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# Nature and determinants of productivity growth of foreign subsidiaries in Central and East European countries

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ABSTRACT

The paper examines the determinants of productivity growth in foreign manufacturing subsidiaries in five Central and East European (CEE) countries by analysing patterns of control, nature of firms' capabilities and firms' market orientations. Building on the so-called 'subsidiary development' perspective, we show that productivity growth is determined jointly by corporate governance, production capability and market orientation variables. Within a dominantly production-oriented mandate, CEE subsidiaries have a relatively high level of autonomy in the control of their business functions. Majority foreign equity shareholding has a significant and positive impact on subsidiaries' productivity growth. Our results show strong regional characteristics.

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## 1. Introduction

One of the key drivers of catch-up in the European Union (EU) new member states is the narrowing of the productivity gap with older member states. So far, foreign direct investment (FDI) has been an important vehicle for these economies' increased productivity. FDI has a mainly direct impact, i.e. through higher productivity of foreign subsidiaries, whether greenfields or acquisitions, rather than productivity growth in indigenous enterprises (Hunya, 2000; Holland et al., 2000; Jindra, 2006). The indirect effects of FDI captured by econometric research suggest that horizontal spillovers are either

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absent or negative (Damijan et al., 2003; Konings, 2001; Jensen, 2002; Gorg and Greenaway, 2002), but that there are vertical spillovers (Damijan et al., 2003; Smarzynska Javorcik, 2004), although more evidence is needed on this latter aspect.

The economic perspective has advanced our understanding of the effects and role of FDI in Central and East European (CEE) economies. However, research on spillovers suffers from definitional problems, i.e. what is being measured, and from poor proxies (Harris and Robinson, 2004). We also know little about the micro-mechanisms through which FDI exerts its influence in these economies. To advance our understanding of the micro-elements of FDI requires new concepts and new types of data (Meyer, 2003). In this paper, we try to address some of these deficiencies by examining the micro-level, based on a large-scale survey of FDI subsidiaries in CEE economies.

We explore the factors explaining productivity changes in foreign subsidiaries, in the manufacturing sectors of five CEE economies (Estonia, Hungary, Poland, Slovakia and Slovenia). Specifically, we try to answer the following questions. What are the factors that determine productivity growth in foreign subsidiaries? What types of subsidiaries in terms of competencies are present in CEE countries? What is the level of strategic, marketing and operational control of foreign parent companies? How do competence and control issues affect the productivity growth of subsidiaries? Our investigation should complement existing economic perspectives and help to explain the rather inconclusive evidence from national level studies.

In conceptual terms, we build on the 'subsidiary development' perspective to examine productivity growth in FDI subsidiaries (Birkinshaw and Hood, 1998; Birkinshaw et al., 1998; Birkinshaw, 2001; for a review of this literature see Paterson and Brock, 2002; Birkinshaw, 2003). The idea underlying this stream of research is that multi-national corporations (MNCs), as the vehicles of FDI, have become 'differentiated networks of subsidiaries' (Bartlett and Ghoshal, 1989). This has enabled subsidiaries to develop resources and capabilities, and to grow either autonomously or through different degrees of integration with their headquarters. In the context of CEE this perspective could shed light on aspects of FDI that remain obscure when analysed from a spillovers perspective. In addition, this type of empirical research should contribute to the emerging literature that bridges between international business and growth theories (Ozawa and Castello, 2001).

This paper reports the results of a study based on a questionnaire survey of 433 foreign subsidiaries in the manufacturing sectors of five CEE countries. Section 2 of this paper briefly reviews the relevant literature and outlines our conceptual approach. Section 3 describes the sample. Section 4 presents a descriptive analysis. Sections 5 and 6, respectively, describe the econometric model used to explore the determinants of productivity growth in foreign subsidiaries, and interpret the results. The conclusions are presented in Section 7.

## 2. FDI and productivity growth through subsidiary upgrading: a literature review and conceptual framework

The impact of FDI on productivity growth has been studied in the literature on FDI and growth, and in the international business literature. The literature on FDI and growth primarily explores the link at the micro-level, through estimates of direct (compositional) and spillover effects (see Navaretti and Venables, 2004, for a review). The main conclusions in relation to CEE countries (Holland et al., 2000; Hunya, 2000; Resmini, 2000; Rojec, 2000; Konings, 2001; Meyer, 1998; Damijan et al., 2003) are that: (i) foreign subsidiaries are deepening trade linkages through disproportionately high export and import shares; (ii) the direct effect of FDI is significantly higher productivity in the acquired companies/greenfields compared to domestic firms: foreign subsidiaries are the main profit generators in CEE countries, with higher relative shares in investments and research and development (R&D) than domestic firms; (iii) FDI plays the dual role in industry and market restructuring of building new sectors (electronics and automotive) and introducing market seekers (food, banking and telecoms); (iv) the effects of FDI remain localised in acquired or newly erected plants; the extent of FDI spillovers is very limited, non-existent or even negative. The view of Holland et al. (2000, p. 46) is that FDI inflows improve 'the overall growth potential of the recipient economies, but primarily through productivity improvements within the foreign affiliates themselves, rather than through increased capital investment, or technology spillovers to domestic firms.'

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