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Offshoring and Outsourcing Business Services to Central and Eastern Europe: Some Empirical and Conceptual Considerations

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ABSTRACT *The global structural shift towards service-based foreign direct investment (FDI) across the world is a relatively recent phenomenon resulting from the increased tradability of services. Although India and Ireland have traditionally been viewed as the main receiver countries, the Central and Eastern European (CEE) region is becoming an increasingly popular destination for business service offshoring and outsourcing. The article focuses first on the empirical and conceptual challenges to understanding the offshoring and outsourcing of business services in the context of significant difficulties with their definition, categorization and classification. It discusses the shortcomings of quantitative data and provides a theoretical framework needed to understand the specific patterns of service sector FDI in the context of CEE. Second, the article outlines the current position of CEE countries as destinations for service sector FDI: it analyses the patterns of service sector investment and discusses the reasons for its emergence as a receiver region. The empirical material is drawn from 30 interviews conducted with senior managers in business service foreign investment in the Czech Republic, Hungary, Poland and Slovakia. The article concludes that the composition of services FDI flows is changing, reflecting the growth of resource seeking vertical investment in the region. The share of CEE countries in the global flows of this type of investments is still low, but the region shows a growing potential. Its attractiveness is based on a number of factors, like 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.*

1. Introduction

An UNCTAD (2004) report proclaimed that “Offshoring reflects nothing less than a revolution in the tradability of services” (p. 148). The scale of offshoring business

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services, the increased number of receiver countries and the expansion in the nature of functions that can be delinked and relocated signal a new structural development in the global economy (Levy, 2005). However, this structural shift towards service-based foreign direct investment (FDI) across the world occurred relatively recently. Between 1989 and 1991, share of service sector FDI in total capital inflows amounted to just over 50%, while the figure had reached almost 60% by 2004 (UNCTAD, 2004).

Although India and Ireland have been established as receiver countries for offshoring business services for the last three decades (Lakha, 1994; White, 2004; Dossani & Kenney, 2007), a wider range of potential regions and countries is now considered (Gordon *et al.*, 2005; Van Welsum & Reif, 2005; Meyer, 2006). Central and Eastern European (CEE) countries have attracted a remarkable amount of foreign investment already since the beginning of the 1990s. While in the first decade of the economic transition, these went mainly to the manufacturing sector, the importance of service sector FDI and, especially business service FDI has been significantly growing since 2000. CEE countries are becoming increasingly popular destinations for foreign investors seeking to expand into new markets or to enhance their efficiency and gain access to cheap resources. Within the CEE region, Russia and the V4 countries (Visegrad economies: Czech Republic, Hungary, Poland and Slovakia)¹ are the main service FDI destinations.

This explosion of relocating a range of business associated services to what are regarded as low-cost locations requires an explanation in general, and more specifically in relation to Central and Eastern Europe. There are, however, two challenges, the first of which is the measurement of these flows in the context of significant difficulties with their definition, categorization and classification. Second, it begs a set of questions regarding the main patterns and specificities of the services being relocated and the motives of companies relocating service activities to the CEE region.

This article focuses first, on the empirical and conceptual challenges to understanding the offshoring and outsourcing of business services. In particular, we discuss the shortcomings of quantitative data and provide a theoretical framework needed to understand the specific patterns of service sector FDI in the context of CEE. We distinguish between horizontal (demand driven) and vertical (cost driven) investments with the latter capturing the tendency to fragment value chains across national boundaries and between offshoring and outsourcing. Second, the article considers trends in the growth of service sector and service sector foreign investment in CEE and discusses the reasons for its emergence as a receiver region.

The empirical material is drawn from 30 interviews conducted between September 2007 and September 2009 with senior managers in the biggest business service foreign investments in the four Visegrad countries.² Six companies were interviewed in the Czech Republic, eight in Hungary, 10 in Slovakia and six in Poland. The companies chosen as representative cases range from shared service to research and development centres, which provide the possibility to deconstruct the service sector and find out what it actually means in the context of CEE. There were only five purely horizontal investments, the rest of the companies are vertical investments, some of which have also horizontal investment departments/subsidiaries in the country. This qualitative research approach overcomes the shortcomings of data and measurement instruments and provides therefore a new insight into the actual patterns of service sector investments in CEE.

The structure of the article is as follows. The first section discusses problems with data and measurement with regard to the production, relocation and trade of business services. The second section discusses conceptual problems in terms of distinguishing between horizontal and vertical investments and offshoring and outsourcing. The third section provides an overview of the trends in business service foreign investment to Central and Eastern Europe. The fourth section examines the motives for foreign investment in business services in CEE and the reasons for its emergence as a receiver region. The final section draws some conclusions.

2. Problems with Data and Measurement

Information derived from service sector statistics, FDI, trade and employment data, should in theory yield useful data for analysing the patterns and the extent of offshoring and offshore outsourcing in the business service sector. However, there are various sources of measurement and data problems which have hindered the study of offshoring (Mol *et al.*, 2002; Mankiw & Swagel, 2006; Sass, 2008). These are discussed in the next section.

2.1. The Lack of Clear Definitions

The first problem is caused by defining the service sector and separating it from manufacturing. Traditionally, service activity was defined as intangible, non-storable and non-transportable output; produced by human work, consumed and bought at the moment of its production, thus requiring the physical proximity of the producer and consumer. This definition is, however, not sufficiently clear for determining which activities belong to the service sector, as in practice, it is becoming increasingly difficult to distinguish where the product ends and related services begin. The increasingly complex nature of the production of services and their delivery modes blur the dividing line between manufacturing and services activities. This was confirmed by the interviews where respondents found it difficult to decide whether activities belonged to manufacturing or services.

A second problem relates to the lack of a generally accepted classification of services. Various names are used for describing the same or similar subsets of service activities, which are affected by offshoring and offshore outsourcing. For example, professional services, knowledge services, knowledge-intensive services, knowledge-based services, business services, other business services, IT-related services, computer and business services are often used inter-changeably. This plethora of definitions can partly be explained by the fact, that the process of offshoring and offshore outsourcing of these services is very dynamic and there is an expanding list of activities that are considered to be candidates for offshoring and outsourcing. This means that research and statistics become outdated relatively quickly (UNCTAD, 2004).

The categories used for the service sector are conflated and offer insufficient detail; 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. Even when there is a relatively detailed breakdown, as in the balance of payments statistics, many countries are unable to collect and present data in the required detail and format. In addition, this insufficient breakdown of available service sector statistics applies to service sector

statistics, FDI, trade and jobs data. Software services, for example, includes customized software service, basic software coding or innovative-creative software development, thereby encompassing activities that range from simple menial functions to sophisticated research and development.

2.2. Data Problems

As well as the high level of aggregation and lack of detail in the service sector data, there are other sources of data unreliability and inaccuracy. In principle, there are many types and sources of data, which are suitable for analysing business services; including GATS (General Agreement on Trade and Tariffs), national statistics, company level data from surveys and information from consulting agencies.

According to GATS, services can be traded; first, in a “classical way”, that is cross border; second, through consumption abroad; third, through commercial presence, that is establishing an affiliate through FDI; and fourth, through on-site delivery. According to the information from the interviews, cross-border trade and commercial presence are widespread in the four CEE countries in business services, while consumption abroad is not relevant and on-site delivery is negligible. While this is an important channel of service delivery, for example, by Indian firms in the US, the interviews showed that this type of delivery was rare for CEE firms.

Data on service exports and imports would be an indirect way of measuring the extent of captive offshoring (in-house) and offshore outsourcing (third party provider), as the overwhelming majority of their output—due to their vertical nature—is sold abroad. However, because not only offshored services are included, these numbers can be considered more as an upper limit for offshoring and offshore outsourcing (WTO, 2005). Compared with manufacturing products, it is more difficult to measure trade flows in services across borders mainly due to the non-physical nature of services, and use of communication technologies. Exporters of services are generally larger and thus more easily targeted than importers of services; further larger-sized companies have higher response rates to questionnaires of statistical offices. Taken together, these result in a distortion of services data in relation to exports and imports.

Similarly to manufacturing, there are certain country-specific threshold levels set for the mandatory reporting of transactions in services. These threshold levels are usually set annually, although the trend is towards increasing the estimated part at the expense of the reported part of the overall data—due to the data collecting capacities of statistical offices. Because of the dynamism of the sector, companies which previously did not export or import services, but have become important traders may be omitted from reporting (Sturgeon *et al.*, 2006). Further, not only quickly growing companies, but also one-off transactions may be left out. In Hungary, “stable” companies in the sample represent only about 70% of total services trade. In addition to data received from banks and enterprises, other sources such as household surveys, government data; and information obtained from partner countries and international organizations can be used (Lindner *et al.*, 2001). However, these are not consistent between countries, and in Hungary, for example, the Statistical Office regularly checks membership and registry information from industry associations, chambers of commerce and relevant national authorities, in order to update the list of companies dealing with trade in services. Other CEE countries may not be so rigorous.

Further problems arise from non-reporting, or double reporting because of re-export, which are reflected in big differences in mirror statistics.³ Differences for trade in services in mirror statistics are larger than for those for trade in goods in European countries (Van Leeuwen & Lejour, 2006). A further problem, is that in the case of the balance of payments, the export and import of services are distorted by the repatriation of profits by multinational companies through inter-company trade in licence fees, financial services, business management consultancy and public relations services (EBOPS).

Compared with foreign trade, business service FDI data are not good measures for captive offshoring and offshore outsourcing. Only a part of FDI in business services is connected to offshoring and offshore outsourcing. Moreover, FDI data on services are unreliable and vary greatly depending on the source of the statistics. Companies report different base capitals for business services projects and interviews revealed that the recorded FDI does not provide a good basis for international comparisons. In Hungary for example, two comparably sized greenfield investments undertaking similar activities had very different capital bases: one of them was approximately 12,000 Euros and the other approximately 2.8 million Euros. In order to get a comprehensive picture of services investment, the number of service projects with foreign participation is sometimes taken into consideration, but as a result of differing activities, labour requirements and the size of the service centres the number of projects as a measure is hardly representative. In our sample, for example, the smallest project employed twelve people, while the largest employed more than, 2000.

National statistics are another source, which can be used for trying to capture sectoral processes. Here problems arise from separating horizontal and vertical related output, employment and assets. For example, occupational categories in principle would provide a good basis for assessing the extent of offshoring and offshore outsourcing from the perspective of both host and home countries. However, high levels of aggregation and missing information on the breakdown of various categories among the domestic-owned and foreign-owned companies hinders the analysis. Even detailed employee data, if they are available, can be misleading. Bardhan and Kroll (2003) point to the difference between manufacturing and services outsourcing in that respect. They suggest that while manufacturing outsourcing affects easily distinguishable sectors, in services outsourcing, various occupational groups are affected, independently of the sector they are classified in. For example, many computer experts work outside the computer services sector, in other manufacturing or services sectors. In principle, detailed company level data would be the most suitable for analysing developments in the geography of the business services sector. Here a specific problem can emerge from the confluent vertical-horizontal cases, but on the basis of our company interviews, these represent only a small fraction of companies.

Kirkegaard (2005) suggests that company surveys of media reporting may be useful; however, this is a reliable source only in countries where companies do not have an incentive to disguise the true nature of their restructuring. Hunya and Sass (2005) compiled a database from newspaper articles, which was made possible by the fact that in Hungary no negative values are yet attached to the term “relocation”, “offshoring” or “outsourcing”. Acquiring “ready-made” company data sets or carrying out company questionnaire surveys may be a similar though more expensive source of information. For example Jensen *et al.* (2006) analysed a data set, which was compiled on the basis of company interviews, for tracing the characteristics and job impact of offshoring and offshore outsourcing

in Denmark. The main problem with that approach is that while it can be good for determining the role of a specific home or host country in the offshoring and offshore outsourcing process, it would be too burdensome and expensive to collect data for a larger group of countries.⁴

Consulting agencies, such as Deloitte and McKinsey have been active in providing data on the processes of offshoring and outsourcing (see, e.g. McKinsey Global Institute, 2004; or Deloitte Touche Tohmatsu, 2004). Although they present internationally comparable statistics, their data may be overestimated (OECD, 2004; Bradford Jensen & Kletzer, 2005), as they have a direct interest in “promoting” the process of offshoring and outsourcing.

These problems with the data for and measurement of investment in business services mean that available statistics need to be treated with caution. However, beyond this, we argue that an examination of the implications for new divisions of labour and impacts of these investments needs a critical appraisal of conceptualizing business service foreign investment to which we turn to the next section.

3. Conceptualizing Foreign Investment in Services

In this section, we raise two important issues regarding the conceptualization of foreign investment in business services. The first is to elaborate the distinction between horizontal (market-driven) investments and vertical (cost-driven) investments, the second is to examine permutations of outsourcing and offshoring.

3.1. *Horizontal versus Vertical Investment*

The distinction between vertical and horizontal FDIs can be well observed not only in manufacturing, but also in the service sector (Caves, 2007). Market-seeking investors establish a subsidiary in the host country to provide services for the local market and are usually attracted by specific market attributes. For vertical investors, the most important motive of investing abroad is reducing costs by obtaining cheaper factors of production (Barba-Navaretti & Venables, 2004). Mainly motivated by the availability of low cost qualified labour, these companies are offshoring only particular service functions to the host country—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 the so-called “back (and middle-corporate) office” functions and support 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. Vertical investments are a relatively new phenomenon within the service sector and result mainly from the advances in technology, which made the fragmentation of the value chain possible (Coe, 1997; Jacobides, 2005) (Table 1).

The fragmentation of service sector functions has been induced by technological development such as the algorithmization of services processes, digitalization and the coding of information. Although there are some similarities with the fragmentation process in manufacturing (Deardoff, 2001; Dicken, 2003), fragmentation can go deeper into services processes.

Table 1. Differences between horizontal and vertical investments

	Horizontal investment	Vertical investment
Main motive for investment	Host country market	Host country resources
Gains	Access to market, customers, competition; avoiding barriers to trade	Cheaper or more abundant inputs
Losses	Economies of scale	Economies of integration
Preferred locations	Countries with large high income populations	Lower factor costs locations
Sectors and sub-sectors	Industries, where final goods have high transport costs or services require direct contact	Industries, where trade and other disintegration costs are low

Source: Adapted from Barba-Navaretti and Venables (2004).

Information technology development has made it possible that the same type of service activities became standardized for more than one manufacturing and/or services activities. For the same reasons, certain services became transportable. New products such as CDs and software appeared which acted as “mediators” in services trade. Further, the offshoring of services was also helped by the ongoing uni-, bi- and multilateral liberalization process of services trade, even if the level of liberalization does not reach that of manufacturing goods (UNCTAD, 2004).

When a company decides to invest abroad, it is primarily motivated to do so either by the host country market, or by host country resources, seldom by both. However, it is possible to see both vertical and horizontal investment of a particular company in one host country. These investments then function either as two separate entities, or as two separate departments within the company (this is the case, especially in the service sector).

3.2. Offshoring Versus Outsourcing

Offshoring is not synonymous with outsourcing. Offshoring means the relocation of the business process across national borders, where it may be provided by a subsidiary (captive offshoring), or outsourced to an external provider (offshore outsourcing). Outsourcing involves subcontracting the activities to a third party, which may or may not involve some degree of offshoring. Captive offshoring and offshore outsourcing refer to a company's decision to transfer certain activities, which were hitherto carried out inside the company, to another unit/affiliate of the firm in a foreign location or to an independent firm in a foreign location, respectively. Table 2 shows the permutation of offshoring and outsourcing arrangements.

Table 2. Offshoring and outsourcing permutations

Location of production	Internalized	Externalized (outsourcing)
Home country	Production kept in-house at home	Outsourcing (at home)
Foreign country (offshoring)	Intra-firm (captive) offshoring	Offshore outsourcing

Source: Based on UNCTAD (2004, p. 148).

At the firm level, the offshoring and outsourcing of non-core activities became the dominant tendency in the 1990s as a way of driving down costs in the context of the increasing intensity of competition. Other motives included improving the quality of services, the timely provision of services, improvements in risk management, access to special skills, improvements in planning and freeing internal sources in order to concentrate on their core activities. This process started in the US, and gradually extended to firms in other advanced and developing countries. As service activities increasingly became a source of competitiveness, managers reviewed the locations of activities and how these were distributed within the corporate network.

Those services, which are affected by the process, have specific common characteristics. These are usually:

- labour intensive,
- structured, describable with simple algorithms, and can be standardized,
- connected to information (e.g. information processing),
- use telecommunications
- routine work,
- relatively easily measured and evaluated,
- mobile
- local embeddedness has low priority
- significant differences in wages (labour costs) between the home and host country for the affected service activity,
- low sunk costs in establishing in new location.

It is important to differentiate between captive intra-firm offshoring and third party independent service providers (outsourcing). On the basis of the interviews conducted in Hungary, these differ from each other in many respects, for example, with regard to size or cost sensitiveness (Van Gorp *et al.*, 2006; Sass, 2010), relying on company-level data and analysing these two sub-groups separately, and point to differences in motives, country destinations, perceived barriers, affected activities, success factors and future plans of these types of providers. Therefore, one of their main conclusions is that captive offshoring and offshore outsourcing cannot be regarded as interchangeable.

Recent developments suggest that captive centres have grown to a point that they may be more efficient functioning independently, which according to Goel *et al.* (2007) and Dipu (2005) is a “natural” stage in the life cycle. However, we suggest that a complex set of factors determine whether a company prefers a captive or independent provider. These factors would include protecting intellectual property, factors related to company culture, decision-making processes, geographical spread of activities, nature of the activity, role of data security, size of the parent company and size of the captive centre.

4. Business Service Foreign Investment in Central and Eastern Europe

4.1. The Growth of the Service Sector and Service Sector FDI

The major development of the service sector in the CEE started at the beginning of the economic transformation. The shift from centrally planned economy to the market economy required establishing various (previously unavailable) services to satisfy the

needs of the market. This included the provision of banking and insurance services, auditing, legal counselling and business consulting, for example. The new demand and lack of competition in CEE countries constituted an opportunity for horizontal (market-driven) investments. 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 significant 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 (Figure 1).

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% and 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. This increasing share of business services in the FDI flows reflects the global growth of vertical investments (cost-driven).

The first business service FDI projects in the CEE region involved mainly back-office functions (finance, invoicing), which are less complicated and do not involve direct contact with the client. In the next stage, 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 specialized mainly in IT-related activities.

According to McKinsey Global Institute (2004), the CEE region's share of global business services is less than 1% and the region is lagging far behind Asia (mainly India). 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 had attracted between 40–50 projects per country by 2009.

Overall we can see that the structure of FDI in CEE countries reoriented to the service sector in line with international trends. In the Czech Republic, Hungary and Poland, foreign investments in the service sector became dominant by the late 1990s, but the

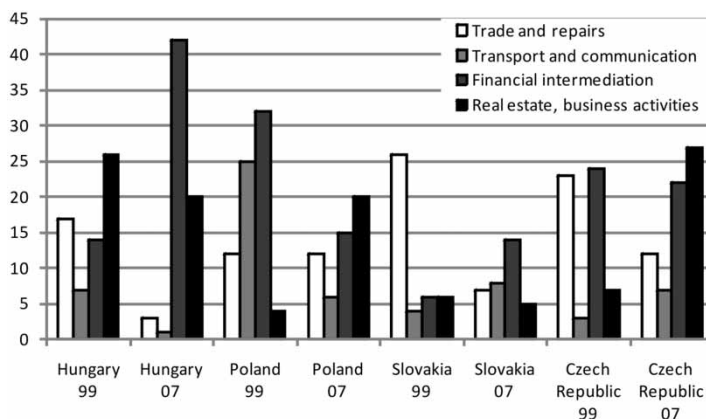


Figure 1. Shares of selected service sectors in FDI inflow (1999, 2007)

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

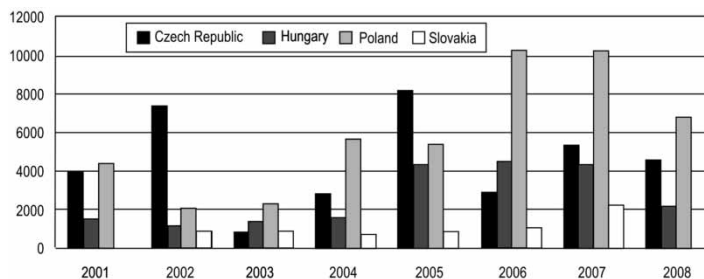


Figure 2. Service sector FDI inflows to V4 countries in millions Euro
Source: Eurostat.

boom started 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 the 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 2).

The Czech Republic and Hungary belong to the regional leaders in attracting the services FDI. Poland thanks to its size usually surpasses all the other countries in terms of absolute FDI inflow, but nevertheless usually falls behind when *per capita* terms are taken into consideration. Slovakia is the V4 laggard in both absolute and relative service sector FDI inflows and attracts the least amount of investment with high added value among the V4 countries. A problem in V4 is that the volumes of FDI inflows into the service sector have changed rapidly each year (mainly as a result of big privatization projects, which distort the statistics and the overall picture), especially in Czech Republic. In Poland and Slovakia, a more stable growth of these investments can be observed.

4.2. Export of Services

While market seeking investments are usually concentrated in developed economies with strong market potential, resource seeking investments are flowing to developing and transition economies which offer low costs. In the case of vertical investment, where the motive is primarily to take advantage of local resources, rather than serving the local market, the majority of the services produced are exported. The growth of vertical investments in the service sector therefore results in increased exports in services (Figure 3).

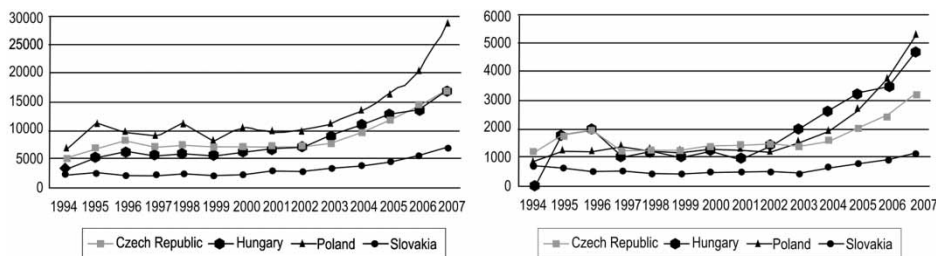


Figure 3. Total services exports; other business services exports in US\$ millions
Source: OECD statistics.

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, the share of travel and transport in exports is much lower while the share of business services is much higher than in CEE countries. Out of these three sectors, the growth rate of business service exports 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 service centres do not account for all exports, the statistics need to be treated with caution (Table 3).

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

5. Motives for (Re)locating Business Services to the CEE Region

5.1. Horizontal Foreign Investments: Access to Domestic Markets

As we have seen, horizontal investments started flowing into the V4 countries in the 1990s. Even though the political situation was unstable and the business environment unfavourable, the emerging markets with their 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. Until 2000/2001, the demand for these new services was still higher than the companies could satisfy. It was clear from the interviews that competition played a significant role in the choice of location as well. 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 (specifically in the case of oligopolies). Gaining access to the market and serving it locally was therefore the main concern of horizontal investments and other factors played a minimal role in the decision-making process. The investment incentives

Table 3. The structure of the services exports in V4 in 2007

	Czech Republic	Hungary	Poland	Slovakia
Total services	100.0	100.0	100.0	100.0
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
<i>Computer and information services</i>	4.6	4.2	2.3	3.0
Royalties and licence fees	0.2	5.4	0.4	2.1
<i>Other business</i>	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

Source: Own calculations based on OECD data.

were not aimed at services companies at that time as the government realized that these firms are entering the market anyway being driven by market access rather than decreasing costs.

5.2. Vertical Foreign Investments

5.2.1. 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, companies 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. Cost reduction as the main motive of relocation proves the theoretical assumption for vertical investments. The choice of the particular location was though influenced also by other factors.

According to the interviewed companies, the region of Europe as a whole, or Central Eastern Europe in particular, were identified as preferred investment locations (long-list). The advantages and disadvantages of specific locations were considered to compile a shortlist, where the V4 countries were usually grouped with Romania and Bulgaria (or other Eastern European countries) and were then compared based on a wider set of factors (Capik, 2008; Fifekova, 2008; Hollinshead & Hardy, 2010; Sass, 2008; Trnik, 2008). The following section discusses the reasons for the selection of V4 location.

5.2.2. “Knowledge advantage”: availability and cost of qualified labour. 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 qualified workforce skilled in information technology or other technical fields and languages. In addition, some companies 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 with other lower priced countries in terms of the knowledge of “smaller” languages and a good supply of university graduates in the required fields (Guzik & Micek, 2008). 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.

The cost of labour was also mentioned in the majority of the interviews. Fifty per cent 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 to cost 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.

Thirty per cent 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.

While the cost of labour was mentioned in 60% of the interviews, all the companies were concerned with the availability of highly skilled labour and technical and language skills. Services, particularly those associated with businesses, often depend on knowledge and information, so the skill level of the available workforce is likely to be the principal differentiating factor among locations.

5.2.3. Strategic location. 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 the CEE region, close to Western Europe and other Middle East and African countries; therefore offer a variety of local languages and a strategic location to serve a relatively large market. Being close to customers, the home country of the investor, other company centres and business metropolizes was cited as important by 50% 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.

5.2.4. Quality of infrastructure. The quality of infrastructure, especially information and communication infrastructure was cited as important by 50% of the companies. A 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. The quality and availability of infrastructure was seen as being far more important than its cost.

5.2.5. Political and business environment. The importance of the political and economic environment was mentioned by 50% of the managers interviewed. 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 10 years of the transformation keeping the demand for 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 2 years.

5.2.6. Cultural affinity. Cultural proximity to the markets served was cited explicitly as important by only one company. However, it is important to note that this was mainly important in relation to language abilities. 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.

5.2.7. Government incentives. Investment incentives are considered to be of crucial importance in attracting 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 the Polish sample none of the firms attached much importance to incentives, although companies did not hesitate to use them when offered. In Hungary, however, 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 and were relatively small, they did not play a significant role in the location choice.

Although attracting service centres is one of the most important targets of investment agencies in the case study countries, the interviewed companies did not benefit from the investment incentives schemes and incentives had little or no impact on their location decision. The situation may be changing as many companies stated that in the future incentives will play a bigger role in their decision about increasing the scope of their activities.

5.2.8. 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. 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) centres, six companies already had horizontal investments in Slovakia and another two companies had other shared service centres. References from the local managers and international customers and the performance of the local subsidiary 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 want to widen their capacities and strengthen their roles in the company.

According to the interviewed companies, 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 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 for (re)locating to V4 countries.

6. Discussion and Conclusions

The stock of global FDI has been permanently shifting away from manufacturing towards the service sector and its share has been continuously increasing in the CEE countries too. While from the 1990s onwards, these countries attracted mainly market-oriented horizontal investors as they offered huge unsaturated markets and improved economic and political environment, after 2000, the composition of the FDI flows started to change in line with the international trends in offshoring and outsourcing. 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 vertical investments. The share of CEE 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.

We have established that the attractiveness of the CEE (and especially V4) region is apparently based on a number of factors, such as 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 (where the main customers reside). Although the labour costs are much higher than in many Asian countries, all the above-mentioned factors have a significant influence on the overall costs and make especially 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. Because quality and availability of skills is the supreme concern in services, low wages alone are not the primary explanation for the services location decisions.

There are various factors, which suggest that service sector outsourcing and relocation will continue. First, technological developments have facilitated outsourcing a wider range of activities. In some cases, even the core activities of companies are outsourced, and then there only a headquarter remains, owning a brand name coordinating various activities with a few dozens of employees. Second, an increasing number of SMEs are outsourcing various service activities, IT activities in particular. Third, the non-profit making sector increasingly outsources and relocates some of its activities including government and public bodies, with, for example, tax authorities from developed countries offshoring and outsourcing activities such as data entry. Four, as firms grow and become more competitive in emerging markets, countries participate in the international division of labour as both senders and receivers of business service offshoring. At the receiving end, the capacity for absorption of the host country is reduced by rising costs and limited availability of skilled labour. Further, new destinations become more competitive as they develop the physical and legal infrastructure. Five, as companies (and consultants) gain more experience, those with failed attempts may try again, or companies, which have so far shied away, may try (Gupta *et al.*, 2006). Six, (offshore) outsourcing is dynamic in that it can serve new elements of the company strategy. Beyond cost reduction, it can contribute to standardization and quality improvement.

CEE countries should realize the benefits and opportunities, which the host countries have from offshoring and outsourcing business services 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 service FDI projects which are believed to drive the development of the knowledge-based economy.

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Notes

1. The Visegrád economies (V4) comprise the Czech Republic, Hungary, Poland and Slovakia. These are generally regarded as the leaders of the transformation process and were admitted to membership of the European Union in 2004. The V4 economies are a sub-set of the wider region of Central and Eastern Europe.
2. The interviews were carried out as part of the project of Economy and Society Trust: "Foreign Direct Investment in Central and Eastern Europe: What Kind of Competitiveness for the Visegrad Four".
3. Mirror statistics are bilateral comparisons of two basic measures of a trade flow. This is a traditional tool for detecting the causes of asymmetries in statistics.
4. More recently, EUROSTAT (2009) carried out an enterprise survey in 12 EU member countries and Norway, on the basis of which realized and planned international sourcing could be analysed in terms of its frequency, employment impact geographical orientation and barriers, among others.

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