoted as the main reason behind a clear increase in the attention paid to V4 countries.

The importance of the business and political environment is well illustrated in the case of Slovakia. The political development in Slovakia slowed the investment inflow in the first ten years of the transformation keeping the demand for the above mentioned services higher than the supply. 1998 brought improvements in the political and economic environment and with the market still unsaturated the amount of investment into the service sector increased dramatically. The majority of horizontal investments came to Slovakia within the following two years.

A favourable political and business environment was less important for horizontal investments, because entry to the market was the most critical factor.

2|2|7 Cultural affinity

Cultural proximity to the markets served was only cited explicitly as important by one company. However, the interviewed shared centres stated that their employees are usually able to cover around 20-25 languages within the centre, which means, that they can speak to the majority of European customers in their mother tongue.

2|2|8 Government incentives

Investment incentives are believed to be of a crucial importance for foreign investors. In the interviewed sample, however, incentives did not play an important role in the selection of a location. In both the Czech and Polish sample none of the companies gave a high mark to the role of incentives, but several companies did not hesitate to use them when offered. In the Slovak sample only one company considered getting incentives important and was also promised financial support from the government. Many other companies did not attempt to obtain financial support, did not consult with the government on their investment and did not receive any incentives. In Hungary four out of the eight interviewed companies received incentives, but none of them received them automatically: they had to apply for them, and the outcome was not guaranteed. As the incentives were granted only after the decision about the investment was taken, it did not play any role in the location choice. Moreover, the application process for the incentives was stated as quite bureaucratic and the amount of incentives small.

In spite of the fact, that in the analysed countries attracting service centres is one of the most important targets of investment agencies and incentives offered to this type of projects could be relatively generous, the interviewed companies did not benefit from the investment incentives schemes and incentives did not impact their location decision. The situation is changing though and many companies stated that in the future incentives will play a bigger role in their decision about increasing the scope of their activities.

----- **2|2|9 Experience of the affiliates already existing in the country**

It is possible to see both vertical and horizontal investments by a particular company in one host country. These investments then function either as two separate entities, or as two separate departments within the company, which is the case especially in service sector. A very important factor in the decision making is the experience of the affiliates already existing in the host country. In the Slovak sample, at the time of establishing the shared service (contact) centre, six companies already had horizontal investments in Slovakia and another two companies had other shared service centres. References from the local managers, performance of the local subsidiary together with references from international customers had very significant influence in all the cases. Also in the Czech Republic, Hungary and Poland companies were influenced significantly in their choice of location by the good experience of affiliates already functioning in the country. This success in attracting further investments may also be due to lobbying by some of the local affiliates as the local managers understandably want to widen their capacities and strengthen their roles in the company.

----- **Conclusion**

According to the interviewed companies, however, not all these factors are seen equally important in the context of service investments. For horizontal investments, the market is the single most important location factor. Investors primarily evaluate market potential and competition structure, but also business, political and economic environment. The most important general motive for (re) locating vertical business investments was cost reduction and the decision to go to V4 economies in particular was driven by available and highly skilled labour. Their geographical position in the centre of Europe, quality of infrastructure along with cultural proximity enhanced their position.

2|3 IMPACTS

Foreign investors impact on the local economy mainly through their effects on labour market, local companies and other institutions.

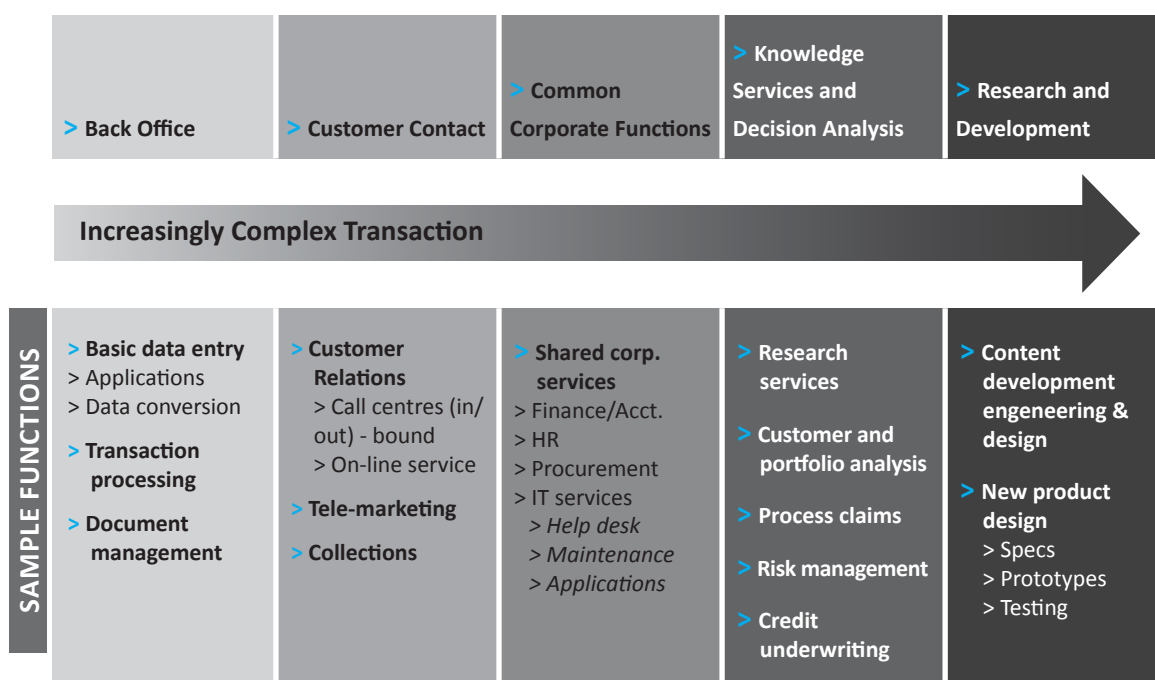
2|3|1 Labour market impacts

2|3|1|1 Extending the range of skilled employment

Vertical investments (shared service centres)

- The shared service centres in the Czech sample created 5000 jobs, in the Hungarian sample approximately 5500 jobs, and in the case of Slovakia almost 9000 jobs.
- The relocated activities within service centres are very diverse and range from simple back office functions to increasingly complex activities such as research and development.
- In the case of the same activity, the skill content may be different, for example a call centre can provide basic information in one language, multiple languages, and more comprehensive information in multiple languages.
- In Poland, the Czech Republic and Hungary companies operate in more complex activities which belong to the third, fourth and fifth columns in Figure 8. In Slovakia the majority of jobs are concentrated in the first three columns.
- Companies stated that they are gradually moving towards high value added activities, increasing the number of skilled positions and searching for more specialist employees.
- The majority of activities within the horizontal investments belong to the category of knowledge services or R&D, thereby bringing activities requiring higher skills than vertical investments.

Figure 8 → Functions commonly relocated to service centres | Source McKinsey Global Institute



- Language skills are required and while English is compulsory, knowledge of other languages is an advantage.
- Half of the companies stated that university education is not a requirement, although on average 80-90 % of the employees do have a university degree (usually this coincides with language proficiency).
- Companies usually do not require any particular degree, specific knowledge or work experience because the employees are trained for the job and socialised into the specific corporate culture (values, practices, language).
- IT skills and other soft skills such as communication skills, analytical thinking, teamwork ability, flexibility, willingness to learn and customer orientation were cited as desirable.
- The average employee of these firms is 28 years old university graduate speaking at least one foreign language.
- The gender structure is usually quite equal with male dominating the IT and technical positions and female being more present in administration and some of the corporate functions, like human resource management or accounting.

Horizontal investments

- University education and proficiency in at least one language is compulsory (usually two languages are required).
- For some positions (e.g. audit and tax services) only fresh graduates are accepted.
- Higher positions required working experience and therefore the average age is slightly higher than in service centres - about 31.
- Gender is more of an issue with higher skilled jobs, as management consulting and IT consulting tend to be dominated by men.

2|3|1|2 Improved pay and conditions

Vertical investments (shared service centres)

- Employing overqualified workers means that the shared service centres have to offer good working conditions, wages, benefits and training in order to stay competitive on the labour market.
- The pay regime comprises basic pay, which increases according to the labour market benchmarking, inflation and job position and variable performance related and company performance related components.
- Increases in salary depend purely on individual performance; only one company had a works council. Most companies do not have any system of collective bargaining and do not consider it is needed.
- There are a variety of additional benefits offered including life insurance, private health care and social benefit packages with sports, relax and culture vouchers, lunch contributions, child contributions, social events, sports events or teambuilding activities.
- Full-time employment was offered and part-time working used only for employees who cannot work full-time for personal reasons. Contractors are used exceptionally for temporary project purposes.
- Leasing from personnel agencies is used by several companies, whose own staff makes only around 50 % of the employees.

Horizontal investments

- These involved mainly high skilled activities and offer the most competitive and demanding jobs.

- Recruitment is extremely selective with assessment centres and interviews taking several days. Less than 10 % of the applicants are successful and fluctuation is therefore extremely low.
- The pay regimes and training are similar to vertical investment, majority of people work full time, although there is higher use of outsourcing and contractors.
- Managerial positions are taken mostly by local managers, which can be a result of the horizontal investors operating on the market longer than the shared service centres.

2|3|1|3 Raising the quality of human capital

- Intensive initial training (several weeks) and then other functional (professional) training was provided in-house, externally and online and can be both compulsory and voluntary.
- Some of the companies offer also language training or the possibility to obtain professional certificates.
- Each company stated that they were highly interested in educating their local managers and gradually replacing the expatriates by local management.
- Skills spillovers to local economy are evident as the former employees move to other companies, or set up their own companies thereby contributing to the diffusion of the acquired know-how.

2|3|1|4 Competitive labour markets

- Shared service centre jobs are considered desirable, with on average 30 % of the candidates being successful.
- In the more demanding jobs, the turnover is usually less than 10 % and in the lower skills jobs between 20-25 %.
- On average the time spent working for one of the centres is up to two years.
- Centres offer relatively comparable jobs, therefore it is not difficult to move from one centre to another increasing the wage levels.
- The shared service centres dramatically increased the demand for fresh university graduates with good language skills.
- Following several large investments in the service centres, the competition on the labour market has increased and some managers complained about the shortage of suitable candidates.
- In Hungary this could be the reason why service centres started to 'spread out' to the countryside, especially to university towns.
- In all the V4 countries (especially the IT centres) finding skilled people is more difficult than few years ago and therefore strengthen their cooperation with universities.
- There is also shortage of specific knowledge and skills- languages, specific IT skills, application specialists etc. Special problem is also with the senior positions.
- The increased competitiveness in the labour market for the required skills created pressure for companies to increase wages, invest more into education and training of their employees and offer more benefits.
- In the last three years the wages in Slovakia increased by ten percent annually and are now about 20 % higher than the average in Bratislava.
- Comparably in the Czech Republic services FDI companies also helped to safeguard a number of high wage jobs, where the salaries are significantly above the national average.

----- 2|3|2 Impacts on domestic companies

2|3|2|1 Product competition effects

- Shared service centres export approximately 95 % of their services so are not in a position of competitors to the domestic companies on the local market.
- Horizontal investments and centres which serve also the domestic market compete with other foreign investors present on the market, rather than local companies.
- Services offered by foreign investors are in general more expensive and standardized therefore suitable for big foreign clients or governments, not small local companies.
- The majority of local firms cannot compete in terms of scope and quality of such services, but can offer cheaper and more specialized services adjusted to local conditions to local companies.
- With foreign companies serving other foreign investors and local companies serving the local market, there is no direct competition.
- The only exception is IT sector, where also domestic companies start to be competitive and offer their services to both government and other foreign investors.
- The Czech IT services market has developed into the most mature market in the CEE region and is dominated by foreign multinationals such as IBM, HP, SAP, Logica, Accenture that are to a largely responsible for the fast growth of this sector.
- Although the leading suppliers are of foreign origin there is still a strong representation of Czech IT services providers which are able to keep up with the continuously increasing market dynamics in the country.

2|3|2|2 Labour market competition

- Foreign firms pay on average fifteen percent more than the local companies and offer additional benefits, training, the possibility to work in an international environment and other advantages, which domestic companies cannot compete with.
- The competition is increasing and headhunting becomes a serious problem resulting in so called 'crowding out' of domestic companies.
- Skills obtained while working for a foreign subsidiary may spillover to local economy as the former employees move to other local companies, or set up their own companies
- Employees trained in foreign companies usually left to work for other foreign companies.
- The exception is the IT sector, where employees sometimes leave to set up their own companies (evident especially in the Hungarian sample) and successfully got footing on the local market. Some smaller consultancy firms were also established that way.
- For shared services centres, where employees have no access and knowledge about the overall service process, this type of 'spin-off' is basically non-existent and overall such a knowledge transfer is quite limited in all the V4 countries.

2|3|2|3 Backward and forward linkages: suppliers and customers

- Foreign companies either export the majority of their services, or serve other foreign investors on the market, therefore the scope for cooperation between foreign investors and local customer is very limited.
- Service centres reported using the services of domestic suppliers only for non-core activities (office equipment, cleaning services, personnel services, catering, security)
- Foreign companies tend to use global service agreements for more sophisticated services which are purchased from their global suppliers.

- For the non-core activities, the service centres through their intensive demand for some elements of local infrastructure and other services contributed to the increase in the quantity and quality of services offered; benefiting indirectly other local companies and the economy as a whole.

2|3|3 Impact on other institutions

- Companies participate in the development and strengthening of the local business life through membership in various associations as national chambers of commerce, AmCham, IT alliances, professional associations or business clubs.
- These are used for discussion and as a lobbying arm of the industry. This type of associations may bring benefits to domestic companies, because they provide a forum where domestic and foreign managers may meet and exchange information and knowledge.
- Most companies set up and maintained contacts and cooperation with higher educational institutions, which serve mainly as a channel for recruiting future employees.

2|3|4 Regional impacts

- Foreign direct investments flow mainly to economically more developed areas and cities, deepening economic divergence of underdeveloped regions.
- The uneven distribution of FDI is deepening the regional differences, putting additional pressures on labour resources and contributing to rising wages in major cities.
- In the case of Slovakia 70 % of all the incoming investments flow each year to Bratislava region, in the Czech Republic the majority of FDI flows to Prague, and in Hungary investment is concentrated in Budapest.
- In all the three countries the capitals are becoming overheated and potential investors are beginning to look at other alternative locations within the country and the interest of investors to invest in the regional cities is undoubtedly on the rise.

3 CONCLUSIONS AND RECOMMENDATIONS

While from the 1990s onwards the V4 countries attracted mainly market oriented investors, after 2000 the composition of FDI flows started to change. Especially in the case of the Czech Republic and Poland the amount of investments into business activities started increasing, reflecting the growth of resource seeking investments. The share of V4 countries in the global flows of this type of investments is very low, but the region shows a growing potential and might attract the bulk of European companies which started later with relocation of service activities. V4 countries should realise this opportunity and adopt specific policies to increase the competitiveness of the region, otherwise they miss the investment boom resulting from the increase of vertical service investments. Attention should be given mainly to the sophisticated, high value added services FDI projects which are believed to drive the development of the knowledge-based economy.

Inside the group of the countries analysed, Poland stands out with its size, geographical accessibility and labour availability, but compared to other V4 members its business environment is assessed less favourably. Geographical proximity puts the Czech Republic in an advantageous position, due to its central location in the region. Moreover, the Czech Republic has been chosen in some cases for its best flight connections in the region. Hungary is recognised for relatively high level of infrastructure and quality of workforce. Continued improvement of the business environment in the Czech Republic and Hungary cannot fully compensate for the deterioration in cost competitiveness and Slovakia with the lowest costs is increasing its attractiveness. With the labour-cost gap, Romania and Slovakia as well as the Baltic states have the potential to outshine more established CEE locations for service-based investment as the Czech Republic, Hungary and Poland.

With one of the main location advantages being the availability of qualified people, the tight labour market can threaten not only the inflow of new investments but also the position of the existing ones. In order to remain competitive as service centres locations, it is important for the education system to respond more flexibly to the needs of the labour market. Majority of companies stated that their investment is long term and as long as the country keeps the main location advantages, they have no intention of relocating the activities elsewhere, so the employment they offer is relatively stable.

STRENGTHS, WEAKNESSES, OPPORTUNITIES AND THREATS

→ Strengths

Highly skilled workforce (languages, IT)
 Wage differential with Western Europe
 Geographical position
 Infrastructure, business and political environment

→ Weaknesses

Emergence of shortages of skilled labour
 Rising wage costs decreases relative attractiveness
 'Overheating' of major cities
 Graduates working in low skilled job leads to long term degradation of skills

→ Opportunities

Increases in vertical investments
 Acceleration of outsourcing as a response to recession

→ Threats

Emergence of competitor sites in the European Union (Romania and Bulgaria) or on the edge of the EU (Ukraine)

RECOMMENDATIONS

→ Investment agencies should seek to increase the amount of horizontal investments

Horizontal investments concentrate mainly high skilled activities and offer most competitive, selective and demanding jobs. Shared service centres' jobs are also desirable, but also more footloose in response to changing cost profiles.

→ Ensure the continued availability of highly skilled workers

Foreign companies decrease fresh graduate unemployment, on the other hand they offer higher wages and better benefits, which increases the competition on the labour market and crowds out domestic companies. Wage levels also increase as a result of the increasing lack of qualified people especially with IT background.

→ Education sector must respond flexibly to labour market needs

With one of the main location advantages being the availability of qualified people, the tight labour market can threaten not only the inflow of new investments, but also the position of the existing ones. In order to remain competitive as service centres locations, it is important for the education system to respond more flexibly to the needs of the labour market.

→ **Enhance the relationship between business service FDI and local suppliers**

Besides the jobs creation impact, these companies have limited contacts with the local economy. The centres use the domestic supplier base, but the nature is usually limited to fundamental services needed for the daily operation of the companies. The situation could be improved using domestic content requirements on the national level.

→ **Support domestic industries and SMEs in particular**

Majority of local firms cannot compete with the foreign investors and the only exception is the IT sector. Government should therefore support the domestic industries to increase their competitiveness. This would increase the competition on the market and help the domestic companies to attract the trained employees leaving service centres. Special attention should be paid also to the support of innovative enterprises in the IT sector, which result from “spin off effects”.

→ **Review after-care services and institutional links with foreign investors**

Build links between different types of contacts and cooperation with higher educational institutions, membership organisations or associations. This should be widely encouraged as the associations provide a forum where domestic and foreign managers may exchange information and knowledge. Cooperation with universities brings benefits not only to the service investors, but also to students and researchers by bringing together the theoretical concepts with practical market needs.

→ **Assist dispersion of business service investment to smaller town and under developed regions**

Foreign direct investments are flowing mainly to developed cities, in the context of V4 to the capitals, which deepens the divergence of underdeveloped regions. Special investment incentives should be offered to the investors willing to locate in remote areas, but emphasis should be rather on the development of infrastructure in these places.

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Business Service Foreign Direct Investment in Central and Eastern Europe
> trends, motives and impacts

Project Report

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February 2010

Published by The Economy And Society Trust
© 2010





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