

## RELOCATION OF BUSINESS SERVICES INTO CENTRAL AND EASTERN EUROPE (EVIDENCE FROM TRADE AND LOCATION STATISTICS)

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**ABSTRACT** – Relocation of business service offshoring-related activities measured by foreign direct investments and exports in services have grown rapidly after the Millennium in the new EU member states of Central and Eastern Europe (CEE). Besides Foreign Direct Investment (FDI), trade statistics support the assumption that an expanding export in business and in ICT services has been associated with relocation of shared services centres created by FDI in the six new member states (NMS). The service export data collected between 1996/2002 and 2012 gives a good proxy to identify those segments of service trade, which are considered to be offshorable. The paper examines the additional location factors selecting Central and Eastern European locations and summarises the effect of crisis on this industry. It concludes that the sector has demonstrated market resilience in the NMS and continued to expand rapidly.

**Keywords:** offshoring, nearshoring, service trade, offshorable services, Central and Eastern Europe, location advantages, economic crisis

### INTRODUCTION

The rise of globalisation, opening up of formerly isolated regions such as Eastern Europe, Russia and China to global trade, has substantially boosted task trade and service related cross-border investments. After and parallel to the outsourcing/offshoring from developed to low-cost developing countries of the low and medium skilled production processes in manufacturing, similar processes have emerged in services (Bryson, 2007). Fragmentation and “trade-in-task” theorems developed by Jones and Kierzkowski (1990) and Grossman and Rossi–Hansberg (2006) examine the new role of services in international trade. Advances in this process have made it easier for companies to disaggregate their value chains around the globe, all the while maintaining management control over them, or to disperse service production among numerous supplier firms even in distant locations. Central and Eastern Europe (CEE) have played a considerable part in these processes. Relocation of service offshoring-related activities, such as outputs, value added, employment, foreign direct investments and exports in services have grown rapidly, particularly after 2000, especially in the new EU member states (NMS) of the region (the Czech Republic, Hungary, Poland and Slovakia, though “latecomers” such as Romania and Bulgaria have also begun to act as host for this type of investment) (Gál and Sass, 2009).

The question is whether this region might stand as a challenge for the overwhelmingly dominant global position of India and the other East Asian forerunners or only offer a complementary offshoring base for the continental European companies preferring to relocate their services nearby.

In many cases, offshoring is not simply a corporate management issue but attracted media and policy responses on far broader fronts, such as labour markets and education. The significance of offshoring is often overestimated and this is because still only a smaller proportion of services are transferred abroad (Amiti and Wei, 2004, 2005). In fact, offshoring by no means generates as drastic effects as one might expect from the ongoing political debate on job losses (Mankiw and Swagel,

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2006). The literature concentrates mainly on (developed) home country impacts, especially in terms of job losses, relative wage decreases for unskilled workers and welfare implications (Kierkegaard, 2005; Hansen et al., 2007). Host country impacts and location spillovers have hardly been examined and even research on the job-creating impact in home countries is missing (Jensen et al., 2006; Ekholm and Hakkala, 2006). Offshoring skill intensive activities to Central and Eastern Europe has contributed to relative wage decrease for skilled workers in some sender countries and increased the productivity in host countries<sup>2</sup> (Protsenko, 2003; Marin, 2010).

The relocation of services also conceptualizes the types and impacts of FDI in business services within the Global Production Network (GPN). GPN model discusses the governance and multi-actor characteristics of *transnational production systems* through intersecting notions of power, intra- and inter-firm networks and embeddedness with understandings of sub-national regional development and clustering dynamics of GPNs. Gereffly et al. (2005) have made significant contribution to the governance and operational typology of GPNs, in which different types of FDI, namely the horizontal and vertical FDI make distinction between the different interconnectedness and embeddedness of the service value chains. On the one hand, horizontal investments are chosen by those market-seeking investors who establish subsidiary in a host country to provide services for the local market. These demand driven investments were the most common throughout the beginning of the transition period in CEE. On the other hand, supply and efficiency-driven vertical investments across national boundaries are seeking for low-cost global locations created by vertical disintegration of firms' operation among different places. The majority of FDI in CEE belonged to this latter group (Hardy et al., 2011).

A bulk of research examines offshoring both as a part of worldwide structural shift towards service-based FDI and a new direction of managerial and localization strategy of corporations (Baldwin, 2006; Blinder, 2006; Bryson, 2007; Grote and Taube, 2006, 2007; Bevan and Estrin, 2004; Hardy, 2007). However, current economic statistics do not provide reliable indicators of the scale and characteristics of offshoring, therefore, our knowledge of developments in services outsourcing/offshoring is limited because of data and measurement problems. Due to the problems with collecting data on business service investment, statistics are supplemented with qualitative research in recent studies (Hardy, 2006; Capik, 2008; Sass, 2009; Fifekova and Hardy, 2010).

This paper attempts to examine the scale and sectoral characteristics of services offshoring in NMS-6<sup>3</sup> by means of using trade data in order to partially overcome the scarcity of consistent empirical contributions in measuring the actual significance of NMS in offshoring services. Despite the deficiencies of reliable and consistent data sources, balance of payments statistics, including the exports of services, are still the most closely related to offshoring/outsourcing. Balance of payments positions are often being used in the literature and authors, particularly at the IMF and OECD, are the keen users of this information to describe offshoring (Amiti and Wei, 2004, 2005a).<sup>4</sup>

The paper is divided into four sections. Following the introduction, the first section gives an overview of services offshoring position of CEE and discusses the measurement problems of service offshoring. It examines the service trade trends in other business and ICT services, and BoP trade data

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<sup>2</sup> Protsenko (2003) finds that German vertical FDI in the Czech Republic has positive effects on the productivity of local firms, while horizontal FDI does not have such effects.

<sup>3</sup> Czech Republic, Hungary, Poland, Slovakia, Romania, and Bulgaria.

<sup>4</sup> We are facing various measurement and data problems. It is mainly due to the definition problems of service sector in general, and the lack of generally accepted and standardized classification of services, which particularly applies to the breakdown of subdivisions (e.g. classification of business services). Moreover, various names are used for describing the same and similar subgroups (e.g. other business services, knowledge intensive business services, computer and business services, etc.) that are affected by offshoring (Chakrabarty, 2006, Sass, 2009). FDI plays an important role in offshoring, although it is more difficult to quantify it, and services trade data provide a more reliable source of measurement. Firstly, one has to make a distinction between FDI serving the foreign market, offshoring and offshore outsourcing. Offshoring is usually connected to FDI, though not all FDI is offshoring (Kierkegaard, 2005). Sass (2008) expresses that constraints of FDI data lie not only in their unreliability but also in their limited size in services compared to manufacturing investments.

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in order to find evidence of offshoring-related service intensity in the NMS. The second part explores the reasons of the comparative advantages and the location factors of nearshoring in the six examined NMS. The service export data collected between 1996/2002 and 2012 helped measure the expanding service trade and have demonstrated continuous growth even during the crisis. The conclusion stresses the positive impact of service offshoring on corporate productivity and on the host countries' economic performance and discusses the sustainability of the region's attractiveness.

### **EMERGING OFFSHORING HUBS IN CENTRAL AND EASTERN EUROPE – EVIDENCE FROM TRADE STATISTICS**

#### **The role of NMS in the global offshoring market**

The 'tradability revolution' in services has resulted in a rapid surge of locational transfers in service activities. Within CEE, the NMS have achieved enormous progress in modernizing their service industries and have witnessed a rapid shift towards services. Countries of the region are gaining importance as offshoring locations. This growth can be partly attributed to the establishment of new capacities and to relocation of existing functions from higher cost locations. In 2003, CEE with its \$1 billion share in the global offshoring market (which is worth an estimated \$40 billion) lagged far behind the more prominent locations (McKinsey, 2005). The share of Visegrad countries in the global business services FDI was less than 1% in 2008. Nevertheless, the share of CEE is rapidly growing. In 2003, only 5% of service-related global FDI projects were realised there, while in 2006, 22% of related FDI projects went to regions in these countries. However, the number of current projects in Western Europe continues to exceed CEE projects-1,600 and 220 respectively by 2009 (Sass, 2008; Gál and Sass, 2009).

CEE is still an attractive supplier for mainly European corporations as a growing number of outsourcing services seekers from Western Europe have found Bangalores in their own backyard. Major companies after targeting its Asian destinations for offshoring services sector jobs, are now looking towards Eastern Europe to meet their nearshoring requirements. During the first stage of service offshoring, captives in the form of shared service centres were the main service providers, and recently independent global vendors are also opening their new offshore outsourcing centres in CEE to serve their European clients (Gál and Sass, 2009).

These service activities are highly export-oriented (their export intensity is around 100%). That is why trade data give the relatively most relevant proxy for calculating the extent of offshoring and outsourcing of these services. The growth of vertical investments in the service sector also results in increased exports in services. The majority of exports from the NMS is directed towards the EU (the exports from V4 countries to EU reached 70%), which illustrates that service centres are providing services mainly for customers and subsidiaries within Europe (Fifekova and Hardy, 2010). Between 1992 and 2005, the increase in global imports of CIS (computer and information services) and OBS (other business services) by EU-15 accounted for 9.5% while their imports from CEE over the same period have increased by 13.5%. By comparison, the total services imports have risen only 6.7% (Meyer, 2006).

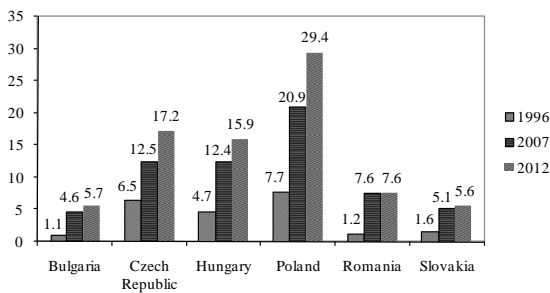
#### **Services offshoring market in NMSs – evidence from trade statistics**

Nevertheless, despite some statistical shortcomings, services trade data would be the most suitable way to measure the extent of offshoring and offshore outsourcing. Nevertheless, not all the trade data registered for CIS or BPO (business process outsourcing) are the result of offshoring. Some authors use trade data as an upper limit for the actual volume (Meyer, 2006). However, reliable services trade data are still missing and available data are incomplete and insufficiently detailed. Sturgeon et al. (2006) argues that the non-physical nature of services and the increased tradability due to the use of communication technologies makes more difficult to measure service trade crossing the borders. In some cases, data are available on intra-firm trade, which could be used as a proxy for assessing the extent of offshoring as in the NMS the majority of total services trade can be still

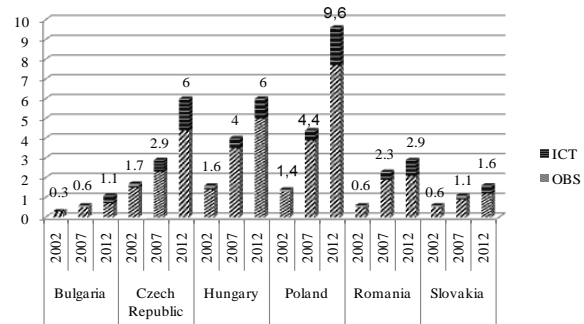
considered intrafirm (Marin, 2005, 2010, Sass, 2008, 2009).<sup>5</sup> However, intra-firm trade covers mainly the captive cases, and transfer pricing, which is easy to perform in certain service sectors (ICT), distorts these data, too. Further, some trade in services is not reported at all, while others are double-reported because of re-export (Sass, 2009).<sup>6</sup>

Following the international methodology (OECD, 2004; UNCTAD, 2005; Amiti and Wei 2005b; Ghibutiu and Poladian, 2008; Sass, 2009) two services categories are suitable to approximate the size of trade in offshorable services.<sup>7</sup> Information and computer technology (ICT) services and other business services (OBS) are the most inclusive categories that can be regarded as potentially offshorable services.<sup>8</sup> Eurostat data make international comparisons possible at a more detailed level.

The question is whether the data support the widely accepted view that the new member states (NMS) are increasingly affected by the relocation or outsourced provision of offshorable services. Export services data in the case of the six new EU member states (NMS-6) included in this study provide an approximate method to define the extent of offshoring services.<sup>9</sup> Exports in services in NMS-6 have been expanding from a very low base amounting to 63 billion Euro by 2007 and 82 billion in 2012, which is almost 4 times higher than that in 1996. The relative share of the NMS-6 in the global service exports is still modest (declined slightly since 2007 to 2.4%) illustrating the still lower services export capabilities of the region although its growth rate was higher before the crisis than the global or the EU-15 average. In absolute terms (Figure 1), Poland, the Czech Republic and Hungary are the leaders in this field.



**Figure 1.** Exports of services in the NMS-6 in 2012 versus 1996 and 2007 (EUR Bn)  
Source: Author's calculation based on Eurostat and IMF BoP data



**Figure 2.** Exports of offshorable services and its sectoral composition in 2002 and 2012 (EUR Bn)  
ICT = Information and Communication Technology Services, OBS= Other Business Services  
Source: Author's calculation based on Eurostat BoP data

<sup>5</sup> Marin (2005) examines the extent of offshoring and outsourcing by looking at the pattern of Austrian and German intra-firm trade both in manufacturing and services with Eastern Europe. She found that more than half of German FDI and about 15% of Austrian FDI realised in the Central and Eastern European countries was connected to offshoring.

<sup>6</sup> Differences between reported and mirror trade statistics can be also significant making the measurement of the real extent of offshore outsourcing and offshoring more difficult. Sass (2009) found the biggest gap (in some cases more than 30%) between the two types of statistics in the cases of Hungarian and Polish exports and imports.

<sup>7</sup> Sass (2009) explores several methodological problems related to the exact quantification of offshoring services, and stresses the difficulties in grouping those particular service categories which are affected by offshoring, partially because the NACE classification packs together offshorable and non-offshorable service categories.

<sup>8</sup> As Ghibutiu and Poladian (2008) pointed out, it is difficult to distinguish between offshorable and offshored service parts because not all service trade is related to offshoring, nor it is possible to distinguish between affiliated and unaffiliated trade, or differentiate between captive and independent providers.

<sup>9</sup> Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia. The share of NMS-6 in the total service export of NMS-10 is accounted for 85%.

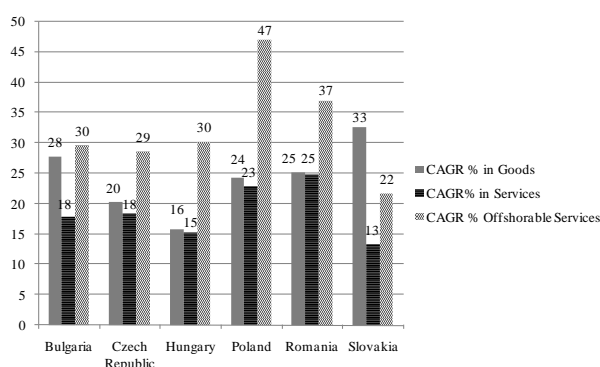
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When looking at the sectoral composition of service exports in comparison with West European countries, the still lower share of other services (including offshoring-sensitive business services) is striking and this means that the higher share of traditional branches of services (travel, transport) reflects the patterns of economic transition.

It is widely accepted that offshoring services means the global sourcing of business and IT services from abroad, therefore to find further evidence of offshoring related service development, export data on the so called “offshorable services”, namely on the other business and ICT services, can be collected for NMS-6 using the Eurostat database. The increased tradability of these sub-categories is more visible in the patterns of services trade and their export/sales intensity is the largest among services (Sass, 2009). The share of offshorable services within total service exports steadily grew from 16 per cent to 33% between 1997 and 2012. The total value of offshorable services in the NMS-6 was equal to 27.2 billion Euros in 2012 and within this aggregate, the overwhelming dominance of business services (78% on average) is striking. In absolute terms, Poland is the largest trader followed behind by Hungary and the Czech Republic (Figure 2).

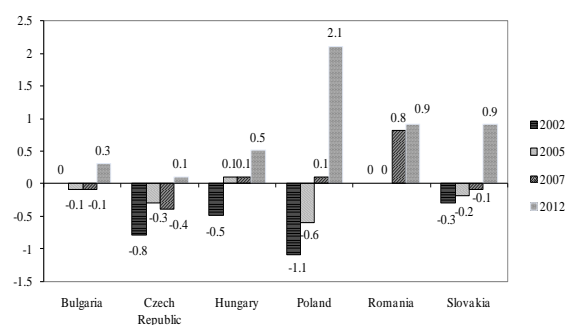
The export of services has grown significantly in the region. In comparison to 1996, in 2012, the level of services exports grew by four times in the Visegrad countries. Within the service sector, the growth rate of offshorable service export increased the most dynamically (by an average of 32% in comparison with 18% growth in services), while Poland and Romania experienced the highest growth between 2002 and 2012 (Figure 3). This could be explained by the rapid expansion of export oriented shared services centre within their countries.

Due to the rapid growth of offshorable service exports over the period of 2002-2012, in combination with the slower expansion of imports, the deficits decreased steadily and this resulted in the development of net trade gains amounting to 800 million Euros in 2007 and 4.8 Bn by 2012 in NMS-6. Hungary reached its export surplus by 2004, earlier than the other neighbouring countries. Poland reduced its trade deficits more rapidly, and turned into largest surplus, while Slovakia and Romania achieved a significant surplus by 2012 within the shortest period (Figure 4).



**Figure 3.** Average annual growth rates of different export sectors in NMS-6, between 2002 and 2012 (%)

Source: Author's calculation based on Eurostat BoP data



**Figure 4.** Net trade in offshorable services in the NMS-6 in 2012 versus 2002, 2005 and 2007 (EUR Bn)

Source: Author's calculation based on Eurostat and IMF BoP data

Summing up, service trade statistics are supportive of the preliminary assumption that offshoring generated expanding exports, even during crisis times in particular service categories and a large proportion of business services export in the NMS has been associated with offshoring. However, it is obvious that not all this kind of trade is provided by offshored services. These data do not show how much of the offshorable service exports are really provided by offshored service centres and do not distinguish between the different organisational forms of offshore outsourcing and captive offshoring at the same time.

### **EAST EUROPEAN BANGALORES? COMPARATIVE ADVANTAGES OF THE REGION**

Due to the methodological constraints, quantitative data alone are not suitable to reveal the complexity of offshoring services. Besides findings based on statistical data there are qualitative approaches to identify the main motives of companies relocating business and ICT service activities in the NMS and to define the comparative advantages of regions which arise from the combination of geographical, organisational and cultural proximity to Western Europe.

On the demand side, growth and new business strategic directions are encouraging more and more European companies to establish service centres in locations with strategic geographical position in the CEE region. Strategic locations provide a good accessibility to potential customers (in some cases to domestic markets) and also indicate the geographical direction of future market expansion of companies. Another driver is the rise of the global service delivery model, which creates a pool of global service centres around the world incorporating CEE as part of a global network (Gál, 2009).

These “closer to home or closer to expansion” strategies are applied when investors prefer the establishment of services-centres nearshore or close proximity to home country and to other company centres. Nearshoring means relocating service activities to a foreign, lower-wage country that is relatively close in distance and within the same continent or time zone<sup>10</sup> (Jahns et al., 2006; Bryson, 2007). Jensen et al. (2006) show that the importance of nearshoring in many cases overwrites cost considerations. Carmel and Abbott (2007) emphasize the importance of time zone and distance, which make the selection of service centre locations a very important issue. The importance of time zone differences is a function of the level of communication required for the project. The distance just like different time zones will also increase the costs of face-to-face interactions (Rao, 2004). Nevertheless, bigger time differences could offer an attractive alternative for global round clock operations. The preference for nearshoring partly explains the growing particular attraction of the NMS in business services offshoring/outsourcing.

Another important, but less emphasized driver of the relocation of services to CEE is the lack of the sufficient number of qualified labour in home countries. Marin (2010) examines the concentration of skill intensive activities at the east European affiliates of German and Austrian companies in order to research the labour market impact of offshoring. She found that indeed, the high-skilled jobs are moving to the east due to the scarcity of human capital in the sender (home) countries.

On the supply side, locational advantages determine which countries are chosen as hosts for new or relocated service centres. These advantages are similar to those of efficiency seeking investments. The most important of these is the availability of those resources of production that are used intensively in the production of the service in question at a lower cost. It also can be argued that the attractiveness of CEE is also based on talented, highly skilled labour and geography, rather than simply on low wages and a vast labour pool. Four groups of apparently important capabilities drive the nearshoring advantages of CEE.

First, these countries have close geographical, political and cultural ties with Western Europe. The advantages of EU membership not only diminished the external risks but dramatically simplified the administration cost, as well. CEE as a nearshoring location scores high marks because of its lower cost for communication between the customer and service provider. Nearshoring locations not only reduce costs and risks of working with distant foreign companies but also simplify personal contacts. Besides close proximity that may improve the efficiency of day-to-day information exchange to a service provider, nearshoring allows companies to facilitate control and smooth operation (Abott and Jones, 2002). Being in the same time zone is a huge advantage, especially, if projects require frequent

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<sup>10</sup> Some companies have special operation requirement within a time zone to provide 24 hours services for other than EMEA region (Fifekova and Hardy, 2010).

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travelling, and also CEE is particularly interesting for companies who require voice and customer-facing services in their mother languages<sup>11</sup> (Meyer, 2006).

Second, the comparative advantages of CEE still to a large extent lie in the wage differences as cost savings are still one of the most important reasons for offshoring. In CEE, labour costs are 40 to 60% lower than in Western Europe, although it varies largely within the region. Hungary, the Czech Republic and Poland have the highest average salaries while Romania and Slovakia have relatively lower average salary levels (ECONOMIST, 2005). Comparative advantages in wages between countries and regions can change relatively fast, although CEE will remain relatively cheap for the near future. However, CEE countries are not among the cheapest locations and cannot outpace those of the low-cost Asian countries. As costs in the most advanced CEE countries converge towards EU levels, companies are moving farther East in their search for high-skill and low-cost solutions (Russia, Ukraine, and Turkey). However, the recent depreciation of the local currencies as a consequence of financial crisis sustains the cost competitiveness of the region for a longer period. Besides labour costs, there are also relevant factors for the selection of service centres locations. Costs of infrastructure, operating costs and taxes were the most frequently mentioned factors by the interviewed companies (Fifekova and Hardy, 2010).

Third, much has been said about the quality of labour in the region, which consists of a highly educated, well-trained and motivated workforce, achieving a high degree of productivity and flexibility. Skilled labour, in many cases is coupled with the knowledge of certain foreign languages. However, the nature of the skill requirement of the activities has some subtle characteristics. CEE countries do not only have factor price advantages compared to more developed countries but also a 'knowledge advantage' in some submarkets compared to other lower priced countries in terms of the knowledge of 'smaller' languages and the supply of well-educated university graduates. In total, CEE produces a much lower number of university graduates than its large Asian counterparts. However, the CEE graduates turn out to be far more suitable to work for TNCs.<sup>12</sup> While the technical universities have maintained their quality standard, the share of science and engineering graduates is lower than the Indian or West European averages, which, in turn, diminishes the region's capability to specialise in IT or sciences-based service provision.

Fourth, other non-cost related factors should also be considered when choosing offshore locations. Good quality telecommunication infrastructure is also an important locational factor and the quality of this infrastructure is now high and can be used at reasonable prices in these countries. This is also true for office space. In order to ensure smooth functioning of the service plant, certain other services (e.g. financial, other business services) must be available. Moreover, a good legal and regulatory environment with effective enforcement is important. These conditions are now present in the required quality in those NMS countries where general levels of legal compliance are high. In some cases, protection of intellectual property is indispensable which lends a competitive edge to these countries over China or Russia. European Union membership also encourages high 'trust' in business relationships (Gál and Sass, 2009).

### **GEOGRAPHIES OF EMERGING OFFSHORING LOCATIONS IN CEE**

Offshoring can have benefits for the host market and generates changes within the service sector as a whole. The following section examines the implications of offshoring for the home markets in CEE, and in particular assesses its impact on their locations and on the urban network.

What is the most likely impact of services offshoring on the host economies? GDP growth of nations largely depends on service innovation. Offshoring is a major driver of shift towards services in

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<sup>11</sup> In Eastern Europe, the share of German speaking graduates can be as high as the number of English speaking ones (nearly 40% of schoolchildren learn German while 70% of them English). Romania is a particularly interesting destination for French companies as 85% of schoolchildren learn French there.

<sup>12</sup> According to the McKinsey survey (2005), job candidates from CEE had higher suitability rate (around 50% on average, whereas 80% in developed countries) across all occupations than their Asian or Latin American counterparts.

FDI. This gains a particular importance in the CEE countries after their EU accession as it helped to mitigate the fear of TNCs' outmigration in manufacturing and it substituted the decreasing share in manufacturing FDI by service investments. The relocation of service tasks results in additional export-oriented capacities in services and increased productivity, which may result in spillovers to the local economy, and thus accelerating growth and providing additional employment, higher wages and tax. FDI can spur local service providers to become more competitive through demonstration and skills diffusions, thus helping them improve efficiency and create their local brands in knowledge intensive business services. Offshoring enables the host countries to shift to higher value services (Sass, 2008; Micek et al., 2011).

Besides the general host market effect the process of selecting and opening new locations is similarly important as offshoring has a strong impact on the cities selected. As more firms recognize offshoring as a part of their longer-term strategies, other factors have to be taken into consideration. Location strategy making is a multi-faceted process, with different indicators coming into play as the focus is narrowed from macro-regions to countries, cities, district and finally individual property level. However, choosing a suitable location is not just a matter of selecting the right country. Nevertheless, companies searching for locations should first focus on defining their priorities in terms of countries (cost, skills, business environment, and proximity) before ranking their specific locations. Country versus city approach is heavily dependent on the selection criteria and equally important to distinguish between some county and city-centric parameters of location sourcing classified. Legal system and business environment are more or less the same for all the cities in a country, the availability of raw manpower, infrastructure and risk are moderately similar within a country, while availability of university graduates, labour and real estate costs and maturity of the ecosystem in a particular offshoring location can be very different within a country. Employment costs differ widely among cities because of limited labour mobility and varying unemployment rates. Companies need to spend time to scrutinise the attractiveness of cities. They must consider various elements of cost, not just salaries and the specific skill sets that each city can provide. Locations that meet requirements for resource availability, quality, operational flexibility and economics stand to become preferred destinations. In choosing a city, companies need to focus less on low wages and more on other ways that candidate cities can fulfil their business needs.

As far as the geographical distribution of the investments in business services is concerned, there is a strong spatial concentration in all the analysed countries. Capital cities are the main hosts to business services companies, and sometimes secondary centres emerged (Cracow, Brno). It is understandable that demand-led horizontal investments locate in the capital city where there is the highest demand for their services. For supply-driven vertical investments, the main attracting factor in capital cities is the large supply of suitable workers (Hardy et al., 2011).

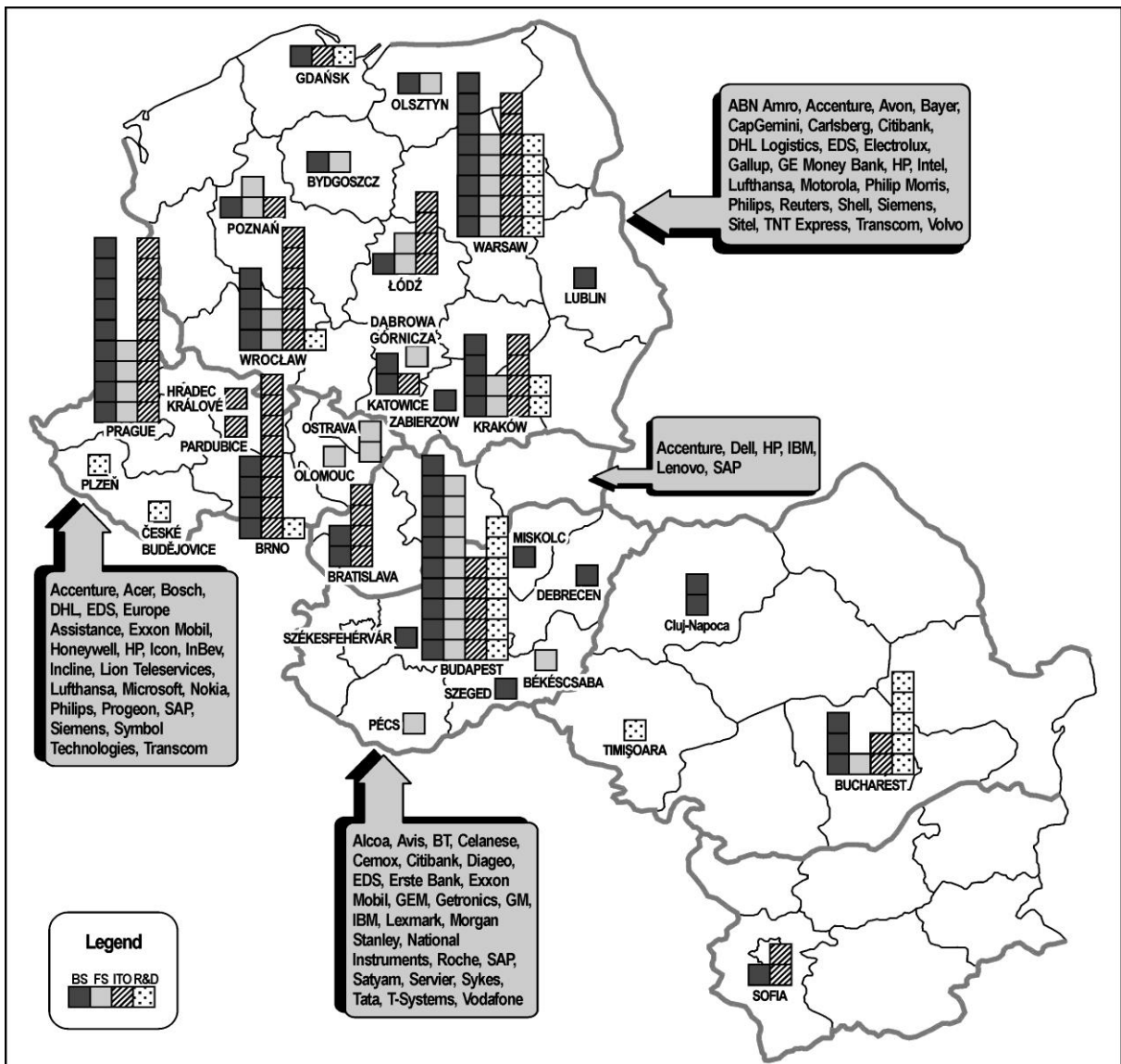
The metropolitan transformation accompanied by both the rapid deindustrialisation and expansion of services has resulted in the concentration of the high-level business and financial services into the capital cities (Lux, 2010). Simultaneously, interactions and symbiotic competition emerged between the capital cities, as they have been competing for attracting investments. EU accession, competitive infrastructure costs and strong education system as favourable preconditions supported the first group of capital cities, such as Prague, Budapest, and Warsaw in the first wave of the offshoring boom, recently followed by Bucharest and Sofia due to the saturation of the former capitals (Figure 5). These cities were the most successful in repositioning themselves during the early stages of transition by exploiting their comparative advantages on global market place. At the beginning, costs (labour cost, real estate prices and facilities) were the most important driver in selecting these locations mostly for routine offshoring activities. However, these capitals have relatively higher wages comparing to their Asian and Latin American counterparts, which, due to the EU accession, resulted in further growth in labour costs. Nevertheless, cost differential with Western Europe is still significant, making these cities still attractive for higher value added nearshore service activities.

The first wave of cities in the offshoring boom, including the first tier capital cities such as Warsaw, Prague and Budapest are saturating in terms of skilled labour and offices supply, to the point that raises the opportunity for the second tier cities to find alternative locations in the mid-sized



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provincial cities and to tap their unexploited talent pool, which has become an increasingly important operational consideration. Vertical investments have better propensity to locate in the countryside, especially if they cannot find suitable workers in the capital cities. Numerous cities, particularly in Poland, the Czech Republic and Romania, are emerging as new destinations for outsourcing. Poland, with the largest potential supply of skilled labour (with nearly half a million graduates annually) and the availability of untapped provincial locations, has developed the most extensive network of offshoring locations. Besides Warsaw, Wrocław, and Kraków, the already established hotspots, Łódź, Poznan, Katowice, and Gdansk are among the emerging ones. While second tier Polish cities have been attracting BPO investments from the late 1990s, BPO work has only recently found its way to the provincial locations in the Czech Republic. Brno and Ostrava succeeded to establish their own location brand even for core services.



**Figure 5.** Geographical and sectoral breakdown of the major services offshoring sites in Central and Eastern Europe, 2010

Legend: BS=business services; FS= financial services; ITO= Information Technology Outsourcing; R&D=Research and development, Knowledge process outsourcing; One box is equal with one offshoring site.  
Source: drawn by the author based on data of PAiiIZ, Czehinvest and ITD-Hungary

The spatial concentration is more pronounced in Hungary and Slovakia, where the capital cities, which are the main locations of this type of investments, represent a higher share of the total population than in Poland and the Czech Republic.

However, Hungary, once a forerunner in the establishment of shared service centres by opening its first location in 1999, has lost its leading position. Contrary to Poland, most of the projects have concentrated into the capital city of Budapest and governmental agency failed to channel most of new investments towards the mid-sized cities. While BPO investment has been selected by the Polish and Czech agencies as a priority, the Hungarian agency, however, received criticism concerning its marketing activity. As in other spheres of economic activity in Hungary, Budapest dominates the BPO and ITO sectors. Hungary has no suitable office market in its mid-sized cities. Companies do investigate provincial locations but invariably return to Budapest due to the lack of suitable offices.<sup>13</sup> Alternative options to the costly Budapest tend to be cross-border, such as Bucharest or even Kyiv rather than Miskolc, Pécs, or Debrecen. Most of the few provincial BPO locations are located nearby the eastern borders of Hungary taking the operators' intention for their future cross-border expansion and easier labour hire into account. More Vendors maintain operations in both the capital city and secondary cities in Hungary. Budapest is leveraged for higher-value work, while lower level processing is accomplished in secondary locations that offer much lower costs and extremely lower attrition sites.

Cities with the right combination of location factors will be the winners in the future waves of services investment into CEE. The challenge for individual cities will be to build their attractiveness and competitiveness by investing into their ITC infrastructure, education, and business environment.

## CONCLUSION

Relocation of business service activities has been a stimulus to develop CEE as an important destination for resources seeking services investment. New member states invigorated by EU enlargement became important locations for shared service centres. The growth of vertical investments in the service sector results in increased exports in services. Trade statistics support the assumption that an expanding export in other business and ICT services has been associated with offshoring services in the NMS. The service export data give a good approximation to identify those sections of service trade that can be regarded as offshorable.

Notwithstanding the various data problems and statistical shortcomings, which hinder the measurement of the real extent of offshoring and offshore outsourcing processes in services, the calculations based on BoP trade data largely support the assumption that an expanding export in other business and ICT services has been associated with services offshoring processes in NMS. The improving net trade position of NMS in offshorable services has moved from deficits to growing surpluses also illustrated in the shift towards the higher value added services. Determining the actual extent and patterns of service sector investment requires a combination of quantitative and qualitative research. The latter must be carried out in the forms of company level investigation, in-depth company interviews and questionnaires.

Offshoring services have not only generated trade in services but also impinge on the positive effects on the dynamic growth of higher value-added 'offshorable services'. Building on the region's nearshoring advantages such as geographical-cultural proximity and on its multilingual graduate supply, CEE is likely to utilise more value added and quality-driven services.

Despite the fact that the service industry is the most promising opportunity for the CEE economies, there are few threats concerning the region's future prospects as a major offshoring hub. It is not just the steadily raising costs. On the corporate side, local providers in CEE failed to establish their global presence on the map and they are more attached to the local market instead of seeking out the global market. Another problem is the bureaucratic environment and the lack of assessment of

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<sup>13</sup> Deloitte's Global location Survey examined Hungary's untapped offshoring locations and selected 5 provincial cities (Debrecen, Kecskemét, Pécs, Székesfehérvár, and Szeged) which should be considered as so-called "under the radar" locations offering an attractive cost/quality ratio that can stand comparison with Budapest.

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direct consequences of financial crisis. However, the pressure to stay competitive is forcing both the companies and the host countries to exploit the further advantages of services offshoring and outsourcing. The impact of the crisis has been less severe for the offshore services industry as it forced providers to increase both efficiency and competitiveness of their services. The sector has demonstrated market resilience in the NMS. However, increased growth and consolidation will drive expansion to new eastwards locations, creating further competition for the NMS.

The steady growth of service exports during the last decade and the changing composition of service trade in favour of the higher value added activities have exerted a positive impact not only on companies' productivity but also on the host countries' economic performance. Services offshoring also generates increased pressures on the NMS to adjust their economies and manage the challenges raised by the rapidly changing global offshoring landscape by continuous upgrading of their comparative advantages.

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