

FACTORS AND ASPECTS OF THE RELOCATION STRATEGIES OF COMPANIES

Serghei Mărgulescu*
Elena Mărgulescu**

Abstract

In the last two decades there have been significant changes in the factors that determine the geographic location or relocation of R &D, production and marketing of all transnational companies. Supply chains have expanded to new areas of the globe and big traditional providers have also expanded their global presence by an increasing trend of co-localization with their main customers. Contract manufacturers have multiplied and strengthened, expanding their geographical distribution. A more obvious trend was that of the geographic dispersion of other global value chain functions such as business services and logistics support functions. Relocation to countries with cheap labor is not always a successful strategy. Therefore the decision to relocate in international geographical area, regardless of the structure formula, offshoring or outsourcing, must be based on a more diverse set of factors.

Keywords: *relocation, TNC, clustering, offshoring, outsourcing*

JEL Classification: M10

Introduction

In the last two decades there have been significant changes in the factors that determine the geographic location or relocation of R & D, production and marketing of all transnational companies. Production was internationally dispersed long ago, but the trend of integration on a so large geographic scale is relatively recent. Supply chains have expanded to new areas of the globe and have virtually integrated regional production areas that were previously separate structures.

Contract manufacturers have multiplied and strengthened, also expanding their geographical distribution.

Great traditional suppliers have also expanded their global presence by an increasing trend of co-location with their main customers. In connection with this, the so-called "postponement" trend appeared, meaning that components are manufactured or assembled as close as possible to the final sale locations to reduce transportation costs, which for some products are still high.

A more obvious trend was that of the geographic dispersion of other global value chain functions such as business services and logistics support functions.

Even innovation, which is supposed to be rooted in their own countries for strategic and skilled professionals reasons, is increasingly performed in overseas locations. Cutting-edge

*Professor, Ph.D., Faculty of Economic Sciences, "Nicolae Titulescu" University, Bucharest, Romania, e-mail: margulescu@univnt.ro.

**Lecturer, Ph.D., Faculty of Economic Sciences, "Nicolae Titulescu" University, Bucharest, Romania, e-mail: elena.margulescu@univnt.ro.

research is still mainly carried out in developed countries, but we can see that emerging countries allocate increasing and impressive amounts on research and development spending.

1. Factors of the relocation decision

To summarize, we can mention the following categories of factors acting simultaneously on relocation decisions of transnational companies:

a) **Differences in costs.** They remain an essential factor in choosing location, especially in respect of the production function, but to a greater extent also in what involves other activities such as research and development, accounting services, IT or marketing. In selecting the location, the production costs are evaluated in the broader context of the efficiency and productivity of the location in question. This aspect is often neglected in discussions of comparative costs, but is essential for the transnational companies strategy of achieving a "systemic" efficiency throughout their entire productive system. Therefore, a location is analyzed according to how efficient performs a particular function in coordination with functions located elsewhere, and not in isolation.

b) **Search for valuable "assets"** such as the workforce qualification or the availability of talented people. The development of informatics and telecommunications has increased the ability of transnational companies to coordinate increasingly complex functions located at increasing distances. This stimulates them to outsource these functions in close relation with the mobilization of a broader range of skills and knowledge.

c) **Clustering**, which has turned into a global process of recognition by transnational companies of the benefits of co-location with suppliers, competitors, service providers, research and development centers. Although distances matter less in closing transactions, it is found that closeness and access to knowledge remains an important factor of competitiveness, and as such relocation to industrial parks or other areas of concentration of R & D activities will further remain a strategy of transnational companies.

d) **The growth potential of markets** is also an important factor. It is obvious when looking at the location of many activities in China, India and other emerging countries with large populations that, with the increasing standard of living, will also become important outlet markets.

e) **Other factors**, such as:

- Existence of a relatively developed infrastructure which creates an increased efficiency from start,
- Quality and cost of public utilities,
- Availability of building land,
- Institutional incentives offered by central and local authorities,
- Laws in the field of financial and economic activities and labor
- Aspects related to the quality of life.

In the field of services, offshoring reflects, in essence, the resulting revolution from the services' commercialization. Traditionally, most services were until recently non-marketable, in the sense that this required the buyers and sellers presence in the same place and at the same time. Unlike goods, they could not be traded between parties placed in different countries (medical services, fitness services, etc..). Other services do not require physical proximity of the parties, but instead they have to be delivered face-to-face due to technical or traditional constraints (sharing, storage, processing and transmission of information). These services were non-marketable because:

- certain types of information could not be stored
- others could be stored, but could not be transmitted quickly and economically across borders for processing,
- others were traditionally processed inside the company (accounting, data storage, design),
- others, traditionally presumed face-to-face presence (medical, financial, legal consultations).

With the development and application of the new information and communication technologies (ICT), such barriers were more frequently demolished.

ICT enables the digitization, encoding and standardization of knowledge and, consequently, the production of a wide range of services which can be fragmented or modularized, the resulting components being re-locatable, in order to obtain cost or quality advantages, economies of scale or another advantages. Thus, the arbitrage strategies of various factors on national and international level have become feasible in the sphere of services.

Requirements for these services to be re-locatable are:

- to involve no face to face interaction
- to have a high information content
- the working process must be compatible with the distance transmission and the Internet
- to involve large wage differences
- installation barriers to be insignificant
- social protection requirements to be modest.

Factors that prevent compliance with these requirements and consequently prevent the offshoring of services are:

- technological limitations (such services cannot be digitized or separated from other activities)
- need face to face interaction (marketing, delivery, etc.),
- the need to be close to customers (fashion, creativity, innovation, medicine, privacy, etc.)
- occupational requirements, labor market restrictions, lack the necessary qualifications or knowledge of foreign languages,
- law and intellectual property rights protection
- risk aversion.

As time passes, more and more of these barriers are overcome, or seem to be overcome, both in terms of technological developments and government policies.

In many respects between the factors that determine the modularity and the globalization of production of goods and services there are many similarities, but some differences persist, such as:

- the offshoring of services is structurally simpler and faster in terms of resources, endowments and equipment necessary, than the offshoring of production,
- the offshoring of services mainly affects white-collar workers, not the blue-collar workers from the manufacturing sector,
- the offshoring of services potentially addresses to a larger number of companies in all areas,
- the offshoring of services require less investments and links with local suppliers.

Large transnational companies play the most important role in the phenomenon of services offshoring, both through captive offshoring, and through subcontracting to local suppliers. The captive offshoring can be implemented both for their own activities and / or to serve third parties. Offshoring is not limited however to transnational companies, but is implemented also by smaller companies.

The main **factors** that have influenced the decision of services offshoring are the following:

a) The need to control those activities, especially when involving intellectual property rights or sensitive information. As in other economic activities, the more strategic those services and closer to the core competencies of the companies are, the less willing are the companies to outsource them. In this situation there are, for example, the financial services or the research and development activities, preponderantly transferred to their own subsidiaries (transnational companies such as Oracle, Texas Instruments, General Electric,

Cisco, Hewlett-Packard, IBM and Microsoft have established research and development centers in India).

b) The internal interaction degree involved in the respective activity. When the services can be split, but involve a closer connection with the other business activities (services, manufacturing, research and development) to ensure a greater efficiency, they will not be outsourced. By contrast, the back-office and front-office operations that can be easily standardized and separated from the other activities are more easily subject to outsourcing. The same thing happens when the software developments are outsourced: the standard or routine activities are contracted with Indian corporations, for example, and the most sophisticated are kept in business.

c) The existing of the service providers in the emerging countries. The activity of such providers in the emerging countries is a relatively a recent phenomenon and has become an alternative to the strategies of the western companies, for about a decade. For example, when transnational companies began to transfer their back-office functions to India, they couldn't find there local companies to undertake the outsourcing. Therefore, in 1998, American Express had to set up their own subsidiaries. Only after 2000, other airline companies that wanted to outsource similar services have found local Indian companies able to take over. For example, Delta Air Lines has outsourced some of the services booked by the call-center company Spectramind, a subsidiary of Wipro company. Also, Swiss International Airlines, Austrian Airlines and Sabena have outsourced the accounting services for the revenues resulting from the cargo and people transport, ticket booking, flight schedules and administration support to air navigation to the company AFS, a subsidiary of Tata Consultancy Services, the largest Indian software company. There is also a range of services, which was developed more rapidly in the emerging countries, as the software services, for which local suppliers competitors can easily be found, while other services have evolved later, so that competition is lower (for example the financial analysis services). Availability of local suppliers in emerging countries is correlated with other factors such as intellectual property protection, cultural and linguistic differences, the information availability on local business.

d) The volume of the activities that can be outsourced. From the analysis of the corporate decisions can be seen that there is a greater temptation to keep in the company those activities with a bigger workload or added value, in order to benefit from the efficiency surplus resulting from the operations of the large yield series. Offshoring's version to subsidiaries is the most frequently used. At smaller sizes of activities, the offshoring to third parties enter into discussion with more power.

e) The costs reducing is one of the main motivations of offshoring, as confirmed by numerous studies. Cost reduction can be achieved either by searching for locations with lower costs, or by consolidating operations and reduce the costs with infrastructure, personnel training and management. Any international bank that has, for example, 50-60 data centers, each with infrastructure, specialists and maintenance costs, can strengthen them in 5-10 centers. This means costs reductions and allows the creation of centers of excellence, and if combined with lower labor costs, the savings can be considerable. It is estimated that the U.S. banking industry saved by offshoring to India about U.S. \$ 8 billion in 1999-2002. In Europe, about 80% of the largest transnational companies with offshoring experience reported savings ranging between 20-39% and another 10% of them showed even greater savings. In call-centers, labor costs in developed countries represent 50-70% of total costs. In India, the salaries were at the beginning of this decade 80-90% lower than in England. However the savings derived from wages are diminished because of higher costs of infrastructure, personnel qualification and travel. Overall the savings are situated in the margin of 30-40% compared to the costs in England and something more compared to that ones from the U.S.A.

f) A better quality of the services is another important factor in the decision of services relocation. Many transnational companies have been surprised to find this, the factors in this respect being of two categories:

- when the "back-office" services of the services customer become "front-office" services of the services provider, the latter gives a higher attention to the quality of the services
- mostly, the low-cost locations use a more educated staff than the one used in developed countries. If in India they are university graduates in industrialized countries are school or college graduates.

2. Aspects of the relocation strategy

2.1. Relocation to countries with cheap labor is not always a successful strategy.

Absolute labor costs are important in labor-intensive industries, but in the overall equation there are other factors that are even more important than we are tempted to believe at first, such as:

- Political risk,
- Risk related to intellectual property rights,
- Cost of raw materials,
- Energy and equipment,
- Transportation costs,
- Interest rates,
- Taxes
- Trade policies of states.

Maybe some items have to be adjusted in the meantime, but a study conducted in 2004 by McKinsey company, based on the experience of a number of companies in California, quantified that, when companies operate efficiently in the home country, the comparison with carrying out the same business in countries with cheaper labor, taking into consideration the above mentioned factors, leads to the following final price advantages in favor of these countries: in high technology field 0.6%, in the processing of plastics 6% and in the clothing industry 13%. These gains seem minor compared with those obtained by a faster satisfying of customers and a prompter respond to fashion trends and consumer preferences.

Also what matters ultimately is not absolute labor cost (dollars / hour), but the unit cost of labor, or labor incorporated into the product. This unit cost is often higher in countries in transition as a result of:

- Lower qualification of the labor force,
- Periods of training required to use certain technologies,
- Losses due to the need of more frequent repair of equipment and machinery,
- Loss of material,
- Increased labor migration,
- Stress caused by living conditions, transportation, and so on.

2.2. Relocation strategies generated by the cost benefits or by the benefits of processes modularization and their outsourcing, show noticeable conceptual differences and approach. The best example results from the comparison between the American and Japanese strategies, especially in the electronics industry.

In this respect, it is of interest the opinion of the president of the Japanese company Kenwood regarding the manufacturing outsourcing strategies, expressed in an interview: "I know that American companies are convinced that production without manufacturing plus EMS (electronics manufacturing services) is the best approach. But I have serious doubts in this respect ... especially on markets that are in rapid change. Managers of companies without manufacturing do not know anything about production anymore. If technologies or markets change, they simply cannot adapt. Newly established companies require contract

manufacturers, is the best approach for them because investments are minimal and development quick. But this is not for me. This is the U.S. power: new technology combined with production without manufacturing and EMS. In such a system, a flexible value chain is an advantage. In the long term, however, where the manufacturing process changes due to changing technologies and markets, you need manufacturing in-house. That's why companies in Japan have a longer life. It is another form of competition. We must specifically adapt to meet the challenges."

Japanese electronics companies have also pursued strategies that use the advantages of assembling in China, but within a division of labor that keeps important percentages of production in the country, along with the phases of product defining, research and development, design and distribution. This trend is also manifested in industries with high potential of the value chain fragmentation. Japanese strategies focus on the complementarities between home integration and abroad networks.

Such an approach, even U.S. researchers say, is simply not possible to be put into practice in the U.S. anymore, in a wide range of fields.

Most likely to remain contracted in the country are activities with a strong non-modular character. Also, due to American penchant for strategies built on modularity and contracting the modules (functions) of that business, modularity covers a wider range in U.S. than in Japan.

The two distinct forms of competition are based also on different thinking. A good example can be the following:

- Kenwood preferred organizing the production of mini-disk players within its factory in Japan, as a means of accelerating the renewal of the product range and their supply to consumers.
- Apple has registered remarkable achievements through another strategy, quickly designing new generations of iPods that are assembled outside the United States from components whose production was also outsourced. Apple has promoted the same strategy in the production of iPads, massively outsourcing it into China.

But what is more interesting is the fact that if an American manager in the electronics industry would like to apply the Japanese strategy to increase its market share of products with short production cycle, it would be hard for him to find within U.S. the ingredients for such a strategy. The widespread transfer of manufacturing functions and of other product design and technology functions to contract manufacturers in the U.S. and abroad have practically broken the production system in a way that seems irreversible.

Zara Company is maybe a "king" of speed on the route of concept-manufacturing-retail, but the U.S. has not left any company that could be like this. On a smaller scale there is still that possibility, and American Apparel and Knapps prove it. But electronics, automotive and auto parts, textiles and clothing, such companies are not the mainstream anymore.

2.3. There are a number of cases that make the manufacturing outsourcing counterproductive, and as such the relocation strategies are not operational.

Such cases can be considered the following:

- High-tech areas where the new knowledge content has yet not been standardized
- Areas which require a continuous relationship between engineers, designers and workers on both manufacturing and product design or technology
- Situations in which major brand companies are reluctant to do outsourcing for fear of insufficient protection of intellectual property rights,
- Situations where the effect of "clustering" makes the leaving of the area counterproductive since in other locations proper factors are not to be found (qualified workforce, talents, research centers) or synergistic effects do not exist (large number of suppliers, manufacturing traditions, the type of relationships between firms, and so on).

Conclusions

The phenomena of the globalization of production have to be seen as a sum of **strategies of companies regarding the reorganization and relocation of their activities.**

The arbitrage of functions of the global value chain of a product is relatively new in corporate management, in the context of the “functional” specialization, and the analysis of the relocation strategies of companies on the basis of the “functions” arbitrage completes the entirely new list of opportunities that globally integrated companies have lately at their disposal.

New opportunities arise also from the **reorganization and relocation of companies in the context of business services offshoring.** That is why companies have to analyze the premises for the services offshoring and the factors in the decision of outsourcing and offshoring of services. There are sufficient motives to assert that the modularization of services is vaster than the one in the sphere of production. At the same time, the new technologies often simplify the “production” of those services, facilitating even more their geographic relocation. However statistical data of the past decade show **differences in strategy among American companies, more likely to establish foreign affiliates, and European, more likely to contract service providers in other companies.**

One conclusion is that the **strategies of companies regarding the relocation of their activities**, driven by the cost advantages or by the benefits of processes modularization and outsourcing, are hard to be standardized as far as companies and managers bear certain national encryptions. It is the case of American and Japanese company strategies.

Another conclusion is that **the relocation strategies are not operational anytime. There are cases that make the manufacturing outsourcing counterproductive and the business can be carried out more effectively and safe with most of the functions kept inside the company.**

References

- Baldwin R. (2006). *Managing the Noodle Bowl: The Fragility of East Asian Regionalism*
- Berger Suzanne and the MIT Industrial Performance Center, How We Compete (2006). *What Companies Around the World Are Doing to Make It in Today's Global Economy*, Currency Book
- Dunning H. John (1997). *The New Globalism and Developing Countries*, N.Y.
- Dunning H. John, Masataka Fujita, Nevena Yakova (2007). *Some Macro-data on the Regionalization / Globalization Debate: A Comment on the Rugman/Verbeke Analysis*, Journal of International Business Studies 38, no.1, January 2007
- Industrial Performance Center at MIT (2005). *Globalisation Study*
- Krugman P. & Venables A. (1995). *Globalization and the Inequality of Nations*
- Inkpen A., Ramaswamy K. (2006). *Global Strategy*, Oxford University Press
- Margulescu Serghei, Margulescu Elena (2009). *Switching from the globalization of markets to the globalization of production and services in a semiglobalized world*, in The 33-rd Annual Congress of the American Romanian Academy of Arts and Sciences (ARA) Proceedings, Volume I, Polytechnic International Press, Montreal, Quebec
- Palmisano Sam (2006). *The Globally Integrated Enterprise*, Foreign Affairs, USA
- Pankaj Ghemawat (2007). *Redefining Global Strategy*, Harvard Business School Press, Boston, Massachusetts 2007: 10
- Rugman Alan, Verbeke Alain (2004). *A Perspective of Regional and Global Strategies of Multinational Enterprises*, Journal of International Business Studies 35, no. 1, January 2004
- Stiglitz J. (2002). *Globalization and Its Discontents*
- Van Agtmael Antoine (2007). *The Emerging Markets Century*, Free Press, New York
- Van Welsum D. & Reif X. (2005). *Potential Offshoring: Evidence from Selected OECD Countries*.