Foreign Direct Investment in Poland: Is Low Cost Labour Really the Sole Determinant?

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Abstract

Of late, much interest has been shown in the effects of Eastern European economic transition and its possible impact on international business. It has often been suggested that Eastern European economies such as Poland will have a major role to play in terms of low cost labour production for multinational firms. However, this is still far from being realised[2] *and equally important too, it is not clear that this would be the sole motivating factor for multinationals wishing to invest in Eastern Europe. This article attempts to establish the key determinants of foreign direct investment (FDI) activity in Poland by application of Dunning's theory of international production. This should help establish whether the common view of low cost labour being the sole determinant is justified.*

1. Introduction

FDI activity in Poland and indeed Eastern Europe in general represents only a very small percentage of world investment flows. There are about 21,800 foreign affiliates located in Central and Eastern Europe; 3,800 of them in Poland out of a world total of 174,900. Only 1 per cent of parent corporations are based in Central and Eastern Europe and over 90 per cent of trans-national corporations originate in developed countries (see table 1).

Nevertheless, the Bank of International Settlement estimates that the inflow of FDI to Eastern Europe has increased from US $300 million in 1990 to US $3.3 billion in 1992 (OECD 1993). This indicates that flows have grown rapidly in the 1990s though starting from a very low base. There also seems to be considerable national variation in the volume of FDI into Eastern Europe: Hungary, Poland and the Czech Republic have attracted the most FDI, with respective inflows of US $4.3 billion, US $2 billion and US $1.67 billion (OECD 1994). Table 2 shows the present situation with Hungary and Poland maintaining their position at the top of the table, attracting 7.1 and US $4.3 billion respectively. Most of the foreign direct investment for Poland comes from the USA and from close neighbours, a notable absence at the moment from the Japanese (see table 3).

Investment has also focused on the expansion of investment projects established in the 1970s rather than on new investment (see table 4). For example, the investments of ABB and Fiat (both in the top 15 investors in the Polish economy to date) can be traced back in some cases to the 1950s. Investment has focused specifically on the low technology sector with construction, chemicals, telecoms, food processing and car manufacture being particularly significant. Recent investments have included Daewoo's 70 per cent stake in the FSO car company and the recent plans of General Motors to build a £252m plant in Poland producing 100,000 cars.

Investments for the majority have consisted of joint venture activity as opposed to fully owned subsidiaries. This may in part reflect the risks currently associated with trading with economies under the process of transition. While the long term future for FDI in Eastern Europe looks highly promising in view of the advantages to be gained from companies in terms of labour production costs, it is important to note that further substantial increases in investment will only occur if it advances the overall global strategy of large multinational

Table 1: Number of Parent Transitional Corporations and Foreign Affiliates by Area and Country, early-1990s

Area/economy	*Parent corporations based in country*	*Foreign affiliates located in country*	*Year*
Central and Eastern Europe	400	21800	1991
Bulgaria	26	114	1991
Commonwealth of Independent States	68	3900	1992
Former Czechoslovakia	26	800	1992
Hungary	66	2400	1992
Poland	58	3800	1992
Romania	20	6900	1992
World	36600	174900	

Sources: UNCTAD, *Programme on Transnational Corporations*, based on world investment report 1994 and national official and secondary sources.

Table 2: FDI in central and Eastern Europe, end 1994

Country	*Direct Investment (US $bn)*	*Country*	*Direct Investment (US $bn)*
Hungary	7.1	Bulgaria	0.5
Poland	4.3	Slovakia	0.45
Czech Republic	3.1	Estonia	0.44
Russia	2.9	Lithuania	0.15
Romania	1.3	Latvia	0.11
Slovenia	1.0	Source: *Deutsche Bank Research Review*	

Table 3: Largest Capital Inflows, 1995, 3rd qr.

Country	*Investment (US $m)*	*%*	*Commitments (US $m)*	*Firms*
USA	1815	30.6	1618	58
Multinational	912	15.4	194	13
Germany	614	10.4	417	71
Italy	390	6.6	1743	10
Netherlands	362	6.1	218	12
UK	350	5.8	165	19
France	335	5.6	191	25
Austria	248	4.3	16	23
Switzerland	196	3.3	69	8
Sweden	178	3.1	100	15

Source: *Deutsche Bank Research Review*

companies. For the moment, though, the initial euphoria seems to have worn off with an air of pessimism.

This article sets out first of all to look at the reason why FDI has fallen short of what was expected to modernise Eastern European economies such as Poland by analysing the true determinants of FDI activity and secondly to suggest possible trends for the future.

2. Ownership

The theoretical approach of Dunning (1994) can be used to analyse the determinants of FDI flows. In order for a multinational enterprise to wish to engage in FDI activity in a host country, it needs to be able to gain ownership, location and internalisation advantages as part of its overall global strategy. By gaining such advantages, an MNE is able to create barriers to entry for other potential firms wishing to enter the industry.

Ownership advantages would include a variety of factors, the level of technological development being the first of them. Eastern European economies such as Poland have a comparative advantage in sectors which are intense users of unskilled labour and physical capital such as motor cars, glassware, steel, plastics, rubber and textiles. Poland is particularly weak in the high technology field such as electronics and computers. It has often therefore been suggested that Poland may have little to offer firms in enhancing their technological expertise. However, one key feature of the Polish economy may often be overlooked. The old system, despite being backward in terms of quality production, did produce considerable expertise in the production of metallurgical equipment, turbine generators and nuclear and electrical power stations. One could therefore argue that there may be a role for foreign firms to link up and develop further the expertise in this area.

Another important ownership advantage to consider is management skill. Poland shows considerable weakness in this area. For example, during the communist period, little was understood about the concepts of work incentives, profit and entrepreneurship. This needs to be encouraged in the future to make the region become more attractive to FDI. Markowski and Jackson (1994) also stress the lack of specialist personnel and general managerial skills as well as the difficulty of using local personnel. Tidmarsh (1993) stresses the lack of enthusiasm for work in Eastern Europe and cites a case of a hired driver arriving 1½ hours late for a job without an apology.

In terms of overall importance of management skills to a multinational, one can say that this advantage becomes more important as a firm grows in size. Indeed, the ability to handle a global network will become more important in the future as global trade increases. Also the superior management skills of Japanese MNEs such as 'Just in Time' and Kaizen have led to much success for them in the 1980s and to some extent Europeans and US MNEs have had to follow similar approaches in order to compete. Caves (1979) also found that inward direct investment was positively related to the professional and technical employees in the total work place.

Marketing features also as a key ownership advantage for an MNE. Countries with established marketing channels can prove advantageous to firms competing on non-price competition in oligopolistic markets. Eastern European economies have limited knowledge of this concept. In many ways though, western firms may be able to take advantage of this situation in their marketing strategies. For example, to ordinary Eastern European people, 'made in the USA' is one of the best attributes a product can have and is often used as a selling point in advertising. Unfortunately, many Eastern Europeans do not know the difference between real US products and counterfeit products from the Middle East and the Pacific rim.

As regards the importance of marketing for the global strategy of MNEs, Caves (1979), Saunders (1982) and Gupta (1983) found it to be a positive determinant of inward investment especially in consumer goods industries.

Table 4: Largest Foreign Investors in Poland

Number	*Investor*	*Equity and loans granted by investor (US $m)*	*Commitment US $m*	*Country of origin*	*Branch*
1	Fiat	280	1750	Italy	Car manufacturer
2	Coca-Cola	180	50	USA	Soft drinks
3	Polish American Ent. Fund	164	63	USA	Capital participation in private sector
4	Thomson Consumer Electronics	147	37	France	TV tubes and sets
5	International Paper Co.	140	175	USA	Paper products
6	EBRD	138	0	International	Banking, capital participation in enterprises
7	International Finance Corp.	123	0	International	Investment in private sector projects across all sectors
8	ABB (power supply systems)	100	20	International	Power supply systems, turbines, electric engines
9	Curtis	100	0	USA	Electronics, construction
10	Unilever	96	0	International	Washing powder, food processing
11	Epstein	90	110	USA	Construction development, meat processing
12	Procter and Gamble	60	130	USA	Personal hygiene products
13	Philips	60	26	Netherlands	Electric appliances
14	ING Bank	56	0	Netherlands	Banking
15	PepsiCo	55	50	USA	Sweets, soft drinks, potato snacks

Source: *State Agency for Foreign Investment* (PAIZ), February 1994

The availability of capital has been shown to be an important advantage for a firm, particularly in the initial development stage. Indeed, it is not possible to have a successful marketing advantage without capital. However, it is also the ability to manage capital that is important for firms as they grow in size. Poland has drawbacks in this area due to the weakness of the Polish banking system which is both inefficient and limited in size. Foreign investors in Poland have also noted the inefficient taxation system and the inability to raise capital. More positively though, legislation in 1988 has made the tax system more favourable for foreign investors and particularly US firms.

Finally, on the subject of ownership advantages, economies of scale figure significantly as a determinant for FDI. Caves (1982) showed economies of scale to be an important ownership advantage by measuring the extent to which an industry is populated by multi-plant firms. The implication is that where domestic industry is characterised by multi-plant firms, it is likely that this feature will be extended to cross border operations. One could argue that there are potential advantages from economies of scale in Poland. The former political system for example was geared towards encouraging mass production at low cost which indicates potential for prospective investors in the field of production. However, this advantage may be outweighed by various other factors associated with location. These location factors also need to be analyzed as part of Dunning's framework in explaining international production.

3. Location

The most commonly suggested determinant of FDI activity in Eastern Europe is the availability of low cost labour. This factor itself is one of Dunning's location advantages. Trade theory, according to the Heckscher Ohlin model, shows that countries will specialise in the production most suited to the factor endowments of that country. This could be in skilled or unskilled labour or in production for which there is an abundant supply of raw materials or natural resources. Furthermore, Vernon (1966) has stressed the importance of low cost labour, particularly in the field of production of products reaching the maturing product stage. However, low cost labour in itself has been found to be an insignificant advantage unless low cost labour can be matched with high productivity (Pearce 1990). Until now, there has been no explosion of foreign firms moving into Poland to realise the comparative advantage of low cost labour.

As can be seen from table 4, there are limited amounts of large scale investment, including Thomson, Philips and Fiat. This could be for many reasons. Firstly, the low cost labour advantage needs to be offset by constraints in the international political economy. Textiles, clothing and agriculture for example, (industries found to be associated with low cost labour), have been left out in recent EU and Visegrad country agreements. Farming in particular remains inefficient in Poland. A quarter of the population still work on the land and the average farm is 12 acres compared with 60 acres in the west. Many farms still use horsedrawn equipment rather than new technology. Furthermore the EU at present is delaying Eastern European enlargement for fear of further pressure on EU funds from the common Agricultural Policy (CAP) in terms of EU subsidies.

In addition, there has been the implementation of rules of origin by the EU and various other non-tariff barriers which have implications for foreign investment. For example, partly finished capital goods with relatively cheap labour require 60 per cent of the product to be made in Poland. Neven (1995) also suggests that western aid programmes such as PHARE, aimed at helping with economic transitions in Eastern Europe, have focused on sectors where the East has little comparative advantage. This may be an attempt by the West to misallocate resources and protect jobs in the low cost industries in the West and reduce the costs of further unemployment, therefore limiting the potential of Eastern economies as a location for low cost labour production.

Finally, one could argue that MNEs have already located in areas of low cost labour, particularly in the Asian pacific countries and the comparative advantage of Eastern Europe is already being used to a great potential elsewhere. On a more positive note though, there have been some recent large investment projects. In 1995 Daewoo purchased a 70 per cent stake in FSO cars.

Location advantages include other factor endowments as well as low cost labour. Poland has a relatively well-educated population with skilled labour in shipbuilding, steel and car production as well as reasonable natural resources including oil. There are however some drawbacks. Although Poland has a favourable location, there are infrastructural problems. Telecommunications, for instance, have been particularly poor. For example, calls in 1989 to the US were taking up to eight hours.[3] Today the situation has much improved. From private telephones, direct calls may be made to the USA without assistance, although local calls often still suffer from poor lines. On the other hand, one can see a positive side to the poor communication situation. There may be an advantage of joining the telecoms market at a later stage. For example, e-mail and telex have both been tried in the west, e-mail proving to be more favourable. Poland is in a position to be able to take advantage from the knowledge and experience of the West.

Another reason frequently suggested for FDI in the Eastern European countries such as Poland is to gain market access and hence increase market share. There is also huge potential from EU enlargement since the total population of the East and the EU would reach over 720 million. However, market size alone may not be a significant location advantage. To be successful in penetrating new markets it is necessary for the local population to be achieving standards of living compatible with the West in order to ensure effective demand for products. This may help explain why the top 30 foreign investments in Poland are dominated mostly by food processing, confectionery and detergents. MNEs producing goods with relatively inelastic demand are likely to be more successful at this stage, given the limited amount of capital of the Polish consumer. However, on a positive note, Poland's GNP growth of over 5 per cent so far for 1996 indicates future potential for market seeking activities and the outlook for GNP in Eastern Europe in general is showing a steady increasing rate.

Also with regard to market access and size, studies have focused on clustering models of foreign direct investment and oligopolistic interaction. Flowers (1976) for example showed how it is not just locational variables that determine the pattern of FDI, but strategic response to these variables and to the anticipated behaviour of the competitors. Once a major firm has engaged in FDI it is likely that rival firms may follow in order to show presence in the market place and for this reason FDI may occur in various clusters. Indeed this may help in explaining why the three major car companies, General Motors, Daewoo and Fiat, have increased their presence in Poland over a similar period of time.

There has also been some work done of late on the geographical concentration of FDI. Studies have focused on the importance of the Triad[4], this will include FDI taking place between the three major trading blocs, Europe, US and Japan. The Triad accounts for 80 per cent of world FDI flows. Scholars including Yannopoulos (1990) have focused on inward investment in western Europe following the formation and subsequent enlargement of the EU. Explanations of the growth and pattern of US FDI in Europe have focused on market size, rate of market growth and barriers to trade. Similarly, explanations for the substantial increase in Japanese FDI flows into western Europe have focused on tariff jumping and defensive investment. New insights have been shown in a critical study by Yannopoulos (1990) who distinguishes other types of direct investment besides defensive, import substituting or tariff jumping. He suggests a weak link in the theory of international production. His other suggested types of direct investment include reorganisational and

rationalised investment. The reorganisational motive would suggest that the Japanese came to Europe as part of the overall global strategy rather than to avoid future EU tariffs for countries outside the union that may result from the creation of the single European market. The motive for FDI can therefore be trade driven as multinationals reorganise and adjust to the prevailing world trade conditions. With regard to rationalised investment, firms may engage in FDI in various countries to achieve the cheapest possible imputs in order to improve their costs which again questions further some weakness in the earlier theories of FDI. These recent developments have particular relevance to the Eastern European economies in view of the fact that Poland, Hungary and the Czech Republic are hoping to achieve European Union membership in the near future. Application of the various types of foreign direct investment mentioned above to the Eastern European case should make interesting future research.

The political climate has also been shown to be an influence on foreign investment. In a survey by Markowski and Jackson (1994), firms ranked the problem of political stability to be one of the main factors deterring firms from investing further in Poland. The success of the former communists in recent elections has done little to calm these fears despite their commitment to greater free market philosophy. However, on the positive side, politicians of all parties have expressed a wish to move towards more Western style economies though the pace of change is still very much open to debate. Connected with political stability is the ability to have a stable business climate and certainty. There have been problems here with inflation reaching 50 per cent per annum (1991) though there have been recent improvements. The target of 18 per cent for 1995 has been encouraging. As noted earlier, growth rates have also been encouraging. There has, however, been further uncertainty imposed by the lack of convertible currency though the country is keen to satisfy the IMF criteria for OECD membership and establish a convertible currency by 1996.[5]

Finally, on the subject of location, there is the question of the effect of Government grants and incentives. A survey of the pull factors for foreign investment ranked Government incentives as being the lowest of importance. Agodo (1978) nevertheless has suggested that Government incentives can be a significant factor in influencing FDI. However, Government incentives only become an important factor when there are two comparable investment projects. Both projects must be economically viable in the long term since any short-term capital gain from government incentives may have to be paid for later on.

Here, with two comparable investments, Government incentives may tip the balance in favour of one particular location. FDI in Poland however is on too low a scale at the moment to warrant many competing sites, therefore this factor can be shown to be of little significance.

4. Internalisation

Dunning's third set of factors that influence FDI activity can be described as internalisation advantages. Internalisation draws on new theory that has often been overlooked in the current economic literature. The modern theory of the Multinational Enterprise is essentially a general theory of contractual arrangements in international business. Internalisation therefore focuses on the mode of entry in which foreign firms enter host country markets, in addition to explaining why cross-border transactions of intermediate products are organised by hierarchies rather than determined by market forces (Dunning 1994). What is referred to as hierarchies in this case would be the establishing of an overseas subsidiary of the multinational in the host country. Alternatively, transactions of intermediate products that were determined by market forces would include the firm licensing out its technology to local firms as well as using local suppliers. Internalisation therefore shows why many multinationals choose to integrate their operations both vertically and horizontally.

5. Alternative modes of entry

There are several ways in which MNEs can enter foreign markets, thereby transferring their ownership advantages to these new markets. Exporting is one particular method, although despite being a low risk approach in terms of initial set up costs, there is less potential for profit compared with establishing a subsidiary and producing locally. The second alternative would be to licence the technological advantage to local firms in the potential new market but this alternative may have drawbacks for the following reasons.

Firstly, it is difficult to licence technology without having first shown the technology to the prospective licensee. By this time, the knowledge may already have been passed on if the firm decides not to have the licence after all; a distinct case of market failure. Secondly, there are costs involved in making the licence agreements, including negotiation costs as well as costs of drawing up agreements. There are also renegotiation costs as well as adding additional clauses to the licence. These can be referred to as the transaction costs. (Coase 1937)

Market failure may also occur. With a pure patent agreement for example, where only the right to produce the goods is granted, how can the licensor be sure that the licensee will produce goods to an acceptable standard of quality? The licensor's reputation may be violated and as a result may lose market share. A 'know how' clause could be added to cover this risk though there are still potential risks. With a 'know how' licence, the licensor shows the licensee how to produce the goods. By doing this, however, the licensee may have to expose its business operations. In this case, there may be a risk of the licensor setting up as a rival competitor after having observed the business operations and the market for technology may fail again in this way.

Alternatively, the licensee may improve on the technology when shown how to use it and gain market share from the licensor. A grant back clause could be added to make sure the licensor gets a share of the profits though even this may have the effect of discouraging innovation.

Caves (1982) has stressed how technology cannot be transferred independently through licensing. Therefore, licensing is less preferable to internalisation and the establishment of a subsidiary due to various risks and transaction costs associated with licensing.

Despite the problems of licensing, there are some examples of successful agreement, franchising for example where the service and the necessary back up is provided along with various other clauses including a grant back. Some good examples of this include hotels and fast food chains.

Also there are some other cases where licensing may be seen as preferable to internalisation, such as where the firm cannot afford to set up a subsidiary, or if there are government restrictions on entering markets. Licensing may also be preferable in markets that are too small to achieve substantial profits.

MNEs may internalise their operations by integrating vertically for other reasons associated with market failure. Suppliers may act opportunistically according to Williamson[6] (1981) and charge excessive prices in markets where there are high switching costs and there is buyer uncertainty. These problems were demonstrated by Thoburn (1982) and Read (1986) in the aluminium and banana industries. To reduce uncertainties, MNEs will internalise their operations with the establishment of a subsidiary and therefore gain internalisation advantages associated with increased certainty in the market place.

There are other benefits to be gained by entering markets through internalisation besides reduced risk and certainty. There is also the benefit of improving the firm's image when the firm is seen to be employing local people. In addition, there is greater potential for spreading the risk of possible changes in global market conditions such as currency fluctuations when the firms are more global in their operations. There is the ability to shift production easily from one country to another by using a global network of subsidiaries if there are changes in world market conditions. Internalisation

therefore has many advantages over using market forces for cross border transactions of intermediate products.

In terms of Eastern Europe, most operations to date have involved little in the form of internalisation advantages. There have been a small number of cases of established subsidiaries such as Fiat though recently most agreements have involved licensing. During the communist period things have progressed in the following way.

In the 1960s, there were just a few dozen licensing agreements with the West, though things progressed by the mid-70s to over 2,000 agreements across Eastern Europe. Such agreements include firms such as Philip Morris Tobacco[7]. A typical agreement involved the knowledge of how to improve the tobacco leaf. The knowledge was paid for by the Eastern firm agreeing to supply a certain amount of their production over seven years. Production was vastly improved though this only helped the Eastern Firm maintain local customers rather than adding to increased exports.

During the 1980s and 1990s, there has been a vast increase in joint venture activity in Eastern Europe from 165 ventures in 1988 to 25,845 by 1991, (Dunning 1994), although Poland is still far away from gaining internalisation advantages of increased certainty and greater potential profits through the establishment of fully owned subsidiaries. Joint ventures may have the benefit of raising more capital for research and development but there is less certainty since the trust of a partner firm cannot always be assured. Both sides may want to exert minimum effort in the venture while trying to gain the most knowledge from the partner since joint ventures are specified only for a limited amount of time.

To some extent, Government is limiting the potential for internalisation advantages by restricting foreign ownership during the transition process. Also foreign firms have complained of problems with local suppliers. This emphasises the lack of internalisation advantages at the present time. Raiszadeh, Helms and Varner (1995) site a recent case of McDonalds in Moscow having to overcome direct material procurement difficulties by setting up its own greenhouses and factories to grow and process ingredients. It is evident that it will take some time before the climate is right for foreign firms to benefit greatly from internalisation advantages in Eastern Europe, hence internalisation theory has its part to play in explaining why FDI is not so buoyant as had been previously predicted.

6. Conclusion

It has been shown then that there are many factors that have influenced foreign direct investment in an Eastern Europe economy like Poland besides access to markets and the availability of low cost labour. Indeed these factors may not necessarily be the main pulling forces as has often been the text book view [8]. Market access will depend on levels of GDP rather than just the size of the market. Equally so, low wage costs need to be matched by sound infrastructure, machinery and high productivity. It has also been shown that poor infrastructure as well as lack of political certainty may offset the low-wage-cost potential advantage.

Application of Dunning's theory of FDI to Poland has revealed that there are a variety of other factors influencing FDI activity besides the common-view factor of low cost labour. These are likely to have both positive and negative influences. On the positive side there may be potential for Western MNEs to link up the ownership advantage of skill in the chemical and nuclear industries of Eastern Europe. Alternatively, firms may benefit from the knowledge of previous mistakes made in western countries in establishing infrastructures in terms of improved location advantages.

However, there are further drawbacks as has been shown with reference to internalisation advantages. MNEs in Eastern Europe may be subject to problems of local suppliers, risks of opportunism, uncertainty and transaction costs. Economic theory shows these risks to be greater with joint venture and licensing activity rather than fully owned subsidiaries. It will take some time before MNEs can establish a fully owned network of production facilities.

Most activity to date has included licence agreements and more recently joint ventures. Indeed both Government restrictions along with risk in the market place are hampering foreign MNEs from fully internalising their Eastern European activities. Ownership, location and internalisation factors will all need to improve in order to attract further increases in FDI activity in the future.

Endnotes

1. East London Business School, University of East London
2. See figures in tables 1 and 2
3. See Raiszadeh, Helms and Varner (1995) p14 for numerous examples of the problem of worker motivation in the Eastern European workforce
4. See World Investment Report (1994)
5. Current economic and political trends from The Economist Intelligence Unit Country Report.
6. See Williamson (1981)
7. Other examples of licensing in Eastern Europe are contained in Lapid (1994).
8. See, *inter alia*, Hardy (1994), Markowski and Jackson (1994)

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