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Upgrading Local Economies in Central and Eastern Europe? The Role of Business Service Foreign Direct Investment in the Knowledge Economy

Jane Hardy, Grzegorz Micek and Paweł Capik

Introduction

This Special Edition addresses the question of how the countries and regions of Central and Eastern Europe (CEE) are fitting into emerging divisions of labour in the context of an increased emphasis on innovation and the knowledge economy. By offering insights into recent trends in and motives for investment alongside organisational reengineering, we will interrogate the benefits of foreign direct investment (FDI) in business services for various groups of stakeholders, and offer new perspectives in the context of CEE and the local economic consequences of the service sector growth. The articles provide insights into current competitive advantages offered by diverse regions and localities across CEE and examine spill-over and multiplier effects of service FDI in CEE and the implications for upgrading the activities of localities and regions.

There is general agreement about the increasing importance of foreign direct investment in the service sector as a key driver of the globalisation process (Coe, 1997; Blinder, 2006; UNCTAD, 2004; Daniels, 2007). Until recently the presence of transnational corporation (TNC) service providers in other countries was motivated by performing activities for the local market which demanded a degree of firm embeddedness (Dossani and Kenney, 2007; Dicken, 2003). This has included services such as banking, insurance, law, consulting and accountancy. More recently, there have been two significant developments. First there has been an expansion in the range of business services considered for relocation. The 'light' and electronically transmittable nature of financial products, has permitted the reorganisation of productive activities into international 'financial factories' with scant regard for national borders (Martin, 1999). These low value added jobs included call centres, data entry, claims processing and medical transcription (Bain and Taylor, 2005). Furthermore, attention has turned to offshoring and outsourcing not only routine business services, but also those that engender high skills and knowledge (Guzik and Micek, 2008). However, there have been two competing interpretations of this trend. Some point to the acceleration in the offshoring of more skilled tasks such as R&D, sophisticated software development, design mathematics based finance and actuarial functions that require post-graduate or higher level skills. A less sanguine view from the perspective of receiver countries of business service FDI suggests that knowledge based functions will remain in the core economies, while simplified and routinised tasks in production and the provision of services will be outsourced and offshored to emerging markets (Hutton, 2004; Coyle and Quah, 2002).

Second, there has been an increase in the potential regions and countries under consideration (Gordon et al, 2005; Van Welsum and Reif, 2005). Numerous TNCs have adopted a hybrid strategy where the activity is shared between some domestic capacity, near-shore capacity in lower-cost labour countries such as Canada for the United States or CEE for Western Europe, and offshore locations such as China, India, and the Philippines (Dossani and Kenney, 2007).

The regional patterns of this relatively new phenomenon of offshoring are, however, ambiguous; for example, a few large investments in less-developed urban areas could lead to the substantial reconstruction of the hierarchy of cities. suggests that Further, the increase in offshoring may result in the reduction of regional income discrepancies, as less-developed places attract a growing bulk of routine activities (Richardson and Gillespie, 2003; Robert-Nicoud, 2008). Therefore offshoring associated with relocation is a spatial phenomenon and is shaped by and shaping complex geographical forms which have profound implications for regions and cities of CEE as emerging destinations for business service foreign investment (Aggarwal et al, 2008).

The issues raised by the changing geographies of offshoring and outsourcing emerged from a set of papers given at a Regional Studies Association Research Network workshop organised by the guest editors in September 2009 at the Jagiellonian University in Kraków. The discussion identified significant gaps in the literature, which the Special Edition seeks to address. In particular, it focuses on the following questions:

What are the methodological issues in examining empirical in trends in business services? What problems are raised by industrial classification and data aggregation?

How are organisational change and the reengineering of value chains related to the emerging geographies of business services? What is the role of network embeddedness in contributing to regional sustainability?

What are the unfolding divisions of labour between the core economies, emerging and peripheral economies? To what extent are regions able to capture knowledge based functions and higher value activities?

What are the economic and institutional factors that contribute to the attractiveness of new regions for the location of business services?

To what extent are business services territorially ‘embedded’ forms of foreign direct investment that can contribute to regional development?

FDI in Business services and Upgrading Regions in Central and Eastern Europe

Three sets of claims were been advanced to support optimistic accounts of foreign investment in Central and Eastern Europe (CEE) and its regions after 1990. The first set of arguments emanated from the conventional literature which pointed to foreign investment as ‘the engine of growth’ in post-communist economies (Lipton and Sachs, 1990). This claim was premised on the argument that, not only would foreign investment bring a vital injection of capital to economies where domestic individual and institutional savings were low, but also that there would be an automatic transfer of technical and managerial know-how to firms. Therefore in CEE, as in other countries, FDI has acquired hegemonic status in many regional and local development strategies (Hudson, 1995; Phelps, 1997).

The second set of arguments supporting the increased potential of FDI for local development are related to claims that new corporate dynamics have led to the emergence of qualitatively new and essentially superior forms of manufacturing investment by TNCs in Less Developed Regions (Amin et al, 1994; Fynes and Ennis, 1997; Rugman and D’Cruz, 1997). Such quality investments were seen as the product of a number of organisational changes, which included increased autonomy for firms, a shift from defensive strategies related to cost, to offensive strategies associated with asset and knowledge seeking in the locality and the need for aftercare.

Thirdly, attention has turned to the locality as an important source of competitive advantage for firms (Cooke and Morgan, 1994 and 1998; Scott, 1995), where firms could access external economies of scale through clustering (Porter, 1994; Krugman, 1995). Strong claims have been made that geographical proximity allows firms to access tacit knowledge from local networks that are central to competitive advantage in a global economy, where knowledge is increasingly ubiquitous and codified (Maskell and Malmberg, 1999a and 1999b).

In CEE in the early stages stages of transformation the purported benefits of FDI were illusive. Throughout the 1990s subsidiaries of TNCs in the region have been popularly characterised as ‘enclaves’, ‘cathedrals in the desert’ (Morris, 1992, Grabher, 1994,1997; Hardy, 1998) or even *maquiladoras* (Ellingstad, 1997). Typically they formed few linkages with local firms, offered low-skilled or semi-qualified jobs involving manufacturing based on mass production technology. The post-communist economies of Europe have generally pursued market based, neoliberal transformation since 1990 and therefore none of these countries have introduced the policy of ‘obligated embeddedness’, based on joint-ventures and follow-up network configurations, popular in other countries including Ireland, China and India (OECD, 2003; Liu and Dicken, 2006). On the contrary in the earlier phases of FDI to CEE TNCs were allowed to obtain local-content waivers and other concessions from the post-communist governments, which has led, in general to their low spatial embeddedness (Barlett and Seleny, 1998). TNCs' failure to develop linkages with local and regional economies has had adverse effects for regional development, including the intensification of regional disparities and increased regional economic instability, (Pavlínek, 2004).

A more sanguine view suggests that the involvement of local CEE subsidiaries in global value chains has changed significantly since 2000. Domański (2004) observes that a growing number of foreign manufacturing companies have become more embedded in Polish regions and localities, while simultaneously integrating with the global economy', as a result of some subsidiaries being transformed into ‘performance’ or ‘quality’ manufacturing plants. Recent research evidence from the CEE automotive industry points to its increasing embeddedness within the region (Domański and Gwosdz, 2009; Jürgens and Krzywdzinski, 2009). It could be also argued that the recent investments by TNCs offering outsourced or offshored business services are transforming the local milieu. It has been suggested that business services companies in non-core Western European localities make a valuable, contribution towards local economic development through the creation of additional employment opportunities and the stimulation of new skills and competencies central to the knowledge economy.

Conceptual and data issues

In their article Sass and Fifekova focus on empirical and conceptual challenges to understanding the offshoring and outsourcing of business services. The terms offshoring and outsourcing are widely discussed, but ambiguously defined (Jahns et al, 2006) and Sass and Fifekova distinguish between offshoring and outsourcing explaining that they are not synonymous. Offshoring means the relocation of 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 (see also Youngdahl et al, 2008; Robinson and Kalakota, 2004).

Emerging industries by their very nature do not fit neatly into existing classification schemes. Sass and Fifekova go on to examine the problems in obtaining accurate data. They point to definitional problems and the way in which categories for the service sector are conflated to mask the necessary detail for analysis; this insufficient breakdown of available data applies to FDI, trade and employment. Further problems exist with the availability of consistent data which arise from non-reporting and double counting (due to re-export), which are reflected in large differences in mirror statistics.

Various conceptual frameworks have been used to analyse outsourcing and offshoring business activities from both spatial and organizational perspectives. This includes the international division of labour, global value chains, industrial clusters and spatial interpretation of product-life cycle model. The resource-based view emphasises the way in companies offshore to enter countries in order to directly acquire emerging unique resources, over which the companies are assumed to have (more) direct control (Jahns et al, 2006; Steinle and Schiele, 2008; Holcomb and Hitt, 2007). Sass and Fifekova make an important distinction between horizontal (demand driven) and vertical (cost driven) investments with the latter capturing the tendency to fragment value chains across national boundaries to both offshore and outsource.

Therefore conceptual challenges and a range of data problems are encountered in the study of outsourcing and offshoring of business services. To date research has been frequently based on case studies of a limited number of companies which tend to be exploratory, but offer little in terms of comprehensive, multidimensional analyses (Nicholson et al, 2006; Sen and Shiel, 2006). Sass and Fifekova, however, provide insights for the motives of business service FDI from 35 company interviews in four countries.

The Knowledge Economy

By the early twenty first century there was a shift of interest to the potentiality of business service foreign investment; new trends in offshoring and outsourcing were paralleled by a new orthodoxy and panacea for economic success. Market forces were no longer regarded as sufficient for assisting the post-communist countries in shifting the trajectories of their nation states or regions and integration with the global economy (World Bank, 2002). It was argued that the economic context of the new millennium has shifted to demanding 'more far-reaching institutional innovations on the part of those who wish to "catch up"' (UNIDO, 2005, p.8). It follows that in order to 'catch up' countries need to develop knowledge economies in order to compete successfully. According to UNIDO 'knowledge' is a critical factor for growth comprising 'variables highly correlated with the creation and diffusion of and use of knowledge such as R&D innovation, scientific publications, Information and Communications Technology (ICT) infrastructure, quality management and education' (UNIDO, 2005, p.xiv). From the European perspective this emphasis is reinforced by the Sapir Report in 2003, which views the poor performance of the EU in general as a symptom of its failure to transform into an 'innovation based economy'.

Drahokoupil and Capik's contribution deconstructs the chaotic concept of 'business services' by analyzing the nature of service sector activities outsourced and offshored to the Visegrád countries (Czech Republic, Hungary, Poland and Slovakia). Using the knowledge-based economy as a benchmark, the authors assess the potential of service sector outsourcing in contributing to regional competitiveness by increasing the innovative capacity. Further, the paper discusses the role of state policies towards service sector FDI. The analysis combines data obtained through multiple case studies of service sector outsourcing projects in the Visegrád four. Moreover, it draws on interviews with senior employees of investment promotion agencies and available statistics on activities within the service sector in the region. It argues that the recent inward investments in business services in the Czech Republic, Hungary, Poland and Slovakia mainly utilise existing local human-capital resources, and their contribution to the development of the knowledge-based economy is limited to employment creation and demand for skilled labour.

The article by Gál and Ptaček focuses on the role of regional universities as one of important contributor to the regional innovation. It is argued that regional universities are often very important players in the field of innovation, especially in non-metropolitan and less-favoured regions. By presenting case studies from the Czech Republic and Hungary the direct and indirect spill-over effect of universities, including spin-offs and foreign direct investment, are investigated. The article raises the question of how can the regional universities compete with their larger and better counterparts which take advantage from the agglomeration economies and other benefits of institutional thickness, which authors argue may be achieved by enhancing knowledge spill-overs and targeted marketisation of regional universities.

Drivers of Offshoring and Embeddedness

The nature of competition in terms of how far it is driven by accessing low costs or gaining market access will have an impact on the locality. Firms locating on the basis of low labour costs, locking firms into low value added operations have been assumed to bring fewer benefits than ‘bridgehead’ investments associated with market access which may demand a wider range of quality functions (Grabher, 1994). In particular, it is suggested that the labour process of firms which locate on the basis of seeking low labour costs will bring poorly paid, routine and repetitive work involving low levels of training and bring few linkages with suppliers in the region. By contrast, firms locating on the basis of market access or to gain know-how through accessing higher level skills from a locality are likely to bring qualitatively superior employment opportunities that involve training and development and will enhance the human capital of the region.

Therefore understanding the factors driving firms to reengineer their value chains, and relocating business services functions in particular, is important in gauging the potential for regions to upgrade spaces of production and employment within them. Although different weights are attached to the motives driving offshoring and outsourcing, agreement has coalesced that these two intertwined phenomena are driven by economic, organisational and institutional factors. There is a general agreement that the underpinning drivers of this new wave of foreign investment is first, that increased competitiveness and the need to sustain profits has led to the deverticalisation of firms and reengineering in order to arbitrage costs and seek new knowledge and innovation (Coe, 1997; Jacobides, 2005). The separation of work geographically and organisationally has involved longer and more complex value chains (Gupta, 2006; Gupta et al, 2006). The second driver of fragmented value chains is attributable to advances in and the standardisation of that have made skills more portable between firms (Miozzo and Soete, 2001; Grimshaw and Miozzo, 2006), while the growth of accepted industry standards has reduced the risks of offshoring (Aspray, 2006; Graz, 2008). Taken together these have increased the distances over which the arbitrage of knowledge and labour costs can occur. Third, processes of offshoring and outsourcing will be shaped by institutional influences in sender and receiver countries (Lakha, 1994; Balasubramanyan and Balasubramanyan, 1997; Grimshaw and Miozzo, 2006). At an international level important institutional developments such as the deregulation of financial markets, GATS, TRIPS and EU enlargement have been important in differentiating the geography of space and costs (Ellis and Taylor, 2006).

Two of the contributions (Sass and Fifekova, and Hardy and Hollinshead) critically evaluate the assumption that low labour costs are the important factor in selecting new locations. For example, firms frequently offshore to improve processes and high quality work potentially results in improved services and products (Currie et al, 2008). Bunyaratavej et al (2007) and Stringfellow et al (2008) argue that visible costs are only part of the total costs. Therefore wage differentials may not be the only factor that firms use to consider where to offshore their services. Moreover, cost reductions that firms anticipate might not be materialized because of the hidden costs of offshore /outsourcing (Hendry, 1995) such as those associated with unexpected managerial training and travelling, reduced service quality and low productivity. The scale of invisible costs will vary between countries and be related to the degree of cultural proximity (Stringfellow et al, 2008). Sass and Fifekova report a number of factors beyond cost reduction that has made CEE an attractive location for business service FDI. They emphasise access to skilled workers, but also explore other factor such as the political and business environment, cultural affinity and government incentives.

The article by Hardy and Hollinshead focuses on the offshoring of software development to the Ukraine, which is emerging as a new site for sophisticated IT functions. The possibilities of regional growth and dynamism as a result of capturing high level functions in the value chains of software development are explored. Interviews with the CEOs of twelve companies are explored through the lenses of structural, cognitive-cultural and network embeddedness. It concludes that this offshoring brings employment for highly skilled graduates in knowledge intensive work. However, the structural characteristics of the industry with no sunk costs, in general suggest that territorial embeddedness is weak. However, an important dimension is that the need to elicit high quality work has produced different organizational strategies by firms regarding human resource management which have significant implications for the quality of employment and time horizon of their operation.

Policy related issues

TNCs and their affiliates have become much more sensitive to opportunities for influencing and exploiting the disposition of local and national systems of governance towards attracting and embedding major inward investments. There is growing evidence that major projects are conceived and negotiated in a politically sensitive way that has not been the case before (Phelps, 2000; Phelps and Fuller, 2000; Mytelka, 1999). The increasing intensity of competition for mobile investment coupled with the increasing ability and desire of inward investors to read local policies highlights some of the limits of local institutional capacity building to effect local economic development (Phelps 2000). Policy initiatives aimed at embedding incoming foreign investment entail a commitment of local capital and public resources in the service of the competitive goals of the incoming company, and TNCs will actively seek out social and cultural settings that shift the cost of reproducing labour power onto local societies and states (Hudson, 1997).

This area of debate is of great interest to policy makers and stakeholders. From a home country perspective, workers engaged in routine activities are threatened by shifts in their functions to lower cost global regions. In the field of employment, serious concerns have been expressed about the effects of offshoring on work in both home and host environments (Robert-Nicoud, 2008). The potential for 'backlash' in the West has been flagged by Taylor and Bain (2003) who noted campaigns in the UK to prevent the transfer of call centre jobs from the United Kingdom to India. The aspiration of policy makers in Europe, encapsulated in the Sapir Report (Year?), to shift to innovative, knowledge based capitalism dominated by high skilled workers may be undermined by the export of more sophisticated knowledge intensive functions that were assumed to be embedded in clusters in the metropolitan regions of the core (Sapir et al, 2003; Sapir Group, 2005).

There are several key questions posed by local and national authorities in relation to policy making. These are focused on the appropriateness of policy responses in relation to attracting firms to and retaining them in a region or locality. The intervention of public bodies to 'embed' firms is particularly pertinent in the case of 'reshoring'. For instance, Doh (2005) refers to Dell's repatriation of services from offshore locations because of language and other problems. In order to prevent such cases after-care policy programmes need to be implemented by local authorities in the host countries to meet companies' needs.

The article by Micek, Działek and Górecki examines the scale and scope of foreign-owned subsidiaries on Krakow in Poland and its bordering localities. Criticising the political economy of offshoring from a host country perspective and the notion of 'cathedrals in the desert' the authors attempt to compare and contrast the perceived effects with the actual contribution made by business services FDI in Kraków. The empirical dataset originates from in-depth research project on the nature of contribution foreign-owned subsidiaries provide to the local economy in Kraków, and includes extensive primary and secondary data (financial data, employment and income multiplier effects, press data, interviews, survey) from companies, companies employees', industry associations and local government. The authors conclude that the image created by the policy makers, lobbying organizations and companies is overly positive in relation to measured impacts..

CONCLUSION

This Special Edition analyses the current qualitative and quantitative changes occurring in the business services sector, particularly those related to its relocation and impacts on the local economies of CEE, which sheds light on emerging divisions of labour in Europe and beyond. More broadly, it offers a new contribution to the ongoing debate on the scale and scope of local spatial embeddedness of FDI in CEE countries.

The tendency to outsource and offshore is being accelerated by financialisation (Andersson et al, 2006; Froud et al, 2006) and is likely to be further intensified in the aftermath of the crisis and recession as firms attempt to restore their profitability and competitiveness. Therefore this debate is of interest to both policy makers and academics. Additionally understanding the consequences of relocating business services for the host country is crucial for local and regional policy stakeholders. It is particularly important in the context of the positive and predominantly unsubstantiated claims that have been made by the media and consulting firms regarding its impacts. From the perspective of local policy studies an understanding of the local and regional embeddedness of business services is salient because of the possibility relocation from the CEE region due to backshoring or moving to other emerging markets (Nicholls et of al,1998; Pavlínek, 1998, 2004).

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