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**Beginning of the End of Cost Competitiveness in CEE Countries –
Analysis of Dependence between Labor Costs and
Internationalization of the Region**

Abstract

The main purpose of this study is to verify whether previous low level of labor costs being one of competitive edges of CEE countries is a factor that may determine competitiveness of this region in the long run.

In the study a regression analysis has been carried out on the sample of all EU countries in order to verify the dependence between internationalization degree measured by OFDI stock per capita on labor costs in manufacturing sector and on GNP per capita. The results of the regression analysis clearly show the occurrence of such dependence. This means that gradual increase in labor costs in CEE countries will result in not only reduced inflow of investments from developed countries to this region but also transfer of production to more cost competitive countries.

In order to exemplify the above econometric model I carried out empirical analysis of the companies listed on the Warsaw Stock Exchange, identifying the companies for which efficiency-seeking is the main internationalization motive. The analysis of internationalization of 26 companies during the years 1990-2010 clearly shows that a significant part of investments is located outside the territory of Poland, in the countries with lower labor costs. This fact confirms that CEE countries will gradually become less and less attractive in terms of

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costs not only for MNEs from developed countries but also for the companies originating from transition economies.

1. Introduction

Over the last twenty years, CEE countries have been an important place from the perspective of FDI inflow from highly developed states. Through the accession to the EU and adoption of an institutional system functioning in the Western Europe, most CEE countries carried out quick and effective market transformation. Inflow of know-how together with investment of MNEs from the EU and USA, systematic growth of GDP per capita as well as the possibility of competing in common European market since 2004 enabled accelerated internationalization of companies originating from this region.

Growth of GDP per capita and the resulting consistent growth of wealth of the societies lead to a permanent increase in costs of economic activities in this region, particularly in the countries which became EU members in 2004. One of the main purposes of this study is to verify whether the motives for internationalization of the Polish companies indicate that the CEE countries (in particular those which joined the EU in 2004) are gradually losing their cost advantage over the Western Europe and are gradually moving production to the countries that are more competitive in terms of costs to improve their profitability.

The paper is organized as follows. In the next section, the applied research method is described. In section 2, a description of the most important internationalization theories is presented. Section 3 concentrates on macro-economic data of OFDI from CEEC. In section 4, discussion of the research results is presented.

2. Research methods

In the study, two research methods have been applied. Firstly, a regression analysis has been carried out on the sample of all EU countries in order to verify the dependence between internationalization degree measured by OFDI stock per capita on labor costs in manufacturing sector and on GNP per capita. Secondly, the companies for which efficiency-seeking is the motive for internationalization have been identified on the basis of empirical data of the companies listed on the Warsaw Stock Exchange. From this group, the

companies which carried out down-market FDI locating their investment in the countries that are cost competitive compared to the Polish companies were selected.

Gradual increase in labor costs correlated positively with the level of internationalization, with simultaneous identification by means of empirical verification of the companies transferring their business activity from Poland to the countries with lower labor costs would be a sufficient evidence – that cost competitiveness gradually ceases to be the main advantage of locating investments in CEE countries, particularly in Poland.

3. Theory of firm internationalization

From the point of view of this study, the most important internationalization theories are those concerning transition economies. However, to make the picture complete, the evolution of the most important internationalization theories during the last fifty years is presented below.

Evolution of the research on internationalization was a function of changing economic reality and more and more clear business globalization. One should remember, however, that the globalization was and is carried out with various intensity. The early works on internationalization (e.g. Vernon 1966; Kindleberger 1969; Hymer 1976; Caves 1971; Buckley and Casson 1976) explained to a large extent the decisions concerning FDI market imperfections. The theory which describes the mechanisms of making foreign investment in the broadest way at the meso level is John H. Dunning's (1981; 1993; 1996) eclectic theory of international production, also known as the OLI Paradigm. The advantages defined in this theory: ownership advantage, location advantage and internationalization advantage have impact on the decisions of the companies relating to FDI. The eclectic theory is supplemented by investment development path, which shows the dependence between the economic development level and the investment position of the state (i.e. the relation between OFDI and IFDI). Goldstein (2009, p. 82) concluded that the IDP model had indeed proven very useful for evaluation of smaller European economies.

An important addition to the above theories is the Uppsala model created by Johnson and Vahlne (1977), who paid attention to cyclical nature of internationalization, which is carried out gradually – sequentially. This is the consequence of a risk arising from a limited knowledge of the foreign market. According to the sequential internationalization model, companies expand their activities first on the markets of culturally close neighboring countries, and then,

using the knowledge gained, consider expansion into more distant markets, with larger cultural distance to their local market. Due to delayed expansion of MNEs from emerging countries, most literature concentrates on issues related to MNEs from highly developed states.

The first most important studies concerning internationalization of businesses from emerging economies are those carried out by Wells (1983) and Lall (1983), and the most recent studies are those carried out by: Ramamurti (2004), Meyer (2004), Jansson (2007), Sauvart (2008), Goldstein (2009) and Narula (2010). From the point of view of narrowing this issue to CEEC only, important publications are those by (Meyer 2001; Goldstein 2009; Meyer et al. 2009; Narula 2010, Wilinski 2011).

All previous publications relating to internationalization of companies from CEE can be divided into three main groups: Firstly, publications in which a group of states and businesses originating from them is analyzed (Svetlicic and Rojec 2003; Kalotay 2004; Rugraff 2010); secondly, those concentrating on one state only and on the businesses established in it (Jaklic and Svetlicic 2003; Rosati and Wilinski 2003; Kalotay 2010; Filippov 2010, Wilinski (2012); thirdly, the studies comparing BRIC states, in which strategies of internationalization of Russian companies are analyzed, compared to Brazilian, Indian and Chinese companies.

4. Background: OFDI from CEE countries

Internationalization of companies from CEE is a relatively new issue. The internationalization started at the beginning of 1990s only, after the economic and political system changed in this part of Europe. In most CEE countries the change of the political system forced the change of the economic system. Generally, during the years 1990-2010 the CEE countries could be treated both as transition economies and emerging markets. At present, the level of economic growth in some of them indicates, however, that they can already be considered highly developed countries; in many cases the market transformation has also been completed.

While analyzing internationalization of CEE enterprises, their specific macro- and microeconomic environment should be taken into consideration. First of all, (1) lack of significant experience in internationalization of business activities before 1990, (2) lack of sufficient capital accumulation by the companies, that could enable them to expand into foreign markets, (3) in case of private companies, short period of the business activities (less than 20 years), (4)

small domestic market before the accession to the EU and, therefore, difficulties in quick achieving the effect of scale on the local domestic market. The aforementioned factors significantly determined the moment when the CEE companies initiated internationalization. The analysis of macroeconomic data of the CEE countries shows that OFDI stock from this region amounts to only 2% of global OFDI stock (Unctad 2010). In his studies, Gorynia (2010) shows that net outward investment position (NOIP) in most of these countries is still negative, and the conclusion of his analysis of the Investment Development Path (IDP) is that the CEE states are still at stage 2.

Note, however, that post-communist countries are characterized by diversified economic growth and diversified degree of internationalization. Generally, they can be divided into 4 groups: (1) EU member states, (2) EU candidate states, (3) Russia and (4) former Soviet Union countries. The last group (4) consists of the countries with the lowest degree of internationalization, and in most cases with the lowest GDP per capita and the lowest degree of progress in economic reforms (e.g. Belarus, Kyrgyzstan).

Russia is classified into a separate category, mostly due to the internationalization model which is definitely different from the internationalization model of the EU member states and EU candidate states as well. It is also characteristic of Russia that it is the only post-communist country where OFDI stock is higher than IFDI stock. The specificity of the Russian internationalization model is caused by the following: firstly (1) the fact that in most cases the Russian companies investing abroad are the companies operating in fuel and power industry, (2) secondly, the fact that such companies operate in this industry in the domestic Russian market results in such companies having significant capital surplus and if they want to develop they have to invest both in the companies related to transmission infrastructure and in the companies of fuel and power industry in the neighboring countries. It is characteristic of the Russian internationalization model that GDP per capita in Russia is lower than average for the new EU member states, nevertheless Russia has been in recent years the only country where the overseas investments of local companies are higher than foreign investments in Russia.

In turn, two first groups, i.e. the states which have already become EU members and the states which are going to join this organization are undoubtedly similar. A thesis can be made that the countries such as Croatia will certainly follow the same way of internationalization as neighboring Slovenia being already the EU member.

The first group of the states, i.e. post-communist EU member states, consists in many cases, as I have already mentioned, of the states which are already completing their market transformation process and are, at the same

time, emerging economies. However, this group is not uniform due to diversified levels of internationalization of their economies, economic growth level (GDP per capita) and domestic market size. The leaders of internationalization among new EU member states are Slovenia and Estonia which had small domestic market, which forced the companies interested in achieving the effect of scale to expand relatively quickly into foreign market. In turn, the companies originating from Poland and operating in relatively large domestic market did not have sufficient motivation to expand quickly into external markets, therefore, in 1990s internationalization of the Polish companies was relatively low. Among new EU member states, we should also pay attention to two states that acceded the EU latest of all. There is no doubt that their internationalization is hindered by a low level of GDP per capita and a relatively large domestic market (larger, for example, than Slovenian and Estonian).

5. Results and discussion

According to the internationalization theory, GNP is one of important determinants of OFDI stock per capita. It is not, however, the only variable having significant influence on OFDI per capita. I present below the regression analysis of dependence between OFDI per capita and two variables:

1. Productivity cost of man-hour in manufacturing sector;
2. GNP per capita.

To carry out the regression analysis I used data from 26 EU member states concerning:

1. Productivity costs of labor in industry, source: Eurostat,
2. GNP per capita published by World Bank,
3. OFDI from World Investment Report,

however, to make the data comparable, the statistics published in EUR are converted into USD at average annual exchange rate for a given year.

Single-equation regression model is defined as follows:

$$y_i = g(x_{i1}, x_{i2}, \dots, x_{ik}) + \varepsilon_i \quad i = (1, 2, \dots, n)$$

where:

y_i – i value of dependent variable,

x_{ij} – i value of independent variable; $j=1, 2, \dots, k$,

ε_i – i rest (error) of the model (difference between estimated and empirical values of y_i),

n – number of observations,

k – number of explanatory variables.

In this case, the function is linear, therefore:

$$y_i = \alpha_0 + \alpha_1 X_{i1} + \alpha_2 X_{i2} + \alpha_k X_{ik} + \varepsilon_i$$

dependent only on two explanatory variables

$$y_i = \alpha_0 + \alpha_1 X_{i1} + \alpha_2 X_{i2}$$

I used the following independent (explanatory) variables in the regression equation :

- cost of labor in 26 EU countries in industry¹;
- GNP per capita in 26 EU countries;

and OFDI per capita as a dependent (being explained) variable and I obtained the following linear equation:

$$y_i = 1.312x_1 - 0.335 x_2 - 0.684$$

For this linear equation, $R^2 = 0.73$ and adjusted $R^2 = 0.65$. Due to the fact that in this regression model there are two small samples with equal numbers, I compared absolute empirical value T-test with critical value of these statistics in order to verify whether explanatory variables are statistically relevant.

$$\text{For } x_{i1}: T\text{-test}_{\text{emp}} \left| 1.75 \right| > T\text{-test}_{\text{crit}} -1.71$$

$$\text{For } x_{i2}: T\text{-test}_{\text{emp}} \left| 0.18 \right| > T\text{-test}_{\text{crit}} -1.71$$

The result confirms that both explanatory variables applied in the model are statistically relevant. The results of calculations for the entire regression model are presented in table 1.

¹ Due to the specific nature of OFDI from Luxemburg I intentionally omitted statistics concerning that country. It is clear that a major part of investment, which is treated in international statistics as the investment originating from that country, actually originates from other countries which intentionally register their companies in Luxemburg.

Table 1. Regression analysis of OFDI per capita determinants

		1 labour hour cost	GNP per capita
R-square	0,69		
Adj. R-square	0,66		
No. of obs.		26	26
α_0	0	1,31	-0,34
Stand. dev.	-	0,47	0,49
tStat (emp.)*	-	1,75	0,18
tStat (theor.)**	-	-1,71	-1,71

* and ** 5%.

Source: own calculation.

The resulting value $R^2 = 0.73$ with confirmed statistical relevance of explanatory variables shows that OFDI per capita for EU member states is dependent in 73% on labor productivity cost increase and GNP per capita level increase. Increase in labor costs by 1 USD results in increase in OFDI per capita by 1.31 cents (with unchanged level of GNP per capita). This means that increased labor costs in industry result in, undoubtedly, a higher value of OFDI per capita and thus higher internationalization of the businesses. Therefore, we can state that this is the factor stimulating the degree of internationalization of the EU member states.

The analysis of the main motives for internationalization (assets seeking, resource seeking, market seeking and efficiency seeking) shows that the motive concerning productivity increase is most frequently related to locating production in the areas that are more competitive in terms of costs compared to the parent country. It is common knowledge that the companies motivated by market seeking search mainly for new markets, whereas those motivated by resource seeking concentrate on exploration of natural resources and the only fact that is of importance to them is whether there are natural resources in a given country rather than labor cost. In turn, assets seeking motives are related to searching for specific assets that may ensure long-term competitive edge to the investing company.

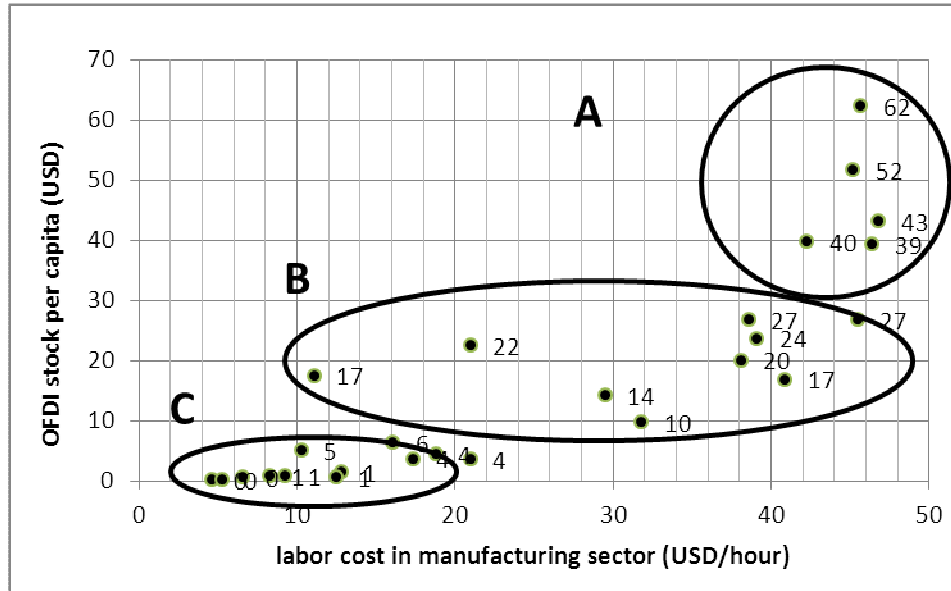
Therefore, we may attempt to make a thesis that in the case of efficiency seeking, the companies seek to improve their economic effectiveness not only

through locating the production in places where it can be more effective - in terms of the production scale, advancement in production technology, but also because of lower labor costs in the country where the investment project is carried out.

There is no doubt that in CEE countries, including Poland, a lot of investments were located after 1989 due to cost competitiveness of this region. The question whether this region is still competitive in terms of costs is not easy to answer. It is generally known that cost competition may take place in the short run, whereas in the long run the region should be able to find other competitive edges based on new technologies and low labor effort. This should have happened to the states which were competitive due to low production costs after their accession to the EU: Ireland, Spain, Portugal and Greece. Obviously, Ireland took advantage of competitive edges, apart from cost advantages; it is rather controversial whether the other three countries did the same.

Compared to other EU member states, the countries which acceded the EU after 2004 still remain cost competitive in relation to old member states. For example, according to Eurostat data (2010), average cost of man-hour in old EU member states amounted to 30.80 EUR in 2010, whereas in new EU member states such cost was four times lower and amounted to 7.64 EUR. Note that the difference between the state with the highest cost of man-hour and the state with the lowest cost is nearly 15 times.

Figure 1. Relation between OFDI stock per capita and labour cost in manufacturing sector in EU countries, 2009 (U.S. dollars)



Source: OFDI data from UNCTAD (2010), countries population and labor costs data from Eurostat (2009).

Such a significant difference shows that both most economically developed EU states and new member states are not homogenous in terms of production costs. In Romania and Bulgaria, the cost of man-hour is more than two times lower compared to average costs of all newly acceded EU member states. Obviously, such a large disproportion is now and will be in future a sufficient motivation for making decisions to transfer production not only from the Western Europe but also from the Central Europe to the countries with the most favorable rates paid to production workers.

The dependence between OFDI per capita and the cost of man-hour in manufacturing is presented in Figure 1. As it has been proved by means of regression analysis, OFDI level depends not only on GNP per capita but also on labor costs in a given country. Figure 1 shows quite clearly such dependence, we can note that the higher labor cost in a given country, the higher OFDI value. In the chart, the countries are divided into three clusters:

1. Cluster A
OFDI per capita \geq 39 USD
2. Cluster B
10 USD \leq OFDI per capita $<$ 39 USD

3. Cluster C

OFDI per capita < 10 USD

Cluster A groups the countries with the highest labor cost and relatively small domestic market at the same time: 4 small countries with number of population lower than 10 million, one with the population of 16.5 million. These are respectively: Belgium, Sweden, Denmark Ireland and the Netherlands. Therefore, the degree of internationalization of companies in this group is determined not only by very high labor costs but also by small domestic market where it is difficult to achieve a sufficient effect of scale or to be competitive on the European scale, which forces the companies to internationalize their business.

Cluster B is the most diversified group of countries, however with the dominating role of the largest EU economies: Germany, France, United Kingdom, Italy and Spain. France and the United Kingdom are the countries with the highest OFDI value in Cluster B. They significantly differ, however, from each other in respect of labor costs. In the United Kingdom, labor cost is only 62% of the costs in France. This can be explained by traditionally more liberal economy of the United Kingdom, which undoubtedly stimulates internationalization of businesses from this country. There are two untypical cases in this Cluster Cyprus and Hungary. Obviously, high level of Cyprian and Hungarian OFDI is not positively correlated with labor costs in these countries. In the first of them, it is a result of locating investments for legal and tax reasons by the companies which intend to minimize tax costs, whereas in Hungary OFDI means mainly the investments carried out by MNEs having their seats in Hungary and carrying out expansion in CEE region from that country. As I have already mentioned, other countries in this group are mainly the largest EU economies.: Germany, Italy and Spain and two smaller countries – Austria and Finland.

Cluster C groups mainly new EU member states admitted to the EU after 2004 and two older member states: Portugal and Greece. As we can see, opposed to the companies in Ireland, Greek and Portuguese companies have not used their membership in the EU to increase competitiveness of their companies and were likely to base on short-term cost advantage only. Perhaps one of the reasons for insignificant internationalization was the lack of institutional system stimulating the companies to expand into foreign markets. The leaders of internationalization in Cluster C are the countries with the smallest domestic market. In their cases, the situation is the same as in case of Cluster A; small domestic market with the highest labor costs among new member states (Slovenia, Malta, Estonia) forced the companies from these countries to start

their business activities in international markets earlier and quicker than the companies in the largest economy of CEE region, i.e. in Poland.

Figure 2. Source and destination of FDI

		Developed countries	CEE countries
		Source of FDI	
Source of FDI	Developed countries	North- North FDI	North-CEE FDI (Down-market FDI)
	CEE countries	CEE -North FDI (Up - market FDI)	CEE- CEE FDI (Mostly down-market FDI)

Source: Based on Ramamurti (2009, p. 6).

Ramamurti (2009) presented the source and destination of FDI between developed and developing countries in a very logical manner (see: Figure 2). The diagram of investment flow between developed and developing countries proposed by him can be adapted to CEE countries. As I have already pointed it out in the section concerning IB theory, in most cases the research in this field concerns inward FDI in emerging economies, although over the last 20 years a lot of articles concerning investment flows from developing countries, mainly from BRIC, have been published. In the case of CEE countries, we observe mostly down-market FDI, although the investments are up-market FDI type.

5.1. Down-market FDI from Warsaw Stock Exchange

Among all companies listed on the Warsaw Stock Exchange, 96 have their subsidiaries outside the territory of Poland. In this group, 26 are the companies for which efficiency seeking is the main motive for internationalization. Only 6 of them are controlled by foreign capital. Among the remaining companies, Polish private capital is dominating – only 3 companies out of the whole sample are controlled by the state treasury. As opposed to other groups of motives, due to high concentration of industrial companies, more than a half of the efficiency seeking companies are those established before the system transformation started.

This thesis is confirmed by the fact that a half of the companies listed on the Warsaw Stock Exchange, for which efficiency-seeking is the main motive for internationalization, are located in the countries with lower production costs compared to the same costs in Poland. i.e. in: Ukraine, Russia, Romania, China, Lithuania, India, Belarus and Moldova. In these countries, 29 investment projects have been started, i.e., as I have already mentioned, a half of all projects related to the internationalization strategy based on efficiency-seeking. Among the aforementioned projects, investments in construction material industry, chemical, electrical machinery, metal, plastics and wood industries are dominating. Other industries are only represented by single projects.

The major part of efficiency seeking investments is down-market FDI (see Figure 2). In most cases these are the investments carried out in order to reduce production costs and increase production capacity at the same time. In many cases, the companies obtain easier access to local market through investments outside of the EU, thus avoiding various barriers related to exports. The most important investments related to reducing production costs are the investments carried out in Ukraine, Belarus and Russia, implemented by Kęty Group (metal industry), Duda S.A., Mispol (food industry), Decora, Cersanit (construction industry) Ciech (chemical industry), Inter Groclin (automotive industry), Forte (furniture industry). In many cases, in addition to getting access to Eastern market, the companies significantly increase their sales in European markets where they only develop their distribution networks (Duda, Ciech, Decora, Inter Groclin). An interesting case in this group of companies is Bioton which develops its activities in biotechnology industry, making investments in low cost countries such as India and China, but also in Switzerland and Israel.

However, in this group up-market FDI also take place, such investments took place in case of 6 analyzed cases and were directed to the countries where labor costs are higher than in Poland (Germany, Sweden, Italy and USA). All such investments were related to acquisition of the companies from the sector of capital-intensive and relatively advanced technologies – this was not, however, the high technology sector. Acquisitions carried out by Polish companies in Germany included mining equipment factory (G.K. Fasing S.A.), plastics factory (Ergis Eurofilms S.A.), fertilizer factory (Zakłady Azotowe Tarnów S.A.). In one case, a Polish company acquired its parent company in the USA (Secowarwick), and in one case, the Polish company Boryszew S.A. acquired the Italian company (Maflow) as a result of difficult position of the latter caused by the global financial crisis. The last example concerning this group is the acquisition of a paper mill in Sweden by a company listed on the Warsaw Stock Exchange but controlled by capital originating from that Scandinavian country.

5.2. Further research

In order to verify whether CEE countries lose their cost advantage and not only gradually cease to be the place where MNEs locate their investments due to low labor costs but also start to locate their production in more cost competitive countries, the analysis of motives for MNEs from developed countries investing in CEE countries should be carried out as well as the study of main motives for OFDI of the companies originating from other CEE countries – not only from Poland. It would also be interesting to identify other factors that determine now both the inflow and the outflow of OFDI from the region, such as the existing tax system, including corporate income tax rate, progress in privatization process, benefits from operating of the companies in integrated European market for the investors.

6. Conclusions

The most important conclusions of the study are:

1. I proved on the basis of the regression analysis on a sample of the EU member states that there is a positive dependence between the labor costs in manufacturing sector and the degree of internationalization measured by OFDI stock per capita. Increase in labor costs by 1 USD results in increase in OFDI per capita by 1,31 cents (with unchanged level of GNP per capita).
2. The highest level of internationalization measured by OFDI stock per capita takes place in the countries with the highest labor costs and relatively small domestic market at the same time (Belgium, the Netherlands, Ireland, Denmark, Sweden). This means that the largest EU economies are not the leaders of the internationalization process.
3. Similarly, in the case of new EU member states, internationalization of business activity is higher in the countries with small domestic market and the highest labor costs (among CEE countries). This group includes: Slovenia, Estonia and Malta. Hungary is an exception, with the highest OFDI per capita due to investments carried out from the territory of that country by MNEs controlled by foreign capital.
4. Systematic increase in labor costs in CEE countries will lead to gradual increase in the degree of internationalization. This is confirmed not only by the regression analysis but also by empirical research of the companies listed on the Warsaw Stock Exchange. Among 96 companies having their subsidiaries abroad, 26 companies are motivated by efficiency seeking in carrying out their investments. Half of them carry out down-market FDI to

the countries that are cost competitive compared to Poland. This fact confirms that cost competitiveness – being a short-term competitiveness – gradually ceases to be the most important determinant for conducting business activities by the companies in the CEE region.

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Streszczenie

POCZĄTEK KOŃCA KONKURENCYJNOŚCI KOSZTOWEJ PAŃSTW EUROPY ŚRODKOWEJ I WSCHODNIEJ – ANALIZA ZALEŻNOŚCI POMIĘDZY KOSZTAMI PRACY A INTERNACJONALIZACJĄ REGIONU

Głównym celem artykułu jest weryfikacja, czy niski poziom kosztów pracy w Europie Środkowej i Wschodniej będący do tej pory jednym z czynników wpływających na konkurencyjność tego regionu pozostanie nim w dłuższej perspektywie czasowej. W pracy na podstawie próby wszystkich państw UE zbadano zależność pomiędzy poziomem internacjonalizacji (stan odpływu BIZ per capita) a kosztami pracy w sektorze przedsiębiorstw i GNP per capita. Analiza regresji potwierdziła istnienie zależności pomiędzy wyżej wymienionymi czynnikami. Oznacza to, że stopniowy wzrost kosztów pracy w państwach Europy Środkowej i Wschodniej prowadził będzie do stopniowego odpływu BIZ z tego regionu do państw bardziej konkurencyjnych kosztowo. W celu egzemplifikacji powyższych zależności w pracy dodatkowo przedstawiono analizę inwestycji zagranicznych polskich spółek notowanych na GPW, z których to 26 dokonało inwestycji zagranicznych o wyraźnych motywach związanych z obniżeniem kosztów produkcji. Fakt ten potwierdza powolny spadek konkurencyjności kosztowej polskiej gospodarki, tym samym zmusza do poszukiwania nowych rozwiązań instytucjonalnych mogących utrzymać konkurencyjność polskiej gospodarki w długim okresie.