

# Foreign Direct Investments and Relocations in Business Services – What are the Locational Factors? The Case of Hungary

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## Resumen

Hungría se ha convertido en receptora de diversos servicios comerciales a través de deslocalizaciones de actividades desde otros lugares de mayor costo, especialmente de Europa occidental, mediante el desarrollo de nuevas capacidades. Las ventajas de localización determinan qué países son elegidos como destinos de los centros de servicios nuevos o relocalizados. En el caso de Hungría, el análisis se realiza sobre la base de ocho estudios de casos empresariales detallados (este número se espera que aumente a diez). La mayoría de ellos representan supuestos de inversión extranjera directa vertical (cerca de un 100% del ratio exportaciones / ventas) y dos empresas representan un caso de inversión extranjera directa vertical y horizontal (orientada al mercado doméstico), donde las ventas al mercado interno son también importantes, aunque no dominantes. El principal objetivo de este trabajo es un intento de contribuir a llenar algunas lagunas en la literatura, en términos de análisis de las ventajas de localización para la IED vertical en los servicios, específicamente en los servicios empresariales. Esto demuestra que las ventajas de localización respecto a la IED vertical y horizontal, difieren entre sí en gran medida. Se identifican los distintos elementos de las ventajas de localización en relación a los diferentes elementos que motivan la inversión, en términos de reducción de costes, reducción de los costes de desintegración de la producción, la reducción de otros gastos, y los motivos derivados de la confluencia de la IED vertical y horizontal, relacionando estos elementos con las especificidades del sector de servicios empresariales.

**Palabras clave:** Subcontratación en el exterior, servicios empresariales, ventajas de localización, Hungría, Europa Central y del Este.

## Abstract

Hungary became host to various business services through relocations of these activities from other, higher cost locations, especially from Western Europe and through opening up new capacities. Locational advantages determine which countries are chosen as hosts to new or relocated service centres. For the case of Hungary, the analysis is carried out on the basis of eight detailed company case studies (this number is expected to increase to ten). The majority of these is vertical FDI (close to 100 % of export/sales ratio), and two companies represent a confluential case of vertical and horizontal (domestic market oriented) FDI, where sales to the domestic market are also important, though not dominating. The paper's main aim is to make an attempt at contributing to filling some gaps in the literature, in terms of analysing locational advantages for vertical FDI in services, specifically in business services. It shows that locational advantages, taken into consideration by vertical and horizontal FDI differ from each other to a great extent. It identifies the various elements of locational advantages connected to the different elements of investment motives, in terms of cost reduction, reducing costs of disintegration of production, reducing other costs, and motives arising from the confluence of vertical and horizontal FDI, and the paper relates these elements to the specificities of the business services sector.

**Key words:** offshore outsourcing, business services, locational advantages, Hungary, East Central Europe.

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# 1. Introduction

East Central Europe, and inside it, Hungary are locations, where especially starting from 2000, more and more independent business services firms set up their operations and many big multinational firms concentrated their regional, European or even global service centre there<sup>1</sup>. For example, in Hungary examples include for the first group EDS, SAP, GenPact, Diageo and IBM. As for the second group, among others, Alcoa, Vodafone, Exxon Mobil, Avis, Cemex, GE, InBev, Morgan Stanley, Celanese, Lexmark, British Telecom, Vodafone relocated certain regional, European or even global service functions to Hungary. Not only the number of projects grew significantly, but there were also some very big projects involved, employing thousands of new employees in their newly opened sites. (See e.g. Gál (2007), Sass (2008a) or Sass (2008b)) In many cases, these service functions are relocated, transferred from other, usually Western European locations, causing white collar job losses there. This is one reason why these movements figure highly in the (Western) media.

Offshore outsourcing and offshoring of service activities is not a new phenomenon. (Metters, Verma, 2007) After and parallel to outsourcing/offshoring the low and medium skilled production processes in manufacturing, starting mainly from the nineties, the offshoring and offshore outsourcing of certain production processes of specific services from developed to other developed or emerging/developing countries has started to become more and more widespread (UNCTAD, 2004). The process has been induced by technological development – in many various ways. As a result of technology developments, the fragmentation, division, standardisation, algorithmisation of services processes, evaluation of certain service process elements, digitalisation, coding of information were made possible. This is similar to the fragmentation process in manufacturing, but on the basis of available evidence, the fragmentation can go deeper in services processes. After such fragmentation, certain service processes can be separated and they can be carried out in locations where it is cheaper, more efficient, or where it provides better quality. As a result, certain services are traded, even internationally. Information and commu-

nication technologies made tradeable mainly services dealing with information. It is now possible to produce certain services in far away locations and consume them in another far away location at the same time, or even at different times (UNCTAD, 2004). ICT developments also allowed reducing the response time (Metters, Verma, 2007). New goods appeared which acted as “mediators” (e.g. CDs, software) in services trade (Lindner et al., 2001). The outsourcing of services has also been helped by the ongoing uni-, bi- and multilateral liberalisation process of services trade, even if the level of liberalisation does not reach that of manufacturing goods (UNCTAD, 2004). “Unilateral” changes in relevant governmental regulations and incentives, with the aim of proactively attracting offshore business services, also played a role. This can be traced in investments in telecommunications infrastructure, and in more and more countries offering tax allowances for such types of activities etc. (Metters, Verma, 2007). Increased presence of global networks also contributed to the process (Netland, Alfnes, 2007; Dicken, 2003). Other specific factors, such as e.g. the acceptance of English as *lingua franca*, general institutional compatibility and adaptability, simpler logistics in services compared to manufacturing also played a role in the quick advancement of the process (Bardhan and Kroll, 2003).

The services functions affected include such a heterogeneous group of activities as various IT services, legal, finance, accounting, marketing services, a range of R&D processes, certain medical and cultural services etc. Table 1 shows the categories used in describing these processes. In this paper we concentrate on captive offshoring and offshore outsourcing. 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 of the firm in a foreign location (captive offshoring) or to an independent firm in a foreign location (offshore outsourcing). Business process outsourcing describes a relationship between a vendor and a client, where the vendor performs an entire business service function for the client (This definition is based on Chakrabarty (2006) p. 35). Relocation is perceived as a process, in which either there is a transfer of production capacities from another country, or there is a

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<sup>1</sup> In this paper these are called captive centers.

capacity extension in one affiliate parallel with a capacity reduction in another, or there is a capacity extension in one affiliate, while other affiliates' capacities do not change (this definition of relocation is in line with Veugelers, 2005). Thus the two processes (offshoring and relocation) are interconnected to a great extent. Relocation happens when companies move part of their production processes and/or service functions to a subsidiary in a cheaper location. The term is usually used in the sense of international relocation and in this respect it means the same as offshoring. The term offshoring has recently been applied mainly to the offshore outsourcing of ICT and ICT-enabled business support services. Relocation is a way of reducing costs thus increasing competitiveness by splitting production and services between locations. Comparative advantages of several countries are combined. Relocation implies that jobs, products and services are moved from the home to the host country. The company terminates the production of some goods or components in the home country and imports it from a foreign subsidiary. It generates FDI and international trade. The relocation is identified as efficiency seeking or vertically integrated FDI, as opposed to market seeking or horizontally integrated FDI (Hunya, Sass, 2005).

**Table 1. Categories used in the analysis.**

Location of production	Internalised (to the firm)	Externalised (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

As far as the geographical dimension of the phenomenon is concerned, the process of services outsourcing started in the US, then other Anglo-Saxon countries (first of all Great-Britain) joined in. While certain activities started to be outsourced as early as in the fifties, the process itself quickened up and began to be widespread only in the nineties (Metters, Verma, 2007). Countries (or rather companies) of continental Europe followed these two countries later, and they are in the process of catching up with the first movers. This can be explained not only by a slower reaction, different culture of continental European companies or higher obstacles to offshoring and outsour-

ing, but also by the language barriers existing for "smaller" European languages<sup>2</sup>. Moreover, in many cases they prefer nearshoring, i.e. keeping the relocated functions close to the original site<sup>3</sup>. On the receiving end, as "mirroring" home countries and reflecting the dominance of the English language, Anglo-Saxon culture and other common elements (e.g. the common law structure (Bardhan, Kroll, 2003, p. 3)) – Ireland, India, Canada and Israel are the most important destinations (UNCTAD, 2004). In Europe, traditionally, Ireland is the most important host country, but other "old" EU-member countries also have a relatively high market share (first of all Great-Britain, Portugal and Spain are important host countries) (UNCTAD, 2004).

All in all, the overwhelming majority of services offshore outsourcing and captive offshoring is still realised between developed countries, though certain emerging economies, especially India are becoming important players. The role of the new member states of the European Union becomes more and more important; however, their market shares are still very small. Because of methodological problems, it is not easy to prove this statement. Statistical data on services foreign trade, foreign direct investments or jobs can not be used to describe international developments and characteristics of the process (Sass, 2009). Estimations, which are available are usually prepared by industry experts or consultancy firms and are based on company surveys and interviews (Kirkegaard, 2005). According to the data of UNCTAD (2004), one third of the services outsourcing projects of European multinational companies went to India, Western European countries (Ireland, Portugal, Spain and Great-Britain) had a 29 per cent share, and 22 per cent of the projects went to East-Central and Eastern Europe, mainly to Hungary, Poland and Romania. Because larger projects go to India, this country's share can be close to 50 per cent in terms of market share. According to McKinsey & Company, the share

<sup>2</sup> Jensen et al. (2006) show the impeding role of the Danish language for offshoring certain service functions. Company interviews in Hungary also underlined the role of language barriers for offshoring and offshore outsourcing, especially for smaller European languages, though French and Spanish speakers are also not abundant in the East Central European region.

<sup>3</sup> Hollinshead (2008) also underlines the importance of nearshoring. Jensen et al. (2006) show that cost considerations are in many cases overwritten by the importance of "nearshoring", thus for Danish companies Sweden, the United Kingdom and Germany are important offshoring partners. The preference for nearshoring explains partly the emergence of the East Central European region in the BPO process.



of the East-Central European region from global business services was as low as 1 per cent in 2005. Thus, the region is left behind the leading Asian countries, but the later start of European companies indicates that the process is only about to take off for the East Central European region. According to the survey conducted by IBM and Oxford Intelligence, East-Central Europe – besides Ireland – is already the location of pan-European service centres, i.e. companies in Continental Europe are supplied from here. Altogether, the role of East Central Europe is growing, though it is not as big as one could expect on the basis of the information presented by the (Western) media.

Hungary has been one of the leading locations in attracting business services projects in the East Central European region. Services centres appeared already during the nineties, partly because Hungary opened up its economy to foreign direct investments the earliest in the region. Affiliates operating in the country provided the demand for business services, which in itself attracted such projects. Moreover, as an attracting factor, relevantly skilled labour with competitive wages, the legal and physical (especially ICT) infrastructure and office space have been available in the required quality and quantity. The number of such centres can be around 50 at present and the number of jobs created around 20 thousand, according to 2008 data, this represents more than 0.5 per cent of total employment and almost 1 per cent of services employment in Hungary (own calculation on the basis of company interviews and data of the Hungarian Central Statistical Office).

Both the international literature and the Hungarian literature are quite scarce concerning the locational advantages attracting business services offshore outsourcing and offshoring projects. In Hungary, the few existing papers describe the main processes, based mainly on the analysis of available statistical data or using information published by consultancy firms. These papers agree on the increasing importance of this kind of services in the Hungarian economy and the role of FDI in it (See e.g. Hamar, 2005; Bajmócy, 2007, Gál, 2009 or Sass, 2008a). Hamar (2005) also calls the attention to the problems of measurability and lack of data, which limits our knowledge about the sector.

There are many definition, data and methodological problems in analysing the characteristics of offshoring and offshore outsourcing of business services (see e.g. Sass, 2009 or for services overall: Francois and Hoekman, 2009). Experts examining these data problems in detail suggest that the best approach in this field is to supplement existing quantitative analysis with more qualitative examinations and to combine quantitative and qualitative research (Sturgeon et al., 2006). This instruction is basically followed in this paper as well: statistical data are used to provide some insights into the extent of this kind of services in the Hungarian host economy. Further analysis of the locational factors affecting this type of activities is based on company interviews, which were carried out using a semi structured questionnaire. Managers of eight companies were interviewed, of which four are independent service providers and four are captive centres. All of them had an element of relocation: activities either partly or fully were relocated from another foreign location. These eight companies represent about one fourth of total employment in the computer related and business services sector connected to captive offshoring and offshore outsourcing in Hungary, which rests upon the fact that the two biggest companies are involved. These eight company case studies do not provide a sufficient basis for making unchallengeable conclusions about the locational factors considered by offshored and offshore outsourced business services FDI in Hungary, however, in some respects, given the uniformity of the companies interviewed, certain common characteristics of this kind of projects are reinforced.

### **1.1 BUSINESS PROCESS OFFSHORE OUTSOURCING IN HUNGARY**

The relatively short period, for which comparable data are available from the Eurostat, hinders deeper analysis<sup>4</sup>. However, one can see that

- Trade in services grew rapidly in Hungary, according to the balance of payments data.
- Hungary registers a significantly positive balance and growing surpluses in trade in services,

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<sup>4</sup> More details see in Sass (2008).

- Its share in total inside EU-25 and EU-27 services trade is growing.
- Its services trade is significantly more oriented towards EU-25 and EU-27 than the EU-25 and EU-27 average.
- As for the big service categories (transportation, travel and other services), the share of other services grew considerably;
- Inside the “other services” group, the share of “Other business services” is the highest, and this share grew a few percentage points between 2004 and 2006;
- Inside the “Other business services” category, the highest (and growing) share is taken by Legal, accounting, management and public relations services.

The following table contains a selected list of companies in the sector present in Hungary. Besides well-known multinationals, there are certain independent service providers (e.g. EDS, Getronics, Diageo), who are also present in Hungary with relatively large plants.

**Table 2. Service centres receiving financial incentives in Hungary**

Company	Home country	Location in Hungary	Number of jobs (actual or planned)
ExxonMobil	USA	Budapest	1200
IBM ISSC	USA	Budapest	1300
Diageo	United Kingdom	Budapest	600
Getronics	Netherlands	Budapest	510
Jabil	USA	Szombathely	719
SAP	Germany	Budapest	600
Tata	India	Budapest	450
Convergys	USA	Budapest	282
EDS	USA	Budapest, Szeged	1150
InBev	Belgium	Budapest	380
Budapest Bank	USA	Békéscsaba	530
Morgan Stanley	United Kingdom	Budapest	450

Citigroup	USA	Budapest	302
Vodafone	United Kingdom	Budapest	746
British Telecom	United Kingdom	Budapest, Debrecen	700
Celanese	USA	Budapest	200
T-Systems	Germany	Budapest, Debrecen	1750

Source: ITDH

## 2. Locational advantages

### 2.1 WHAT DOES THE THEORY TELL US?

Locational advantages determine which countries are chosen as hosts to new or relocated service centres, in accordance with the theories of Dunning and Porter (see e.g. Dunning, 1993). Locational advantages for this kind of activities are similar to those of efficiency seeking investments: the availability of those factors of production at a lower cost that are used intensively in the production of the service in question and exploiting the economies of specialisation and scale (Dunning, 1993, p. 144). However, to find out further details about locational advantages, it is important to differentiate between the locational factors of two distinct types of MNCs: those of horizontal and vertical MNCs. While services FDI was dominated by horizontal MNCs for a long period of time (Caves, 2007, p. 13), at present, due to the fragmentability of services production processes, which was made possible by technological innovations (UNCTAD, 2004), vertical type FDI has been appearing in services as well. Moreover, the overwhelming majority of the firms analysed in this study is of that nature, given their high export orientation and servicing of foreign markets. There are only two firms in the Hungarian sample, where the share of sales to the domestic market is significant. All the other affiliates in the sample sell their products almost exclusively to foreign entities: either the parent company or other related affiliates, or other independent companies.

Locational advantages, taken into consideration by vertical and horizontal FDI differ from each other to a great extent (Caves, 2007; Barba-Navaretti, Venables, 2004)<sup>5</sup>. For vertical

<sup>5</sup> Not differentiating between horizontal and vertical FDI results in an incomprehensive set of locational factors, e.g. investors preferring high wages (resulting in high domestic disposable income and thus high demand for their products) and at the same time low wages (supplying the investors with a cheap factor of production).

FDI the most important motive of investing abroad is reducing costs due to economizing on the money spent on the factor of production, which is used the most intensively by the given activity. Elements of this cost reduction are the most important: price of that factor of production, i.e. wages of relevantly skilled labour and other measures reducing their costs of production. This latter means that this type of FDI is more sensitive to tax differentials and FDI incentives (Caves, 2007, p. 236). Basically, supply-side factors are essential. Moreover, vertical FDI faces a major cost due to the disintegration of production (Barba-Navaretti, Venables, 2004). Factors influencing the disintegration cost are also important when taking the decision about the investment. Thus, costs connected to the transportation of the outputs of the fragmented production also matter, e.g. trade costs and the host country's general policy towards openness to trade (Haveman and Schatz, 2004). Other elements of the business environment, which help the company functioning smoothly, are common elements with the locational factors of horizontal FDI (For example, political stability, regulatory environment, rule of law, infrastructure etc.). On the other hand, demand side factors, e.g. the size and the dynamism of the domestic market, are not important for vertical FDI. However, because in reality, these two types of FDI can be confluent, elements of the locational advantages attributable to horizontal FDI can also be present, especially in cases where sales on the domestic market are significant.

Another set of locational factors can be deduced from the specificities of the sector. They need relevantly skilled labour, in many cases together with the knowledge of certain languages, though the skill requirement of the activities varies to a great extent. Because the products need to be transported to the place where they are consumed, and in this sector this is made mainly through the internet, telephone, fax etc., good quality telecommunication infrastructure (especially broadband) is an important locational factor. In order to ensure smooth functioning of the service plant, certain other services (e.g. financial, other business services, community services) must be available. Moreover, good legal and regulatory environment (with effective enforcement) is important (in some cases protection of intellectual property is indispensable due to the nature of the products). The service activity is carried out in offices, thus availability of sufficiently big and relevantly equipped office

spaces at competitive prices is also important. Geographical proximity is an advantage in some cases, together with the coincidence of time zones with the market served (Though for certain activities different time zone is required.).

**Table 3. Main locational advantages for business services FDI**

Motive	Elements in business process outsourcing
Cost reduction due to lower factor costs	Lower wages (ULC) of relevantly skilled labour
Reducing costs of disintegration of production	Transport costs (infrastructure, esp. telecom, geographical proximity in cases where regular personal contacts are required) Trade costs (trade barriers, institutional openness, economic integration etc.)
Cost reduction: other costs	Incentives Economies of scale Costs connected to office space, to IP protection, to other elements of infrastructure Labour market regulations Cultural proximity
Cost reduction: due to the "smoother" functioning of the affiliate	Stability of the economic and political environment
Other motives (partly from confluence with horizontal FDI)	Together with factors affecting the "smoother" functioning of the affiliate, demand side factors (e.g. size and dynamism of local market)

Source: own compilation

Motives can be "deviated" from the above lists by

- activities, characteristics of the investment (e.g. physical activities involved; knowledge of certain languages; specific skills)
- company type (captive or independent: independent may be more cost sensitive, than captive, where there is a possibility for cross-financing activities, and where there may be a longer "moratorium period" for the affiliate to become profitable)
- the size/geographical position of the market served, and connected to that:

- geographical orientation of the centre (global, regional, local, where e.g. transport and trade costs to that relation may differ).
- size of the company (bigger companies may be less cost sensitive on a shorter run).
- nationality of the investor (home country characteristics e.g. in determining the inclination of the company towards offshoring and offshore outsourcing of business services; different business culture and decision taking processes)

Locational factors determine where a new or relocated investment is realised. However, the decision making process of a company concerning an investment/relocation comprises more steps. When a company decides about a foreign investment, first they compile the list of the potential locations, which may contain up to 20 countries. These can be grouped into three categories: 1) the most popular investment destinations of the world, 2) countries close to already operating foreign affiliates of the company, and 3) “emerging” investment host countries. This longer list is then reduced to a shorter one with approximately 5 countries, after taking into account various costs and characteristics of the business environment. These remaining countries are then visited personally by the responsible managers of the company. They may visit more than one site inside a country. Before the final decision about the site is taken, they compare costs, elements of the business environment, and investment incentives (Harding, Smarzynska-Javorcik, 2007). Investment decisions are taken at least one to two years before the actual investment is realised, though longer periods between the investment decision and the realisation of it are also possible.

## **2.2 LOCATIONAL FACTORS: WHICH ARE THE MOST IMPORTANT IN PRACTICE?**

The analysed country became a major destination for FDI connected to business process outsourcing, for both captive and independent service providers. It hosts mainly regional and European centres, but there are some global centres present as well. Among the companies interviewed in Hungary, there are five global centres. Some companies comprise numerous units, among which there are global centres,

regional centres (for bigger or smaller regions, e.g. EMEA region, European region or East Central European region), and there are units, which serve only the local market. These latter are very infrequent in the Hungarian sample, there is only one of this type of units inside one company comprising several units. This indicates that the analysed countries and among them Hungary, contain those locational advantages, which are important for FDI realised in the business services sector.

According to Table 5, companies in the Hungarian sample were all concerned with cost reduction, which can be realised through locating to a site where costs of relevant labour (skilled, language speaking) are significantly lower. The activities carried out by these centres determine, what kind of skills are sought for.

This reinforces the predictions of the theory concerning the most important locational advantages from the point of view of vertical FDI. East Central European countries, and among them Hungary, have the relative factor price advantages in that respect compared to more developed countries. They also have a “knowledge advantage” compared to other lower priced countries in terms of the knowledge of “smaller” languages and a good supply of university graduates in the required fields. As it is obvious, language requirements vary considerably, but usually English and other European languages are preferred, which underlines the market orientation of these companies. According to the opinions of the interviewed managers, Hungary has the tradition of a relatively good education system, especially in certain fields, e.g. in mathematics, engineering, computer related activities, and it is not outstanding, but provide a relatively good education in economics, accounting etc. All in all, wages were mentioned in seven of the eight interviews, skills in six and knowledge of languages (usually other than English) by five.

**Table 4 Activities carried out in the companies interviewed in Hungary**

Back office	Customer contact	Common corporate functions	Knowledge services and decision analysis	Research and development
Transaction processing	Call centres	HR	Program and project management	Software development
Document management		Accounting	Financial program management	
Data entry		Administrative	Integration engineering	
Data processing		Financial services	Supply chain management	
		IT call centres and other IT services	Analytical accounting services Business performance analysis Cost analysis	

Source: own compilation based on company interviews

The countries of the region all have geographical and cultural proximity to Western European and/or Anglo-Saxon markets, which the main markets are served by these centres. Their cultural proximity makes them a unique place for Western European (and to some extent for North American) investors in the sector. Their geographical proximity to the served region (and/or to the home country of the investor) is important, when frequent personal contacts and visits are required. In some cases, the served region includes South European, African and Middle Eastern markets, the relative geographical proximity to which is also an advantage of the countries of the region, and inside them of Hungary. Three of the eight interviewed managers gave a high mark to this factor.

A relatively frequent mention was made of the relatively stable political and economic environment. In international comparison, in the region, and inside it in Hungary, the regulatory environment is fine, some elements are outstandingly good. The rule of law is relatively strong. EU-membership can provide a good “trust” basis, which can be backed by the fact that with the advent of their EU-membership, Bulgaria, and especially Romania started to attract this kind of projects in great numbers. Five of the eight interviewed managers “appreciated” the relative economic and

political stability in Hungary.

Correspondingly to the list compiled on the basis of the theoretical approaches to locational advantages, the fact that relevant infrastructure, especially IT is available in relatively good quality and at reasonable prices, as well as office space, was underlined by four managers. One of them mentioned also the availability of office space as a factor determining their choice of location.

The above opinions, expressed in the interviews are subjective, and they were not influenced by giving a list of possible factors. However, their correspondence with the original list of locational factors influencing the investment decisions of vertical FDI provides us with some insight into the relative importance of these factors.

After compiling a longer list and then a shorter list of possible locations, it is important to see, what those factors are, which determine the final choice of the site of the investment i.e. reducing the short list to one item. The last column of Table 5 gives information on that. The countries of the region (especially the Czech Republic, Hungary and Slovakia, but to a certain extent even Poland) are considered to be more or less identical, or very similar in those characteristics which may act as

### **Box 1. Celanese Magyarország Kft.'s choice of location**

Celanese is a US corporation. It produces chemical products, found in consumer and industrial applications, and which are manufactured in North America, Europe and Asia. It is a leading global producer of certain chemical products. It established a Finance and Accounting Shared Service Center in Budapest. The Center was launched in September 2007, and supports certain financial operations for the USA, Mexico and Western Europe. This is a real global centre, serving in some respects Asia and other continents as well.

In transferring and concentrating the service functions to Budapest, cost motives were important together with other motives, such as reaching scale economies by concentrating these activities into one place, control processes and risks, standardisation and mitigating risks.

When choosing the location for the new shared service centre, the company first of all considered the company headquarter in the US (Dallas, Texas). Second, Germany was considered, because there are significant operating capacities. However, gross wages were at least four times higher in these locations, than in Central and Eastern Europe, while quality differences were minimal. So relative cost considerations overwrote the list, and Central European countries became the main targets of locational choice. In this region, the following cities were on the list: Cracow, Vilnius, Prague, Bratislava, Bucharest, Budapest and Warsaw, which were all visited in person by a representative of the company. On the final list, only Prague, Bratislava and Budapest remained.

At the end, Budapest became a clear favourite. The reasons for this were the following:

1. the number of students available for that type of work,
2. the level of infrastructure, especially IT,
3. "small" languages (e.g. Chinese, Spanish) spoken and many languages available,
4. the role of ITDH, however, concerning this latter, the picture was more mixed: there were problems with processing government subsidies: it was very slow and bureaucratic; and another problem, which emerged later: ITDH did not give a correct picture about the tax situation (e.g. training costs or taxes on meals), and about hidden costs: e.g. district/local tax; and a third problem: mixed impression about follow-up in terms of helping established companies.

Source: interview with the managing director of the company.

locational advantages for FDI in business services. For example, ULC and other elements of human capital, measures of labour market tightness, the level of development of the relevant elements of the infrastructure, relative

(effective) taxes are very similar in the four Visegrad countries. However, the research made by the investing companies (or by a commissioned institute or agent) revealed significant differences among them, which were of vital importance in the decision taking process. From the point of view of Hungary, which is considered to be the least good in languages, four companies indicated that fresh university graduates were the best in language knowledge in this country according to their results. One of them attributed that to Hungarian minorities living in the neighbouring countries. Besides English, companies mentioned German and smaller European languages, which were readily available in Hungary (however, this was partly due to native speakers living in Hungary.). Four companies found that the price-quality ratio of skilled labour was the best in Hungary.

Also four companies were influenced significantly in their choice by the good experience with the country based on performance of their affiliates already functioning there. This success in attracting further investments may also be due to instant lobbying of the local affiliate. Because in almost all interviewed companies the change to local managers is an explicit aim, these predominantly local managers understandably want to widen their capacities, strengthen their roles in the company. Moreover, agglomeration effects seem to be at work when choosing a location inside a region (Caves, 2007, 63-65). This latter can also play a role in choosing an already known site.

Three companies found the level of the infrastructure, the most relevant from the point of view of their activities being the highest in Hungary. In order to evaluate this, it is important to note, that all these three companies are located in the capital, in Budapest.

**Table 5. The main characteristics of companies interviewed and their preferred locational advantages**

Company	Captive (C) or independent (I)	Centre type and market served	Nationality of the parent company	General motives (of compiling the long list)	Geographical region considered for the investment	Motives of choosing from the short list
1	I	Global, in some functions European centre	North America	-inside Europe -labour costs -skills -language knowledge -geographical proximity to main markets -predictable business and legal environment -harmonisation with EU laws	Only inside Europe	-minorities in neighbouring countries -German language spoken -dynamic affiliate -no incentive until late, then minimal
2	C	Global centre	North America	-labour and other costs -economies of scale and risk reduction by centralisation - skills - infrastructure (IT) -small languages	1. US 2. Germany 3. CEE Inside CEE: Cracow, Vilnius, Prague, Bratislava, Bucharest, Budapest Final 3: Prague, Bratislava, Budapest	-price/quality ratio of relevant labour -level of infrastructure related to costs -incentives: mixed "feelings", later
3	C	European centre	North America	-labour force (skills, languages, costs, availability) -political stability -infrastructure -the possibility of changing to local management	Europe: Austria, France, Germany, Spain, and CEE Inside CEE: Brno, Warsaw, Budapest	-languages -skills -infrastructure -no incentive at all
4	I (formerly C)	European centre	Asia	-costs: wages -business environment -languages (small and big European languages)	CEE	Strongest presence in Hungary (other affiliates)

5	I	In some functions global, in others European, in others CEE region, in others local	North America	-best cost/value relationship esp. for skilled labour -specific skills: IT (good supplies) -culture -political and economic stability	CEE	-better knowledge of languages -Hungary was considered to be the regional centre
6	C	EMEA region centre	North America	-cost reduction: main elements: wages, infrastructure (telecom), office space, together with quality	CEE for EMEA region Short list: Cluj, Brno, Gdansk, Budapest	Budapest: best balance between quality and cost
7	I	In one function global, in others regional centre	Europe	-availability of a team of highly skilled people (less cost sensitive in some segments) -good business environment	Short list: Prague and Budapest	-better skills in specific segments -availability of labour -incentives
8	C	Global centre	Europe	-costs: wages of skilled labour -languages: high level English -geographical proximity -infrastructure	CEE, short list: Visegrad countries, Moscow, Romania	-workforce, -English language -good geographical position, good experiences with other affiliates -incentives: received after the investment decision was taken

Source: own compilation based on company interviews

Effective taxes strongly impact upon the location of FDI (Hassett and Hubbard (1997), Clark (2000), or Taylor (2000)), and fiscal incentives may play a role in influencing the effective tax rate. Financial incentives may impact upon the costs associated with the investment, and thus they can be important for vertical FDI. In the sample, however, incentives played a minor role in the investment decision. Four of the eight companies received any type of incentives (usually financial ones connected to job creation), however, none of them received them automatically: they have to apply for them, and the outcome is not

guaranteed. One of them even complained about the very bureaucratic nature of getting any support. Basically all of them received incentives (if any) only after the decision about the investment was taken. Moreover, in the given framework of financial support for job creation, the amount of grants is quite small. This is true, in spite of the fact, that the analysed countries, and among them in Hungary, attracting regional headquarters, service centres is one of the most important targets of investment agencies. Incentives offered to this type of projects are relatively generous, though their generosity does not differ to a great ex-



tent among the countries in the region. Moreover, projects deemed to have strategic importance can receive additional “tailor-made” support from the respective government in the analysed countries. However, among the interviewed companies there were no beneficiaries of such “tailor-made” incentives.

### 3. Conclusion

With technological advancements, especially in the field of communication technologies, fragmentation in services has been made possible. This induced a process of relocation of certain services activities to locations where they can be carried out at lower costs and/or in better quality and opening up new plants due to increased demand for these services. Due to that process, and to the liberalisation of services trade, especially among member-countries of regional integrations, new countries have been increasingly appearing on the map of trade in services. Among others, Hungary is affected in that process to a great extent. It has become host to various business services through relocations of these activities from other, higher cost locations, especially from Western Europe.

Locational advantages determine which countries are chosen as hosts to new or relocated service centres. To find out further details about locational advantages for this type of activities, it is important to differentiate between the locational factors of two distinct types of MNCs: those of horizontal and vertical MNCs. While services FDI was dominated by horizontal MNCs for a long period of time, at present, due to the fragmentability of services production processes, which was made possible by technological innovations, vertical type FDI has been appearing in services as well. The service projects analysed here are predominantly of vertical type.

The analysis is carried out on the basis of eight detailed company case studies. The majority of these is vertical FDI (close to 100 % of export/sales ratio), and two companies represent a confluential case of vertical and horizontal (domestic market oriented) FDI, where sales to the domestic market are also important, though not dominating.

The paper’s main aim is to make an attempt at contributing to filling some gaps in the literature, in terms of analysing locational advantages for vertical FDI in services, specifically in business services. It identifies the various elements of locational advantages connected to the different elements of investment motives, in terms of cost reduction, reducing costs of disintegration of production, reducing other costs, and motives arising from the confluence of vertical and horizontal FDI, and the paper relates these elements to the specificities of the business services sector. It differentiates general motives, which play a role in compiling the “longer list” of possible investment locations and then motives which play the most important role in deciding about the final location of the investment, on the basis of the company case studies.

Hungary has the specific locational advantages preferred by these types of vertical FDI, for which factor cost considerations, especially in terms of relatively low wages of relevantly skilled labour and elements reducing costs of disintegration of production, especially a good IT infrastructure play a determining role. Being inside the European Union is important (reducing the cost of disintegration), thus one can expect that other new member states of the European Union will be major hosts of intra-European movements and Europe-oriented services centres.

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