Change Management in Transition Economies: Integrating Corporate Strategy, Structure and Culture

by Heinz-Jurgen Stuting, Wolfgang Dorow, Frank Claassen and Susanne Blazejewski (eds)

ISBN:1403901635

Palgrave Macmillan © 2003 (314 pages)

This book investigates the concepts and instruments for managing change in companies striving toward a market orientation in Poland.

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Organized around a case study centered on Beiersdorf-Lechia SA, Poland, this book investigates the macroeconomic context and the structural, strategic and cultural processes of managing radical change in companies in Central and Easy European countries. It focuses on concrete, efficient instruments and concepts for changes in this dynamic environment, and delineates important options for strategic development of the regions' enterprises in view of the pressing international competition and pending enlargement of the European Union. The contributors are managers and academics from the East and the West.

This book will help managers better to assess alternatives for action in radical change processes and will also appeal to students of business needing information on economic development in transformation countries, providing theoretically sound models on the management of change and in-depth case studies of successful turnaround management processes in companies in Central and East European countries.

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Individual chapters (in order) © Andrzej Byrt; Witold Malachowski; Reinhard Klein; Jan Jezak; Josef C. Brada; Roderick Martin; Susanne Blazejewski, Frank Claassen, Wolfgang Dorow and Heinz-Jürgen Stüting; Jutta Emes; Arnold Schuh and Hartmut Holzmüller; Tomasz Domanski; Gerhard Reber and Werner Auer-Rizzi; Thomas Otte; Krzysztof Konecki; Krzysztof Oblój; Stefan Schmid; Klaus E. Meyer and Camilla Jensen 2003

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First published 2003 by

PALGRAVE MACMILLAN

Houndmills, Basingstoke, Hampshire RG21 6XS and

175 Fifth Avenue, New York, N.Y. 10010

Companies and representatives throughout the world

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ISBN 1–4039–0163–5

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

Change management in transition economies: integrating corporate strategy, structure, and culture/edited by Heinz-Jürgen Stüting . . . [et al.].

p. cm. Includes bibliographical references and index. ISBN 1–4039–0163–5 (alk. paper)

1. Industrial management—Poland. 2. Business enterprises—Poland. 3. Poland—Economic policy—1990– 4. Industrial management—Europe, Eastern. 5. Germany—Foreign economic relations—Poland. 6. Poland—Foreign economic relations—Germany. I. Stüting, Heinz-Jürgen.

HD70.P6 C4 2003

338.09438—dc21 2002192669

10 9 8 7 6 5 4 3 2 1

12 11 10 09 08 07 06 05 04 03

Typeset by Cambrian Typesetters, Frimley, Camberley, Surrey

Printed and bound in Great Britain by

Antony Rowe Ltd, Chippenham and Eastbourne

Team LiB

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Preface

Since the breakdown of the socialist regimes in Central and Eastern Europe, with their planned economies and lack of entrepreneurial freedom, a dramatic development of free markets and competitive enterprises in an extremely turbulent economic environment has been observed. One of these countries, Poland, can be regarded as a laboratory for scientific research on macroeconomic transformation and managerial change. Poland not only spearheaded the process of economic democratization and liberation, but in 1989, immediately after the political turnaround, it also became a preferred target market for concentrated investment by foreign enterprises. One prominent example, which is a focus of our research, is Beiersdorf-Lechia in Poznan, which produces and distributes the Nivea Creme brand in Poland and other Central and Eastern European countries. The many facets of the process of developing a market-oriented strategy, structure and culture reveal the enormous challenges of managing change in a transforming society.

Although there is a rapidly growing body of work on the macroeconomic transformation processes in Central and Eastern Europe, less has been written about the managerial challenges and problems of changing state-owned conglomerates into highly responsive, consumer-oriented, lean-structured private enterprises. Those managers of Western companies who were sent to the region were like astronauts venturing into unknown space. Most were unable to speak the language or understand the customs and culture of the countries in question. Furthermore they had to develop their own situation-related solutions as prior experience of similar change management processes did not exist.

The aim of this book is to fill the knowledge gap in this area by analyzing the complex transition of production-centred, highly diversified, vertically integrated conglomerates into thriving consumer-oriented private enterprises. One of the main findings of our in-depth analysis of the change process is that standard theories, models and recommendations for change management have to be reformulated. Many important facets of the change process are often underestimated or neglected, including the need for speedy action, the pressing demand for appropriate capital investment, the problem of inappropriately trained human resources, the resolution of conflicts of interest and the struggle between old and new holders of authority, all of which require a flexible, situation-dependent, management leadership style.

This book takes a multidimensional approach to change management in transforming economies and is divided into three parts. Part I describes the expansion of international trade and foreign direct investment in Central and Eastern Europe since the early 1990s, considers various aspects of mass privatization, including firm behaviour and corporate governance in state-owned and privatized firms, and traces the evolution of labour relations in Central and Eastern Europe. It focuses specifically on the development of economic, political and cultural relations between Poland, the region's largest market, and Germany, which is Poland's most important economic partner within the European Union. By analyzing the threats, opportunities and constraints that exist in Central and Eastern European countries, Part I reveals the scope for and limitations on managerial action in this region.

In Part II the case of Beiersdorf-Lechia in Poland is used as a vehicle to examine how management can handle these opportunities, threats and constraints when trying to bring about full-scale radical change. The case study addresses the adjustment of strategies and structures, the establishment of a strong marketing and sales function, the crucial question of human resource management in change processes, the integration of subsidiaries into international corporate networks, and the process of transforming the organizational culture.

Part III considers a broad range of specific aspects of managerial action and options for handling change, including barriers to and strategies for market entry into Central and

Eastern European countries, the marketing and branding strategies of multinational corporations in the region, the evolution of the trade sector, human resource and leadership issues, change of organizational identity, and the accession of Central and Eastern European countries to the European Union.

In view of global trends, this volume will be useful to any manager who is confronted with change management problems not only in Central and Eastern Europe but also in other parts of the world. The editors hope that the analysis will encourage new perspectives on the process of change management and will help managers in similar situations to reflect critically on their own management decisions and leadership style. Furthermore we hope to contribute to scholarship on the management of change in transition economies by offering a framework for further research into this area.

Acknowledgements

The editors of this volume would first like to extend their gratitude to all the contributors, who in line with the objectives of the project come from both academia and the world of management, and from both East and West – thus providing an insider's perspective, in contrast to many other publications on Central and Eastern Europe. We are also deeply indebted to all those employees and managers at Beiersdorf-Lechia who never tired of giving yet another interview or searching for yet another piece of information in the company's archives. Dr Rolf Kunisch, CEO of the Beiersdorf group, supported our project from the start and provided important insights into the international strategy of the Beiersdorf group and its expansion into Central and Eastern Europe.

We also wish to thank Roksana Sopinka and Simone Oberländer for their never ending patience with the tedious formatting and correction of the final manuscript. Francis Page helped us to put it into correct English – not an easy task as the bulk of the contributions were written by authors for whom English is a foreign language.

Finally, we thank Caitlin Cornish and Palgrave for their support of this project and for the opportunity to share our ideas on and experiences of the process of change with you, the reader.

Heinz-Jürgen Stüting
Wolfgang Dorow
Frank Claassen
Susanne Blazejewski

List of Abbreviations

AWS	Akcja Wyborcza Solidarnosc
AWP	Ankietowe Wartosciowanie Pracy
CDU	Christlich-Demokratische Union
CEE	Central and Eastern Europe
CEEC	Central and East European countries
CEFTA	Central European Free Trade Agreement
CEO	Chief Executive Officer
EBRD	European Bank for Reconstruction and Development
EFTA	European Free Trade Association
EU	European Union
FDI	Foreign direct investment
FDP	Freie Demokratische Partei Deutschlands
GDP	Gross domestic product
GUS	Glowny Urzad Statystyczny
IT	Information technology
MNC	Multinational corporation
MNE	Multinational enterprise
NATO	North Atlantic Treaty Organization
NIF	National Investment Fund
NSZZ	Niezalezny Samorzadny Zwiazek Zawodowy
OPZZ	Ogolnopolskie Porozumienie Zwiazkow Zawodowych
PAIZ	Polish Agency for Foreign Investment
PSL	Polskie Stronnictwo Ludowe
PHARE	Poland and Hungary – Aid for Reconstruction of the Economies
R&D	Research and development
SA	Spolka Akcyjna
SLD	Sojusz Lewicy Demokratycznej
SLD-UP	Sojusz Lewicy Demokratycznej–Unia Pracy
SMEs	Small and medium-sized enterprises
SPD	Sozialdemokratische Partei Deutschlands
TWG	German–Polish organization for business promotion
UMEWAP	Uniwersalna Metoda Wartsciowania Pracy
UN	United Nations

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Team LiB

Part I: Establishing the Framework: Economic and Political Constraints on Business in Poland

Chapter List

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Chapter 1: Political, Economic and Cultural Developments in Polish–German Relations Since 1989

Andrzej Byrt

Abstract

This chapter briefly describes the history of postwar German–Polish political relations until 1989, the conclusion of the border treaty (in 1990) and the signing of the Treaty of Good Neighbourliness and Friendly Cooperation in 1991. It outlines the consequences of these treaties in the political, economic and cultural spheres in the years 1989 to 2001, just before Poland's accession to the European Union.

1.1 Introduction

The history of German–Polish relations after World War II was marked by the post-Yalta westward shift of the border between (and the populations of) Germany and Poland and by the Cold War division of Germany, its Western part becoming a member of NATO and later of the European Economic Community, and its Eastern part, together with Poland, becoming a member of the Warsaw Pact and the Council of Mutual Economic Assistance (Comecon).

As a consequence of the decision taken in Yalta and Potsdam, Poland lost nearly 50 per cent of its prewar territory to the Soviet Union (182 000 square kilometres) but gained 103 000 square kilometres of Germany. Thus Poland's net loss of territory amounted to 20 per cent. Germany lost 25 per cent of its prewar territory (114 000 square kilometres), of which 22 per cent was handed over to Poland and 3 per cent to the Soviet Union. Both countries had lost six million of their citizens in the war, amounting to 22 per cent of the Polish population (including three million Polish Jews murdered in Holocaust) and 10 per cent of the German population (Dimitrów, 2001, p. 12). As well as those who had already fled, 3.5 million Germans were deported immediately after the war from Poland to Germany and 1.5 million Poles from the Soviet Union to Poland (Ociepka, 2001).

The postwar territorial and human losses and trauma, the German–Polish border changes, and the painful and tragic deportations meant that German–Polish political and human relations were governed by mistrust for many years. The imposition of the new German–Polish border formed the cornerstone of Poland's foreign policy after 1945. Non-acceptance of the territorial change was similarly important to West Germany until the 1970s, and it strove to repatriate those Germans who had been stranded in the new Polish territory after World War II, or to force Poland to recognize them as a minority group. These circumstances have continued to influence the course of German–Polish political, economic, cultural and human relations, and although progress towards reconciliation has been made, goodwill, mutual understanding and a readiness to continue the dialogue are still required.

1.2 Polish–German relations, 1945–89

The German Democratic Republic recognized the new German–Polish border in 1950. The Federal Republic of Germany followed suit in 1972, and as a consequence re-established diplomatic relations with Poland. This facilitated the conducting of bilateral political relations as well as economic cooperation and trade between the two countries. This phase of the 'Ostpolitik' of the SPD/FDP West German government peaked in 1975, when as a consequence of the spirit of détente that followed the Helsinki Conference on Security and Cooperation in Europe, West Germany and Poland signed an agreement that enabled 120–125 000 German nationals to leave Poland. In return Poland received a development credit of DM1 billion.

The birth of the independent trade union Solidarnosc (solidarity) in Poland in 1980 and the consequent introduction of martial law in 1981 brought West German–Polish relations to a standstill. There followed a period of stalemate, with repression of the opposition in Poland being supported by East Germany and attempts being made by West German officials to continue their dialogue with their contacts in the Polish government. The inability of the government to resolve Poland's political and economic problems, a new wave of political and social protests in 1988 and Gorbachov's policies of perestroika and glasnost prompted the two sides of the Polish political division to strike a compromise: the staging in June 1989 of the first semidemocratic elections in Central and Eastern Europe since the 1950s (June 1989). As a result a new government came into power in September 1989, with the first non-communist prime and foreign ministers in the Warsaw Pact countries. A new era had begun.

1.3 New beginnings, 1989–91

1.3.1 The German–Polish Common Declaration, 1989

The unexpected events in Poland offered the chance for the Poles and Germans to re-examine their bilateral relations. Chancellor Kohl arrived in Poland on 9 November 1989, but returned to Germany the next day because of the fall of the Berlin Wall. The symbolic significance of this event was beyond question. Upon his return to Warsaw on 12 November Kohl and Prime Minister Mazowiecki signed a ‘Common Declaration’, comprising 78 points in nine chapters, the most comprehensive political document since the German–Polish normalization treaty of 1970. A major breakthrough was made with regard to the rights of the German minority in Poland, and the Federal Republic pledged to support the transformation process in Poland. The two sides also signed eleven agreements and protocols, the provisions of which ranged from economic cooperation, financial arrangements and environmental matters to youth exchange programmes and cultural institutes. However no significant progress was made on the question of the German–Polish border.

1.3.2 Confirmation of the Polish–German border, 1990

The eventual resolution of the border question resulted from the negotiations between the two German states and four allied powers, United States of America, France, Great Britain, Soviet Union (the two-plus-four negotiations) that led to the reunification of Germany. After extensive political contacts and consultations, it was agreed in July 1990 in Paris that the united Germany, comprising the territories of the two German states, would recognize the existing German–Polish border in a bilateral, legally binding treaty. The treaty was signed on 14 November 1990 in Warsaw by the foreign ministers of Poland and Germany (Skubiszewski and Genscher), a year after the signing of the German–Polish Common Declaration. The treaty was ratified by the two states in October 1991. Thus the most sensitive political and psychological issue in German–Polish relations since World War II was closed.

There are many Polish words with roots in the German language, particularly with regard to buildings, for instance *fundament* (from the German *Fundament* – foundation), *mur* (*Mauer* – wall), *cegla* (*Ziegel* – brick), *dach* (*Dach* – roof) and *ratusz* (*Rathaus* – town hall), all of which entered the Polish language as a result of centuries of German–Polish cooperation. In the German language only few words originate from Polish, but one is highly symbolic: *Grenze* (*granica* – border), which was first used at the turn of the twelfth century in agreements on the delimitation of territories between the Teutonic Order and Polish princes (Krämer, 1997, p. 14).

Border conflicts have been part of European history since its beginning. With the signing of the German–Polish border treaty in 1990 the two nations closed, it is to be hoped forever, a particularly bloody chapter of German–Polish history. The two countries can now devote their time and energy to building a common future – an appropriate vocabulary and traditions already exist.

An immediate consequence of the 1990 border treaty was the bilateral introduction in April 1991 of the visa-free movement of tourists. This was one of the most visible and positive consequence of Poland’s political change for both the country’s citizens and their Western counterparts, as well as a decisive confirmation of the fact that acknowledged borders no longer constituted barriers for human beings. As German Foreign Minister Genscher put it in his speech at the signing of the border treaty in Warsaw, ‘The confirmation of this border, binding from the point of view of international law, is a decisive contribution to the perspective of Europe without frontiers’ (Auswärtiges Amt, 1995).

1.3.3 The German–Polish Treaty on Good Neighbourliness, 1991

In order to solidify the 1990 border treaty the governments of the two countries promptly started to negotiate the contents of the German–Polish Treaty on Good Neighbourliness and Friendly Cooperation. Signed on 17 June 1991 in Bonn by Polish Prime Minister Bielecki and German Chancellor Kohl, it was based on the declared 'German–Polish community of interests'.

This treaty was the first, most detailed and most comprehensive of those signed between Eastern and Western European countries after the collapse of communism. Its 38 articles covered the entire range of issues of interest to the two states, including bilateral and multilateral security, political, economic, social and cultural cooperation, the recognition of German minorities in Poland and of Germans of Polish origin in Germany, the establishment of a youth exchange programme (Jugendwerk), the maintenance of war graves and much more. It also took note of Poland's determination to join the European Union, but not with its (as yet unstated) readiness to join NATO: Soviet troops were still stationed in both Poland and East Germany. In tandem with the treaty it was decided to create a German–Polish Reconciliation Foundation to support surviving Polish victims of Nazism.

This treaty, which was ratified by the two countries' parliaments in 1991, constituted a strengthening of the border treaty of November 1990. In the words of Poland's Foreign Minister Skubiszewski, while the border treaty had put an end to the most difficult issue in German–Polish relations, 'The treaty of good neighbourliness and friendly cooperation is directed towards the future . . ., is a message for other nations of our continent, . . . it has a European dimension . . . and it confirms Europe's unity' (Skubiszewski, 1997, pp. 180–1).

For Germany the treaty was a fulfilment of Adenauer's wish to establish a permanent reconciliation with Poland, which due to international circumstances had taken longer than expected to come into being. For Poland the treaty was to serve as a model for its negotiations with its six other neighbouring countries – the Czech Republic, Slovakia, Ukraine, Belarus, Lithuania and Russia – none of which had functioned as a sovereign state before the collapse of the communist order in Central and Eastern Europe. The Polish–German treaty therefore created a new paradigm for Poland's foreign policy: establishing and developing friendly relations with all its new neighbours, born out of the political and economic transformation of the central part of the European continent.

1.4 The German–Polish community of interests, 1991–2002

The fundamental changes generated by the two German–Polish treaties created a solid foundation for the development of Poland's foreign relations in all fields, ranging from politics to military and economic matters and bilateral and multilateral involvement in the UN, NATO, EU and other international bodies.

1.4.1 Political cooperation

The frequency of official and unofficial German–Polish contacts has increased enormously: meetings between presidents, prime ministers and chancellors, government ministers, top ministerial officials and officials at regional levels are now very well established. Some of these are worth highlighting:

- Annual German–Polish governmental consultations, held alternately in Germany and Poland (for example in June 2002 in Wrocl/aw).
- Annual meetings of foreign ministers and prime ministers of East German borderlands with marshals of western Polish provinces (*voievodships*).
- Annual tripartite meetings of Polish, German and French presidents, foreign ministers and occasionally other cabinet ministers of the three countries (finance, defence and so on).
- Regular meetings of Polish and German ministers, deputy ministers and representatives of their ministries.

In addition, the increasingly multilateral character of Poland's foreign diplomacy and negotiations, particularly in respect of the UN, NATO, the European Union and regional groupings, the predominant role played in them by Germany and the growing intensity of Poland's presence within their structures is strengthening the relationship between top politicians from the two countries.

It is also worth highlighting the active part played by non-governmental and multilateral organizations. Think-tanks, foundations, research institutes, media groups, financial bodies, fairs, societies, associations and universities are staging a growing number of important conferences, where very often top politicians of Poland and Germany meet to present their views as lecturers or members of discussion panels. In this respect the attendance of Poland's foreign minister at the annual meeting of German ambassadors in Germany's Foreign Office in 2001 was of great symbolic importance.

1.4.2 Parliamentary cooperation

Contact between the Sejm and the Bundestag, and their upper chambers the Senat and the Bundesrat, has strengthened over the years. German–Polish parliamentary groups meet on a regular basis, as do their presidents within the Parliamentary Assembly of the Council of Europe and the North Atlantic Council. Contact is also being maintained between Polish parliamentarians and German representatives from the European Parliament.

Only once during the past 13 years has there been open conflict between the two parliamentary institutions: in 1998 the Bundestag voted on a declaration on the so-called *Vertriebene* (Germans who had fled or were transferred or expelled from former eastern German territories as a result of World War II). The Sejm reacted immediately with a counterdeclaration, invoking the events of World War II and the inviolability of postwar European borders. However the prompt arrival in Warsaw of Bundestag President Süssmuth

with an explanatory mission enabled the two sides to settle the matter.

1.4.3 Military cooperation

Since the signing of the German–Polish treaties important progress has been made in military cooperation between the two countries. Military cooperation began in 1991 and intensified after former Soviet troops stationed in Poland returned to Russia in 1992. In 1993 Poland and Germany signed a military agreement that enabled Polish officers to be trained at the Academy for Military Leaders in Hamburg, German troops to be trained on military firing ranges and training grounds in Poland, and Polish and German troops to cooperate on a bilateral basis across the common border.

Today Polish and German military forces jointly conduct over 300 operations a year, more than German troops engage in with their French counterparts. A milestone in that respect was laid in 1999 in Szczecin, when Poland, Germany and Denmark opened the headquarters of the newly created North-East Corps, transferred there from Schleswig-Holstein in Germany. The Polish air force has received a number of upgraded Soviet fighter planes from the German Luftwaffe, and the Polish army has obtained several Leopard tanks. Furthermore the Polish and German armament industries have started to work together on certain common projects. All of these are the result of Poland's and Germany's NATO membership, with the two countries being military allies within a joint political and defence structure for the first time in their history.

1.4.4 Poland's EU accession

While Germany's support for Poland's accession to the EU was inscribed in the 1991 treaty, during the now completed stages of the negotiations (in 2002, 25 of the 30 chapters to be discussed were closed) the two countries often stood in opposition, fuelled by the conflicting interests of trade unions and industrial and agricultural lobbyists. Despite this Poland managed to find rational solutions and compromises that helped it to advance the negotiations. This new experience of a tough but constructive dialogue between two partners of unequal weight, strength and position in relation to the European Union has taught Poland a lot about alliance-building among and compromise-finding with its future EU partners, including German *Länder*, whose regional interests do not always coincide with the federal ones.

1.4.5 Bilateral trade

Economic and financial cooperation between Poland and Germany has boomed since 1989. The major factors behind this were the extent and speed of Poland's economic transformation, the geographical proximity and potential of the Polish market, Poland's association agreement with the EU and the settlement of Poland's longstanding foreign debt.

Since the signing of the German–Polish treaties in the early 1990s bilateral trade has grown nearly fourfold, rising from DM15 billion in 1991 to almost DM60 billion in 2001. Between 1995 and 2000 the trade balance was negative for Poland – on average DM5 billion a year. In 2001 Germany accounted for 35 per cent of total Polish exports (half of Poland's exports to the EU) and 25 per cent of total Polish imports. Germany is Poland's top trading partner worldwide in both exports and imports, whereas Poland is Germany's tenth largest export market (a 2.4 per cent share of German exports, ahead of Sweden, Russia, Japan and China) and its fourteenth largest import supplier. Poland is Germany's largest trading partner in Central and Eastern Europe. As a result of foreign direct investment in Poland during the past 12 years and the ongoing process of economic and industrial restructuring, the composition of Polish exports to Germany has changed: 50 per cent of exports now consist of electrical and mechanical equipment and machinery, cars and spare parts, furniture and textiles, with the

two last industries losing their previous importance step by step.

1.4.6 Mutual direct investment

At the end of 2001 the total value of German direct investment in Poland was US$6.3 billion. Germans held the third place among all foreign investors in Poland. Two hundred and three German companies had invested more than US$1 million each in Poland, and the total number of investors exceeded 3000, most of which were small or medium-sized firms. This investment has had the positive effect of stimulating the climate for growth and innovation.

Polish investment in Germany reflects the asymmetry of the two countries' economic and financial potential. Polish companies have so far invested C=125 million, mostly in construction. On the basis of a German–Polish agreement signed in 1990, in 2001 just over 500 Polish firms offered their construction services (as subcontractors to German building companies) in Germany, employing 22 000 Polish building specialists. This enabled German developers to reduce their construction costs substantially and thus to cut house prices and rentals. Although the German demand for Polish construction services has grown, trade union pressure has blocked a further increase in the number of work permits. This situation will be resolved after Poland's accession to the European Union in 2004 and the expiry of the seven-year interim period in which the German labour market will be closed to workers from new member countries.

As a consequence of the improvement in German–Polish economic relations, in 1999 Poland was upgraded to group 2 (minimal risk) on the Hermes guarantee scale.

1.4.7 Regional projects

Transborder and regional cooperation has grown spectacularly since 1990/91. There are now 250 school partnerships and more than 300 partnership agreements between Polish and German cities, districts, communes and provinces. The Treaty of Good Neighbourliness and Friendly Cooperation resulted in the establishment in 1991 of the German–Polish Commission for Regional and Cross-border Cooperation, with four committees being set up to manage projects within the PHARE, CBC and INTERREG programmes. The legal basis for interregional cooperation has gradually been broadened, and there are now 12 interregional cooperation agreements between Polish provinces and German *Länder*. These cover not only common projects and exchange programmes, but also cooperation among regional authorities in connection with the future accession of Poland to the EU, such as the provision of training to Polish regional delegates by German delegates in Brussels.

In 2000 the Union of Polish Districts and its German counterpart signed a cooperation agreement, the first such agreement for both Germany and Poland. There is also considerable activity between German and Polish cities. So far about 300 intercity, interregional and interprovincial partnership agreements have been signed. Similarly active are the Union of Polish Cities and its German counterpart. The Union of German Cities regularly stages an annual joint conference, and the two unions have also established a trilateral relationship with the Union of French Cities, thus fostering at the regional level the cooperation that reigns at the state level.

The Polish administrative reform, which in 1998 reduced the number of Polish provinces to 16 (the same as in Germany) and gave them greater legal and financial independence from the central state authorities, has encouraged further cooperation. Additional stimulation will be provided by the first direct elections of city mayors and presidents of communes and districts in 2002.

1.4.8 Cross-border human and trade flows

The 450 kilometres German–Polish border, the most easterly EU border in mainland Europe, has 22 road, eight train and five river crossings. Five additional border crossings are expected to be opened soon. What once divided is no longer an obstacle – in 2001 the German–Polish border was crossed 90 million times, making it the most intensively used frontier between Poland and its seven neighbours (40 per cent of all Polish border traffic). Of the 90 million people who crossed that year, 31 million were Polish citizens (35 per cent) and 59 million were foreigners (65 per cent), of which 88 per cent were German. This was a fall of 24 per cent as a consequence of tightened border security following the terrorist attacks in the United States on 11 September 2001 and the continuing effort to prevent the spread of BSE ('mad cow disease'). On average 248 000 people crossed the border every day: 78 per cent by car, 18 per cent on foot and 4 per cent by train. At Swiecko (near to Frankfurt/Oder and the largest road checkpoint on the eastern EU border), every 1.5 minutes two lorries crossed in opposite directions, amounting to more than 2000 a day. Although many improvements have been made since the border opened so dramatically in 1989/90, there are still long queues of lorries waiting for customs clearance.

At the same time the Polish and German police have joined forces to combat cross-border organized crime. German–Polish patrols on both sides of the border have helped to reduce illegal border crossings by an impressive 60 per cent.

1.4.9 Euroregions

There are four German–Polish Euroregions: Neisse–Nisa–Nysa (established in 1991 and incorporating a small area of the Czech Republic), Spree–Neisse–Bober (established in 1993), Pro Europa Viadrina and Pomerania (both established in 1995). Administrative districts on both sides of the border are engaged in the development of various joint projects. In 1994 in Gorzów Wielkopolski the Organization for Business Promotion (TWG) was set up to foster cross-border economic cooperation and the flow of information. It has subsequently helped many German and Polish companies to set up joint ventures and trade projects in the preparation for Poland's accession to the European Union. Because of its excellent results it is likely to continue its activities after Poland attains EU membership.

The decentralization of German–Polish cross-border activities also led to the establishment of the Polish–Bavarian Experts' Commission in 1996, which meets regularly to discuss and launch joint programmes in the areas of health, environmental protection, agriculture, home affairs, economics, education and culture.

1.4.10 Social institutional cooperation

German–Polish social contacts have also flourished since 1989/90. Three institutions, all established on the basis of the German–Polish treaty of 1991, are worth mentioning: the German–Polish Youth Exchange (*Jugendwerk*), the German–Polish Reconciliation Foundation and the German–Polish Cooperation Foundation.

Since 1993 the *Jugendwerk* programme has enabled more than one million young Poles and Germans to visit their contemporaries on the opposite side of the border, thus following the example of the similar but much older French–German project. In 2001 alone nearly 150 000 young schoolchildren and students from both countries participated in more than 3000 exchange programmes. The German–Polish Reconciliation Foundation was endowed by the German government with DM500 million to assist Polish victims of the Nazi regime. Since 2001 it has also handled compensation payments worth DM1.8 billion for those Polish forced labourers who survived World War II. Meanwhile the German–Polish Cooperation Foundation was appointed by the German government to handle the Polish repayment instalments of the so-called jumbo credit that Germany extended to Poland in 1975. In addition it has supported the realization of joint German–Polish cultural and social projects aimed at developing mutual relations. There are also a number of social projects by German associations, societies,

foundations, churches, cities, communes, districts and individuals to promote German–Polish reconciliation on a spiritual or humanistic basis. Particularly active in this field are the political foundations named after Friedrich Ebert (SPD), Kondrad Adenauer (CDU), Friedrich Naumann (FDP) and Heinrich Böll (Bündnis 90/Grüne), as well as the numerous Polish–German societies that have arisen since 1996 in both countries.

1.4.11 Germans in Poland and Poles in Germany

The 1991 German–Polish Treaty of Good Neighbourliness and Friendly Cooperation included a political novelty: three articles (20, 21, 22) relating to Germans living in Poland and Poles living in Germany. This was the first formal acknowledgement of the existence of a German minority in Poland. Today this population numbers about 250 000 people (Kurcz, 2001, p. 25) organized into more than 70 sociocultural groups, mostly in the regions between Katowice (Upper Silesia), Cze stochowa and Opole (Lower Silesia), where they gained a majority in a number of communes and towns in three communal elections after 1991 (Urban, 1993; Bingen, 1999, p. 134). Not limited by the voting barrier of 5 per cent that exists in Poland for candidate parties, the German minority in Poland also have representatives in the Polish parliament (two MPs in 2002). They publish their own German newspapers, run radio stations and TV programmes, conduct mass in German and have their own schools. A sizable number also hold German citizenship and already enjoy EU freedom of movement.

The treaty of 1991 guaranteed German citizens of Polish origin living in Germany the same rights as the German minority living in Poland. However, as they do not live in concentrated groups, they have not gained political representation at the regional or the federal level, nor have they managed to secure a satisfactory degree of Polish-language teaching. This could be of importance after Poland's accession to the EU in view of the German–Polish business ventures that are likely to mushroom.

Apart from certain difficulties, that still exist in these people's relations with the authorities in the respective countries, the treaty of 1991 and subsequent developments have substantially improved not only the position of the two national groups in the country in which they live, but also the chances that will be open to them following Poland's accession to the EU.

1.4.12 Cultural promotion

The development of German–Polish cultural, scientific and educational initiatives since the political changes in the two countries is also of importance. These initiatives include a new legal framework at the governmental level, agreements on cultural cooperation (1989) and scientific-technical cooperation (1997) between the governments of Poland and Germany. In addition a number of new institutions have been created, and every two years the Polish–German Commission for Culture meets in order to evaluate the progress achieved and to propose new initiatives.

In Poland two Goethe Institutes (in Warsaw and Cracow) and the German Historical Institute (Warsaw) promote German art, culture and history, as well as German–Polish joint research and publications in these areas. They are assisted in these endeavours by German political foundations (see Section 1.4.10). On top of this, numerous German arts events (literature, film, theatre, opera, ballet, music, painting, sculpture) are held in Poland, promoted by various non-governmental organizations, institutions, companies, foundations and individual sponsors.

Polish art and culture is promoted in Germany by Polish institutes in Berlin, Leipzig and Düsseldorf, the Deutsches Polen Institut in Darmstadt and a number of cultural institutions, associations, societies and foundations that act on a countrywide or regional basis. Every year nearly 1500 political, economic, scientific and cultural German–Polish events take place in German cities, communes, districts and regions, most of them organized by non-

governmental institutions and with a particular focus on multilateral aspects of Poland's preparations to join the European Union in 2004.

Among the many important events worth mentioning are the millennium celebrations of the meeting in 1000 in Gniezno between Emperor Otto III and Prince Boleslaw Chrobry (Brave), a series of literary lectures on Polish literature in 40 cities in North-Rhine-Westphalia in 2000, and Poland's successful participation at EXPO 2000 in Hanover and at the International Book Fair in Frankfurt/Main the same year. Every year Polish politicians, scientists and artists are awarded special distinctions and prizes, take part in important public events as guest lecturers, and appear in newspapers, magazines and radio and TV programmes on matters of importance for the two countries. Among the well-established cultural phenomena it is worth mentioning the German–Polish Prize, which is awarded annually by the foreign ministers of the two countries to institutions or persons who have contributed to a better understanding between the two nations, and the Cultural Prize of Silesia, which was established by the government of Lower Saxony to honour the best German and Polish artists coming from or living in Silesia.

1.4.13 Education

German–Polish cooperation has developed between hundreds of scientific and school organizations, universities and research and development institutes in practically all educational and scientific fields. An unparalleled institution in this respect is the European University Viadrina in Frankfurt/Oder, which was founded in 1991. Polish and German students enrol jointly, with the Polish group amounting to more than one third of the total student population. Another institution is the Collegium Polonicum in Slubice, a project of Poznan University in cooperation with the University Viadrina. German is taught in practically all Polish secondary schools and universities, and in the very short time since the establishment of normal political relations between the united Germany and democratic Poland, German has become the second foreign language in Poland, especially among young people. However this has not been the case with the Polish language in Germany, and progress in this respect will depend on the development of Poland's attractiveness to Germany as a political, economic and cultural partner within the EU.

Team LiB

1.5 Where does Poland stand now?

In the last phase of Poland's EU accession negotiations German–Polish relations are being put to the test, bearing in mind the difference between the two countries' positions *vis-à-vis* such controversial issues as direct payments to farmers, the amount of structural and cohesion funds available to new EU members and their net contributions to the EU budget. There are also unsettled issues of importance such as the mutual return of cultural artefacts displaced during the war. Should this be satisfactorily settled before Poland's accession to the EU, it would be an important symbol of the new German–Polish togetherness.

Although Poland and Germany are still separated by their substantially different developmental and income levels and this is unlikely to change in the years to come, since the renewal of relations in 1989 their rich experience of resolving their differences through dialogue can only enhance future bilateral contact. The continued strengthening of German–Polish relations will help both countries to cope with unexpected challenges in the always unpredictable future.

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Chapter 2: Polish–German Economic Relations in the 1990s: The Track Record and its Implications

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Abstract

Poland and Germany are two important but very different economic players in the centre of the European continent. This chapter examines how relations between these countries have developed since the political changes at the end of the 1980s, and concludes that Polish–German economic relations intensified during the 1990s. The chapter also takes a detailed look at the development of mutual trade relations in various major economic sectors and of German direct investment in Poland.

2.1 Introduction

Economic relations between Poland and Germany have gained momentum since the reunification of East and West Germany in 1990. Germany is a leading player in the global economy and has the third highest GDP in the world, just behind the United States and Japan. Germany's role in the international division of labour is even greater. In terms of volume of exports it ranks second only to the United States. Yet unlike the United States, Germany usually has high foreign trade surpluses as German goods enjoy prestige and a remarkable reputation for quality among consumers.

Germany is a net contributor to the EU budget, with the largest contribution to the budget coming from that country. Consequently Germany can be seen as the driving force behind European integration in terms of both deepening and enlargement.

After reunification, even though more than DM100 billion was transferred to the five new federal states each year the economy retained its competitiveness and the currency preserved its stability and strength. Despite this, in a bid to deepen European integration Germany strongly supported the plan to introduce a single European currency and 12 EU member countries duly introduced the Euro on 1 January 2002. Germany thus became an even more important economic pillar of united Europe, while continuing to guarantee its own citizens extensive freedoms and a high degree of social welfare. This rare combination of economic growth, high living standards and social harmony has strengthened the image of Germany as one of the most stable and smoothly functioning parliamentary democracies in the modern world. As a result Germany is an attractive partner for economic cooperation, although the German market sets high standards for foreign imports.

2.2 Polish–German economic relations

How did Polish–German economic relations develop in the 1990s, after the start of the reforms in Poland and the reunification of Germany? Has the cooperation been mutually satisfactory? Should Germany be viewed as Poland's most important economic partner? Do the existing legal and political foundations permit the optimization of economic cooperation between the two countries?

This section addresses all these questions, although the asymmetry between the two countries' economies and the huge part played by Germany in European integration, especially in the context of Poland's EU bid, make the analysis a difficult task. This asymmetry applies not only to the economic capacities of the two countries, especially their GDPs, but also to their international economic relations, technological standards, quality of organization and management, competitiveness, capacity for innovation and financial reserves.

2.2.1 Foreign trade

The development of Polish–German trade relations over the past decade clearly demands a positive assessment. Poland has become one of Germany's key trading partners in Central and Eastern Europe. For German exporters, Poland is a more important market than Russia – it is the tenth largest importer of German goods, ahead of Sweden and Japan, and its position is strengthening. Meanwhile Germany has become Poland's most important trading partner, accounting for one third of it's foreign trade compared with 14.2 per cent in 1989. Poland's exports to Germany are now greater than its combined exports to its next seven largest partners (Italy, France, the Netherlands, Britain, the Czech Republic, Denmark and the United States) and Germany accounts for more than half of Poland's trade with the EU countries. Furthermore Poland's trade with Germany has grown more substantially than Poland's overall foreign trade.

This dynamic growth is due to the following factors:

- The transformation of Poland's economic system, including the liberalization of foreign trade and its reorientation towards the West after the decline of the former Comecon export markets.
- Improved access to EU markets as a result of the Association Agreement (also known as the Europe Agreement) signed in February 1992.
- Favourable economic trends.
- The German market's relatively high capacity to absorb Polish goods.

The added significance of Germany for Poland is linked to Poland's bid to secure full membership of the EU in 2004: Germany plays a major role in the EU and its position on Polish accession will be of paramount importance. In the meantime the decisive part played by Germany in Poland's foreign economic relations has influenced the transition process in Poland and its adaptation to EU standards.

In 1995 Polish–German exports and imports were more or less balanced, with exports and imports of a little over DM12 billion and total bilateral trade of DM25 billion. This guaranteed Poland the position of Germany's top trade partner among Central and Eastern European countries, ahead of the Czech Republic and Russia. However in the second half of the 1990s there was a growing imbalance between exports and imports in favour of Polish imports from Germany. In 2000 Poland's trade deficit with Germany was DM5.1 billion, and DM3.5 billion in

2001.

Notably, Germany is the most important trading partner for most Central and Eastern European countries (Table 2.1). As can be seen, for six of the ten Central and Eastern European countries Germany is the top partner in imports, and for four it is the most important partner in exports. It is a particularly important partner for the Czech Republic, Hungary, Poland and Slovenia in terms of both imports and exports. Overall, Germany is one of the two most important economic partners for all ten Central and Eastern European countries. Another characteristic feature is that these countries' trade with Germany generally shows a deficit.

Table 2.1: The CEE countries' leading trading partners, CEE 1997 (percentage of total imports/exports of respective countries)

Rank	**Country**	**Imports from**		**Exports to**	
1	Poland	Germany	24	Germany	33
2	Bulgaria	Russia	25	Italy	12
3	Estonia	Russia	23	Finland	19
4	Romania	Germany	16	Italy	20
5	Latvia	Germany	16	Russia	21
6	Lithuania	Russia	24	Russia	25
7	Slovakia	Czech Republic	23	Czech Republic	27
8	Slovenia	Germany	21	Germany	29
9	Czech Republic	Germany	32	Germany	36
10	Hungary	Germany	27	Germany	37

Table 2.2 shows Germany's position in Poland's exports and imports in comparison with its other international trading partners. The data clearly show that Poland's exports to Germany are greater than to the next seven countries combined. However Germany's position in the structure of Poland's foreign trade weakened slightly at the end of the 1990s. Table 2.3 summarizes the development of German–Polish bilateral trade since 1990.

Table 2.3: Poland's foreign trade, (percentage of total exports/imports)

	Exports from Poland		Imports to Poland	
	1995	**1999**	**1995**	**1999**
Germany	38.3	36.1	26.6	25.2
Italy	4.9	6.5	8.5	9.4
France	3.6	4.8	4.9	6.8
Netherlands	5.6	5.3	4.5	3.8
Britain	4.0	4.0	5.2	4.6
Czech Republic	3.1	3.8	3.1	3.2
Denmark	3.0	2.8	2.2	2.0
United States	2.7	2.8	3.9	3.9

Throughout the 1990s bilateral trade between Poland and Germany grew steadily, as reflected in the consistent increase in the value of total trade. However Germany's exports to Poland grew at a much faster rate than its imports from Poland. As a result Poland continuously recorded a trade deficit with Germany, especially in the second half of the 1990s. This cumulative deficit far exceeded the value of Poland's annual exports to Germany in the 1990s, so Poland had to strive to balance its exports and imports without restricting their overall growth. Thereafter the deficit narrowed from DM5.1 billion in 2000 to DM3.5 billion in 2001, and the expected recovery in Germany in 2002 is likely to produce a further increase in Poland's exports and a further reduction of the deficit to DM2.3 billion.

Table 2.3: Poland's trade with Germany, 1991–2001 (million DM)

Year	Imports from Germany	Exports to Germany	Total bilateral trade	Trade balance
1991	8475	7250	15 725	–1225
1992	8233	8287	16 520	54
1993	9702	8639	18 341	–1063
1994	10 353	10 126	20 479	–227
1995	12 695	12 413	25 108	–282
1996	16 366	12 203	28 569	–4163
1997	20 669	14 347	35 016	–6322
1998	24 113	16 443	40 556	–7670
1999	24 157	18 010	42 167	–6147
2000	28 427	23 314	51 741	–5113
2001	30 025	26 514	56 539	–3511

Source: Statistisches Bundesamt, Wiesbaden, Aussenhandel, Fachserie 7.

About 17 200 Polish companies (mostly small and medium-sized businesses) exported goods and services to Germany in 1994. This figure had risen to 18 750 by the end of the decade, accompanied by growth in the range of goods exported. The number of types of goods rose

from 1200 in the early 1990s to 4843 in 1994 and 5300 in 1999, a more than fourfold increase. This points to the growing popularity of Polish goods among German importers.

Exports to Germany in 2001 included most of the types of goods that Poland exports worldwide. Estimates by the economic department at the Polish embassy in Berlin, based on German statistics, show that imports from Poland in 2001 consisted of more than 5500 different goods, according to the 8-digit PCN code (Polish Combined Nomenclature). This was over half of the German import list. The unit value of more than 2500 of these products exceeded DM250 000. It is also estimated that the number of Polish exporters rose to approximately 21 500 in 2001, with a continually growing share taken by small and medium-sized private businesses manufacturing finished products. Hence 2001 saw a diversification of exports in terms of product groups, leading to a further restructuring of Poland's exports to Germany.

During the 1990s the share of raw materials and components in Poland's exports to Germany dropped to 14.4 per cent (down from 19.8 per cent in 1994), while the share of finished products rose from 71.2 per cent to 77.1 per cent. However the share of high-tech products remained low. In 2001 farm produce and foodstuffs accounted for just over 5 per cent of Poland's exports to Germany. This represented a fall, despite the higher value of these exports. A similar situation existed in the case of raw materials (under 4 per cent) and components (less than 10 per cent). Finished products with the highest rate of growth accounted for the remaining 81 per cent, up from 80 per cent in 2000. High-value-added finished products accounted for 70 per cent of the total value of exports. Sectors with the highest rates of growth included machinery and equipment, paper products, rubber and plastic products and motor vehicles (passenger cars and delivery vans). Vehicles, car engines and components, machinery and equipment promise further dynamic growth in the coming years as a result of heavy investment.

The value of Polish exports to Germany increased by DM5.3 billion in 2000 and DM3.2 billion in 2001, due mainly to the rising share of the following finished products in total exports to Germany:

- Non-electrical machinery and equipment (PCN 84): DM3.3 billion, up 20 per cent from DM2.8 billion in 2000.
- Furniture and lighting equipment (PCN 94): DM2.8 billion, up 2 per cent from DM2.7 billion in 2000.
- Motor vehicles (PCN 87): DM2.3 billion, up 10 per cent from DM2.1 billion in 2000.
- Knitted and fabric clothing (PCN 61 and 62): DM2.2 billion, up 5 per cent from DM2.1 billion in 2000.
- Electrical machinery and equipment (PCN 85): DM2.1 billion, up 17 per cent from DM1.8 billion in 2000.

Finished products also dominate Germany's exports to Poland. Vehicles, (mainly cars) and machinery and equipment account for almost 45 per cent of the total value of these exports. Imported machinery and equipment are mostly used to launch production in Poland, including export-oriented production.

Industrial cooperation has also grown in importance over the past few years, particularly in the case of component production and product assembly to take advantage of economies of scale. Especially successful examples of cooperation can be found in the car industry. On the German side, partners include Volkswagen and Adam Opel, and on the Polish side are local automotive plants and their suppliers. Most of these plants were built or expanded through capital investment by the parent corporations. The value of Polish supplies for industrial assembly in Germany rose from DM91.4 million in 1995 to DM637.7 million in 1999,

DM1608.5 million in 2000 and DM2 billion in 2001.

Outward processing traffic (OPT) is another form of industrial cooperation between Poland and Germany. Its beginnings in the textile sector, involving cutting, measuring and tailoring services, date back to the early 1970s, but over the past few years OPT has expanded to include sectors such as wood, metal, chemicals and plastics. However textiles continue to account for 30 per cent of the total value of German OPT imports from Poland. In 2000 OPT products accounted for 5 per cent of the total value of Poland's exports to Germany. In 2001 their share dropped, due to reduced interest in this form of cooperation among companies on both sides of the border. The year 2002 is likely to see a further drop in Poland's share in Germany's overall OPT, although OPT may well remain a major source of new export streams. Poland is Germany's second largest OPT partner after the United States, with a 9.7 per cent share in 2000. Other leading countries in this area are the Czech Republic, Romania, Hungary, South Africa and Ukraine.

As discussed above, in the 1990s Polish–German trade was characterized by a Polish trade deficit. The total deficit from the period 1991–2001 amounted to DM35.6 billion, including DM32.1 billion between 1996 and 2000, when direct investment in Poland increased (capital investment in industry and trade requires the importation of technology and supplies, generally amounting to 40 per cent of the total value of the investment project). However, the deficit was relatively small compared with the value of Poland's exports to Germany and it shrank over time, falling from: 47 per cent in 1998 to 34 per cent in 1999, 22 per cent in 2000 and 13 per cent in 2001. According to Central Statistical Office (GUS) data, in 2002 Poland's trade with Germany began to show a surplus.

2.2.2 Foreign direct investment

Poland's attractiveness as an economic partner for German companies grew in the 1990s. This also applied to German foreign direct investment. According to an annual ranking published in Germany, on a scale of 1–100 Poland received 62 points in 1998, up from 53 in 1997 and 45 in 1996. The 51–65 point range in this classification denotes countries with a credit rating that is better than average, considering their economic situation. Furthermore the German government decided in November 1999 to upgrade Poland's rating on the five-level Hermes guarantee scale from group 3 to group 2 (up from group 4 in 1994). Group 1 includes the EU countries, the United States, Japan and several other highly developed countries.

Table 2.4: Leading German investors in Poland (cumulative investment, $USmillion)

No.	Company	Value of investment
1	Bayerische Hypo-u. Vereinsbank AG	1000
2	Metro AG	600
3	Adam Opel AG	500
4	Commerczbank AG	460
5	Reemtsma	420
6	Deutsche Bank AG	230
7	Volkswagen AG	200
8	Aral	180
9	Siemens	150
10	Dyckerhoff	140
11	OBI Heimwerkermarkt	110

The value of German direct investment in Poland increased consistently in the 1990s, especially in the second half of the decade, when Germany advanced to the top FDI position. The total value of its investment in Poland exceeded US$8 billion at the end of 2001, with a cumulative value of US$40 billion since the start of Poland's transition.

In 2001, of the top 394 foreign investors in Poland 117 were German, as ranked by the Polish Agency for Foreign Investment (PAIZ), whose list only covers investments in excess of US$1 million. At the same time there were almost 9000 German firms among the 29 000 or so joint-venture companies operating in Poland.

In contrast, Polish direct investment in Germany came to a modest DM250 million in the 1990s and mainly involved trade, services and real estate.

2.2.3 Regional cross-border cooperation

A commission for regional and cross-border cooperation was established at the Polish–German intergovernmental level in 1991. The commission comprises three sections:

- A cross-border section that plays an informational and coordinating role, as well as initiating joint projects.
- A section for interregional cooperation, especially cooperation among provinces, cities and communes, covering areas such as the labour market, youth exchanges, environmental protection and historical heritage protection.
- A section dealing with joint programmes under the PHARE Cross-Border Cooperation/Interreg programme.

Euroregions are an important manifestation of Polish–German cross-border cooperation and four have been established to date:

- The Neisse-Nisa-Nysa Euroregion (ERN), created in December 1991 to cover the border municipalities and cities of Poland, Germany and the Czech Republic.
- The Spree-Neisse-Bober Euroregion, created in September 1993 to cover associations of Polish and German cities and municipalities.
- The Pro Europa Viadrina Euroregion (PEV), created in December 1993 to cover an association of Polish municipalities and a German association of municipalities called Mittlere Oder (Central Oder).
- The Pomerania Euroregion, created in December 1995 to cover the Communal Union of West Pomeranian Municipalities and the city of Szczecin on the Polish side and the Communal Union of Europaregion Pomerania on the German side. In February 1998 the Union of Skania Municipalities of southern Sweden joined this Euroregion.

Poland's 1999 administrative reform, which led to the establishment of 16 large provinces, created more favourable conditions for cooperation within the Euroregions by offering greater independence to local governments. Especially noteworthy successes of Euroregional cooperation can be found in the areas of environmental protection (for example the construction of new sewage treatment plants), infrastructure (including the construction or modernization of roads, bridges and border crossings) and scientific cooperation, as exemplified by the European University Viadrina in Frankfurt (Oder) and the Collegium Polonicum in Slubice. As the Euroregions are still in the early stages of development there are enormous opportunities for further progress in the future.

2.3 Conclusions

Polish–German cooperation has developed on the basis of the 17 June 1991 Treaty on Good Neighbourliness and Friendly Cooperation, which regulates mutual cooperation along both bilateral and multilateral lines. Poland's overall foreign economic relations, including trade with Germany, are regulated by the Association Agreement with the EU (also referred to as the Europe Agreement), which took effect in Poland on 1 March 1994. Bilateral economic cooperation has also been stimulated by a series of detailed Polish–German agreements.

An especially important factor in this relationship is Poland's prospective membership of the EU: Germany's political elite supports Polish accession and many politicians and commentators say that without Poland the EU's eastward enlargement would be meaningless. EU membership, which Poland hopes to acquire on 1 January 2004, will have a huge impact on the furtherance of Polish–German economic cooperation.

A survey by the CBOS, a leading polling centre in Warsaw, has yielded encouraging findings for the further development of Polish–German economic cooperation. When asked to name countries with which Poland should enhance its economic, political and military relations the respondents put Germany in top place in the economic sphere with 77 per cent, followed by the United States with 58 per cent. In the political sphere the figures were 74 per cent and 67 per cent respectively, with each achieving 67 per cent in the military sphere. This high level of support for cooperation with Germany is of great significance to politicians, entrepreneurs and investors as it promises an extremely favourable social climate for the further development of bilateral relations.

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Chapter 3: Investing in Poland: The Experiences of German Enterprises

Reinhard Klein

Abstract

This chapter describes the development of the Polish economy since the early 1990s and analyzes the experiences of German companies that have invested in Poland. Based on extensive primary data collected by the German Polish Organization for Economic Promotion (TWG), it discusses the specific opportunities and risks for foreign companies in this region. It is concluded that the competitiveness and attractiveness of the Polish markets will increase and their development accelerate when Poland becomes a member of the European Union.

3.1 Poland's economic development and German–Polish business relations

In the second half of the 1990s Poland, as one of the Central and Eastern European reform countries, developed into Germany's most important business partner. The following factors were most decisive:

- Market size: with the purchasing power of almost 40 million inhabitants, Poland developed into the economic locomotive of Central and Eastern Europe during the second half of the 1990s.
- Market proximity: the most important economic centres are situated no more than 600 kilometres from the German border.
- Poland's dynamic economic development and positive market data during the 1990s.

Between 1994 and 1999 GDP grew at an annual rate of 4–7 per cent (Figure 3.1). Despite the subsequent slowdown (with a rise of just 0.3 per cent, economic growth almost came to a standstill in the fourth quarter of 2001) Poland will, according to domestic and international analysts, be able to maintain itself in the medium term as a stable market and business location. The Polish government expects a noticeable improvement to take place in the economic development from 2003.

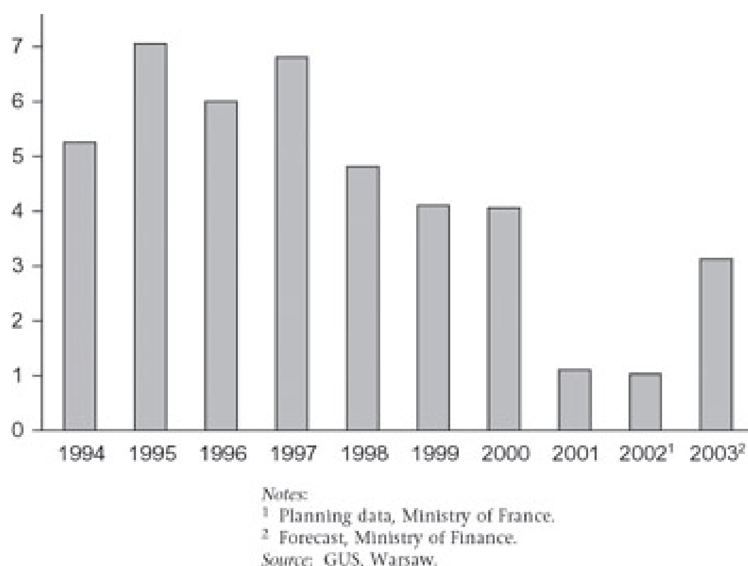


Figure 3.1: GDP development, Poland, 1994–2003 (annual growth rate, per cent)
Notes: 1 Planning data, Ministry of France. 2 Forecast, Ministry of Finance. Source: GUS, Warsaw.

The fall in growth in 2001 was accompanied by a sharp drop in domestic demand, which for the first time since the beginning of the 1990s had become negative (–2.0 per cent). Restrictive monetary policies, high unemployment and stagnating wages were key factors behind the economic slowdown. For the whole of 2001 a small reduction of 0.2 per cent occurred in industrial production.

The overvalued exchange rate for the zloty, high interest rates (which were holding back economic development) and the budget deficit turned into highly problematic issues. After several amendments were made to the law governing budget planning in 2001 the situation improved slightly in 2002. Given that there was a considerably lower deficit at the end of the

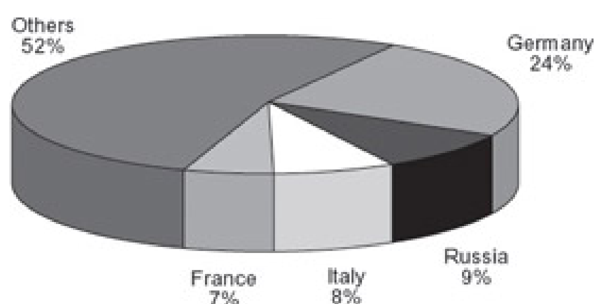
first quarter in 2002 and an increase in total income of 2 per cent compared with the same period the year before, Polish analysts believe that a further adjustment of budgetary policies will not be necessary in 2002.

The unemployment rate – a most critical indicator – rose quickly from 13.1 per cent in 1999 to 18.1 per cent in March 2002. Whether the levelling off of the unemployment figures during February and March 2002 and other signs of hope in industrial production and retail turnover can be seen as signalling the end of the general downward trend cannot be answered definitely, but a comparison of the figures for the first quarter of 2002 with those for the last quarter of 2001 does not indicate an upward trend.

Another problematic area, the current account balance, was helped by an increase in exports in 2000 and 2001, the gap being reduced by high foreign direct investments. The overall GDP growth achieved in 2001, despite the downward trend, can be attributed to a 14 per cent rise in exports for the whole of the year and a simultaneous rise in imports by 2.7 per cent. However in the first two months of 2002 exports deteriorated notably in comparison with the previous year.

Germany was, as in previous years, Poland's most important trading partner in 2001. Until 2000 Poland was Germany's top trading partner in Central and Eastern Europe, but figures released by the Federal Office for Statistics show that the Czech Republic ousted Poland from that position in 2001 (Table 3.1). This was largely due to higher Czech exports, and Poland remained the region's most important market for German products.

At present almost 70 per cent of Polish exports go to the EU (Table 3.2). The second most important target region consists of the Central and East European (CEE) reform countries. In the ranking of individual export destinations Germany leads by far (34.4 per cent of Polish exports), followed by France and Italy (5.4 per cent each), Britain (5.0 per cent), the Netherlands (4.7 per cent) and the Czech Republic (4.0 per cent). Germany also leads the group of main exporting countries to Poland (Figure 3.2)



Sources: GUS, Warsaw; TWG.

Figure 3.2: Sources of Poland's imports, 2001. Sources: GUS, Warsaw; TWG.

Table 3.1: German foreign trade with selected CEE countries, 2001 (DM1000)

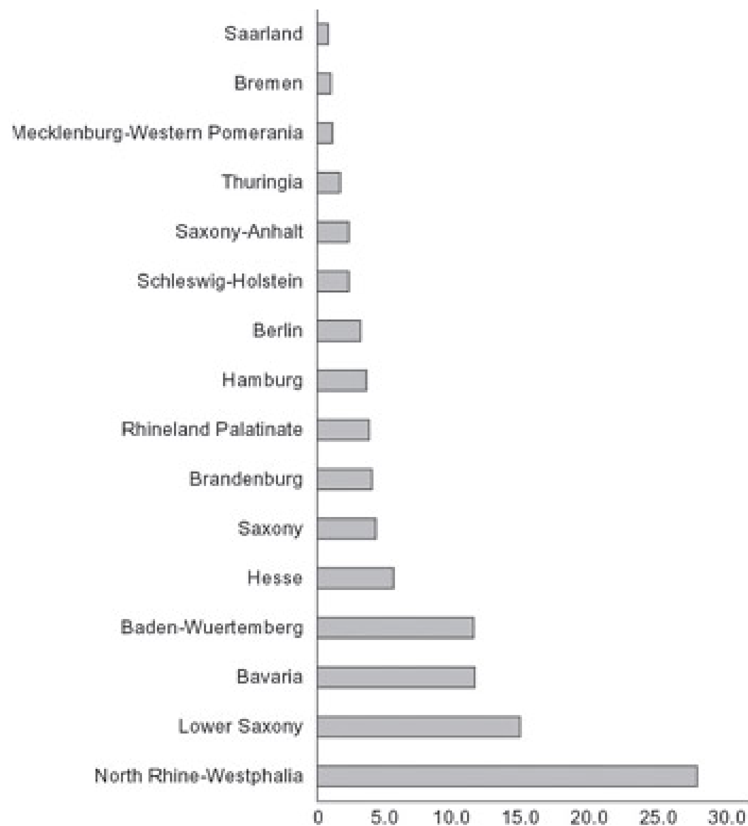
	Imports	Exports	Turnover
Czech Republic	28 380 640	29 215 842	57 596 482
Poland	26 409 938	29 783 089	56 193 027
Source: Federal Office for Statistics, Germany.			

Table 3.2: Poland's export structure, target regions, 2001

Regions	Share of Polish exports
EU countries	69.2
Other industrial countries	5.9
CEE countries	18.3
Developing countries	6.6
Total Polish exports	100
Source: GUS, Warsaw.	

As a result of the worsening economic conditions in Poland and Germany the overall pace of foreign trade between them has slowed. Nonetheless, due to an increased export effort and a drastic fall in domestic demand Poland has been able to reduce its long standing trade deficit with Germany, which fell from DM5.1 billion (C=2.6 billion) in 2000 to C=1.87 billion in 2001.

On the German side, foreign trade with Poland is mainly conducted by the economically strong old federal states, with the new eastern states, including Berlin, being found at the lower end of the scale (Figure 3.3). The largest exporters to Poland, which are also the economically strongest regions of Germany, are North Rhine-Westphalia, Baden-Wuerttemberg and Bavaria. Brandenburg, however, gains first position when we compare the contribution of the various federal states to German GDP with their respective share in German–Polish trade. This reflects Brandenburg's close geographical proximity to Poland as well as positive developments in foreign trade with its eastern neighbour.



Source: Federal Office for Statistics; Polish Embassy, Berlin.

Figure 3.3: Germany's trade with Poland, by federal state, 2001 (percentage of total trade). Source: Federal Office for Statistics; Polish Embassy, Berlin.

Although Poland continues to be the top investment location in Central and Eastern Europe, unfavourable economic conditions in Poland and the rest of the world resulted in a marked slowdown in the influx of foreign investment in 2001. Nonetheless, after an increase of US$3.3 billion in the first six months, an increase of US$7.1 billion was achieved for that year, according to PAIZ (the state-owned agency for foreign investment). The projected figure for 2002 is of a similar magnitude.

By 1998 Germany had become the most important investor in Poland, in terms not only of the number of companies founded (which had been the case for sometime) but also of accumulated investment. However, from 2000 it lost its leading position and by the end of 2001 the most important investor was France (US$10 221 million), followed by the United States (US$7806 million) and Germany (US$7138 million) (Figure 3.4). The largest investing company, as of June 2001 was France Telecom, followed by Fiat, Daewoo and Citibank. The most important German investors were Bayerische Hypo- und Vereinsbank, Metro, Reemstma Cigarettenfabrik, Commerzbank, and Beiersdorf.

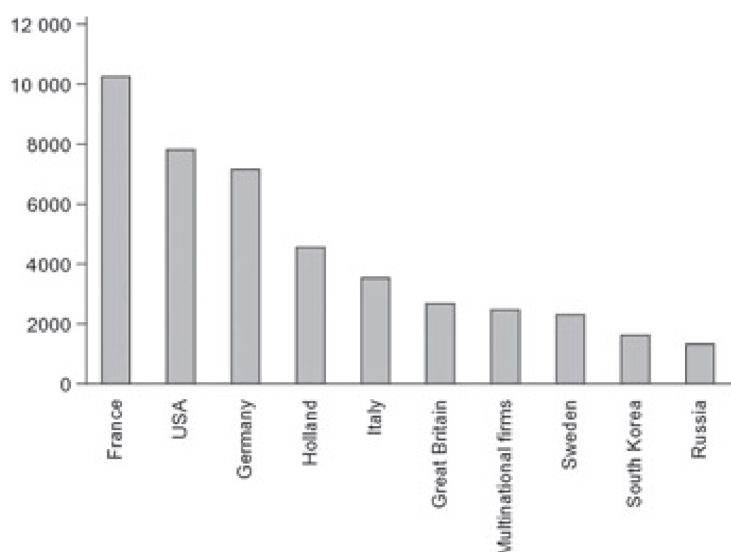


Figure 3.4: Accumulated foreign direct investment in Poland, by country (US $million). Source: GUS, Warsaw.

3.2 The experiences of German enterprises in Poland: a survey[1]

3.2.1 German enterprises in Poland

Official statistics show that 45 765 enterprises with foreign equity interest were registered in Poland at the end of 2001 (Figure 3.5). However according to the TWG (a German–Polish organization for business promotion), this figure included a number of ‘letter box’ or one-man firms that were not actively engaged in business but had been established in anticipation of future business opportunities. Furthermore the longstanding expectation that there would be an increase in the minimum deposit for limited liability companies – which in fact was implemented in January 2001 – may have pushed up the number of enterprise registrations. A figure of about 30–35 000 active enterprises is probably more realistic.

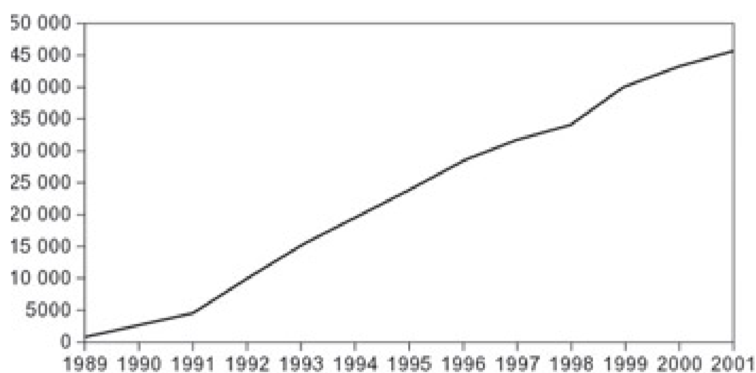


Figure 3.5: Enterprises with foreign capital investment, 1989–2001 (absolute numbers). Source: GUS, Warsaw.

Of all the enterprises with a dominant foreign ownership in Poland, German enterprises form by far the largest group, with approximately 6000 active firms, although the TWG again considers this figure to be artificially high. Between 1993 and 1998 there was a rapid increase in the number of foreign enterprises (Table 3.3), including a sizeable number of small German enterprises with minor investment budgets.

Table 3.3: Number and investment budget of foreign enterprises in Poland, 1993–1998

	Number of firms			**Investment budget (million zloty)**		
	1993	**1998**	**Change in rate (%)**	**1993**	**1998**	**Change in rate (%)**
Germany	2943	5 177	76	1356	8 928	558
Total foreign	7935	12 649	59	4854	43 545	797
Source: GUS, Warsaw.						

3.2.2 German investors in Poland: the trend towards autonomy

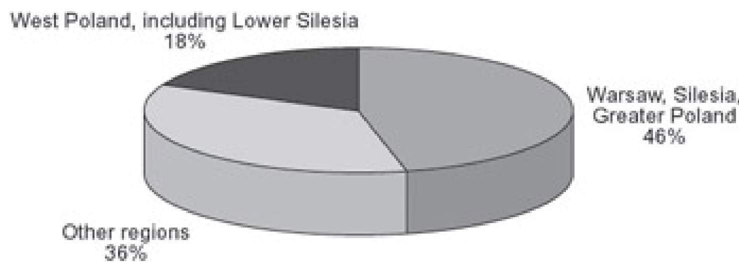
German enterprises prefer forms of ownership that guarantee them autonomy over their operations in Poland. Over half of such firms are entirely funded with German capital and almost 75 per cent hold a majority, controlling share. Official statistical data and the TWG's consultancy experience and surveys indicate an increased trend towards a high degree of decision-making autonomy and a controlling share among German investors. The main reasons for this development are as follows:

- Poland's continuing political and economic stability has created confidence among German investors about their medium- to long-term prospects.
- Increasing market know-how has enabled German firms to rely on their own skills and resources.
- The majority of German enterprises have moved away from the cautious strategy they adopted during the early exploratory stages and are actively engaging in market development.

During the last two years this tendency has markedly increased, and even small and medium-sized enterprises prefer to take an autonomous approach to the Polish market. Unlike investors from the United States, France and other countries, the German engagement in Poland is strongly characterized by medium-sized enterprises.

3.2.3 Attractive regions for foreign investment

According to Polish statistics, foreign enterprises invest mainly in the traditional industrial areas of Warsaw, Silesia, Greater Poland and Lower Silesia, especially the Wroclaw area (Figure 3.6). While the regional distribution of German firms generally follows this trend there is a concentration of medium-sized enterprises in West Poland. Geographical proximity to the parent company in Germany facilitates cross-border activities and even the management of the enterprise by the German headquarters.



Source: TWG.

Figure 3.6: German investment in major Polish regions. Source: TWG.

3.2.4 Key reasons for locating investment in Poland

According to a TWG survey, the main reason for investing in Poland is not the low labour costs or other cost-related factors, but rather the sales potential of a market with almost 40 million people (Figure 3.7). Low labour costs come a distant second, according to the survey. This trend has steadily intensified in recent years: for 65 per cent of German enterprises Poland's market potential has become more important in recent years (Figure 3.8) and low labour costs have declined in importance. However, for almost 45 per cent of enterprises low labour costs were a strong factor in their decision to enter the Polish market.

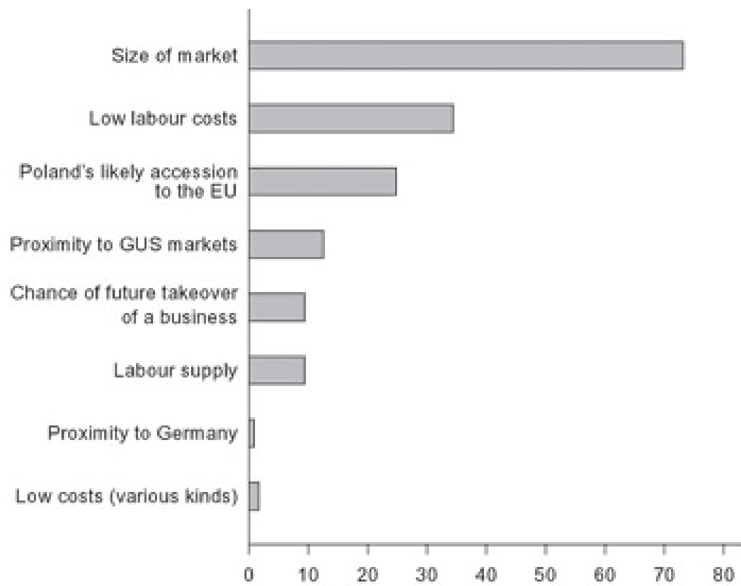


Figure 3.7: German enterprises' main reasons for investing in Poland (percentage of all responses). Source: TWG.

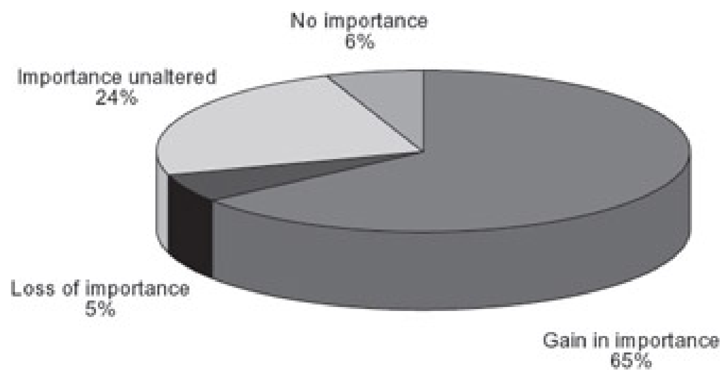


Figure 3.8: The importance of Poland as a sales market. Source: TWG.

The perceived potential of the Polish domestic market is also reflected in the priorities set by German enterprises in respect of their future marketing strategies in Poland. High expectations are placed on the expansion of the entire national market and – in stages – international expansion as well. In contrast less importance is being placed on concentrated local markets (Figure 3.9).

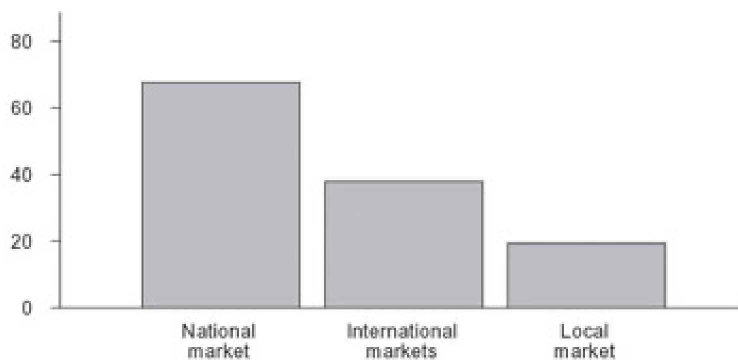


Figure 3.9: Expected market development in 2003 (percentage of total citations, multiple answers). Source: TWG.

3.2.5 Poland as a procurement market

With regard to Poland as a procurement market the situation is by no means uniform. Foreign car producers in Poland, for example, still purchase most of their supplies abroad or from foreign suppliers based in Poland. In contrast 90 per cent of all input supplies for the food industry are purchased on the Polish market. On the whole, however, the number of companies for which Poland is an important procurement market is growing (Figure 3.10).

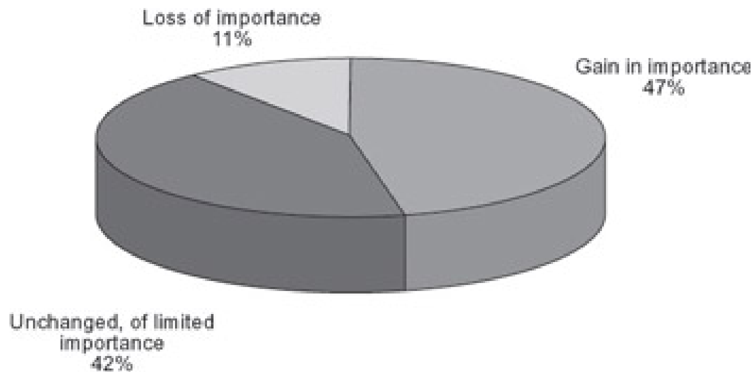


Figure 3.10: The significance of Poland as a procurement market. Source: TWG.

3.2.6 Machinery and technological equipment

Almost 70 per cent of machines used by German firms in Poland were new when installed (Figure 3.11). Only about 26 per cent of equipment had already been in use outside Poland, refuting the common supposition that German enterprises have a strong tendency to move their old equipment to Poland. Furthermore 80 per cent of enterprises intend to carry out a further modernization of their plants.

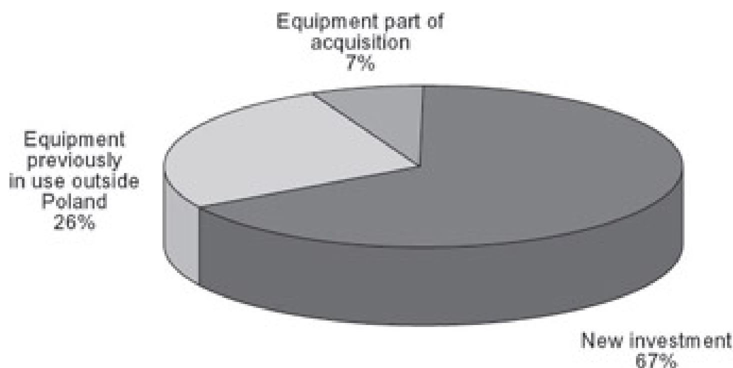


Figure 3.11: Origin of machinery and equipment used by German firms in Poland. Source: TWG.

3.2.7 Workforce performance

There is a common prejudice that Polish workers are less industrious and less motivated than

their German counterparts. However the assessment of Polish workers by German enterprises in Poland paints a different picture (Figure 3.12). This finding is underlined by the respondents' conclusions on the positive attributes of Polish employees, with industriousness, flexibility and resilience heading the list. Entrepreneurial spirit, accountability and the ability to work in teams were evaluated less favourably, as was company loyalty, as Polish employees, especially those with high qualifications, are much more apt to change jobs than are their German counterparts. However, German managers stress that Polish employees are highly motivated and eager to learn, particularly younger workers.

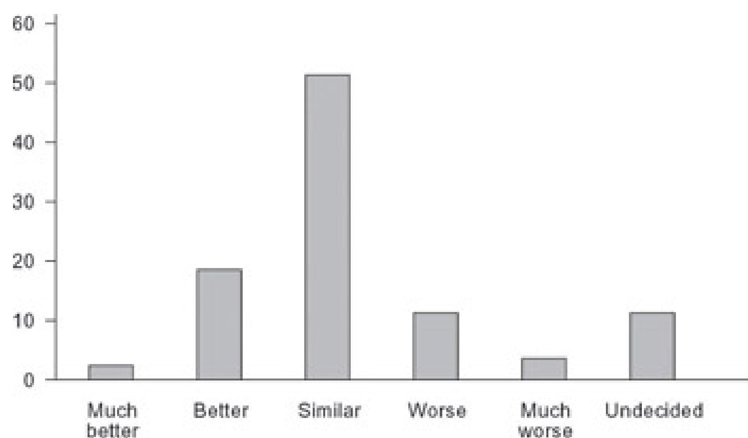


Figure 3.12: Performance of Polish workforce in comparison with German coworkers. Source: TWG.

3.2.8 The competitive situation in Poland

In recent TWG surveys more than 75 per cent of German enterprises judged competitiveness in Poland to be high or extremely high (Figure 3.13), compared with only 30 per cent in 1996. Fifty-seven per cent of German firms considered Poland to be as or even more competitive than Germany. This intensification of competitiveness was an expression of the strengthened performance of domestic enterprises as well as growing competition among foreign enterprises in the Polish market.

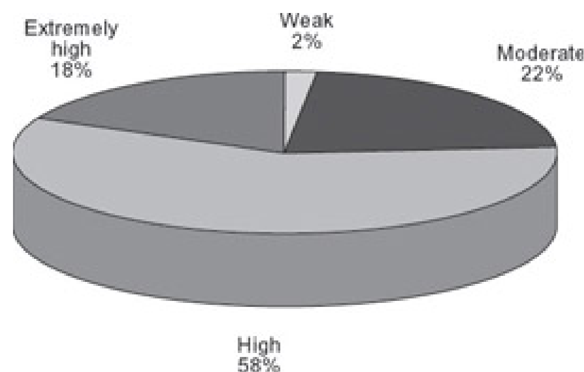


Figure 3.13: Degree of competitiveness in Poland. Source: TWG.

3.2.9 Positive and negative location factors

In 1996 the difficulties encountered at border crossings and the cumbersome administrative

processes were among the factors most heavily criticized by German enterprises. However they gave a high rating to Polish wage levels and employees' motivation and qualifications. The Polish populations' acceptance of and positive attitude towards the German enterprises was also noted. In view of German–Polish history and the strong awareness of this in Poland, this finding was especially pleasing.

In 2002 the border crossing problem dropped from first to fifth place on the negative scale (Figure 3.14). This could be due to the fact that efficient logistical procedures had been developed, but it could equally be the result of real administrative improvements. However general administrative problems and the controlling and monitoring activities of the Polish authorities (from tax inspection to hygiene regulations), which were perceived as highly excessive, still ranked one and two on the list of negative factors respectively. In this regard allowances must be made for the numerous new rules and regulations that had to be adopted in preparation for Poland's accession to the EU.

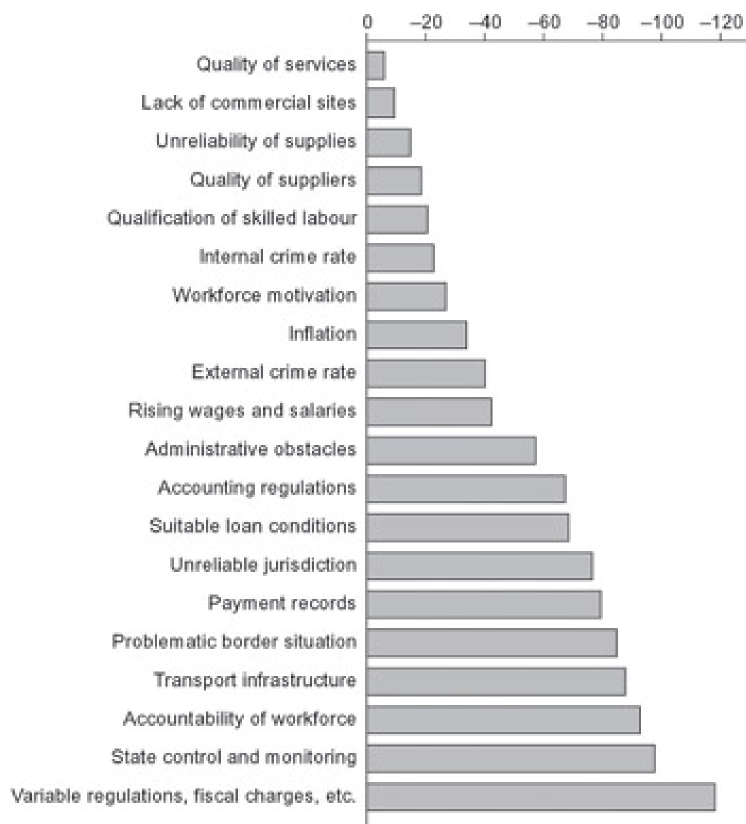


Figure 3.14: Perceived business obstacles in Poland, 2002. Source: TWG.

Also viewed unfavourably were the lack of individual accountability of Polish employees, the transportation infrastructure and the unavailability of loans with suitable terms and conditions.

The respondents noted general progress in the service sector in Poland, especially in the banking and transportation industries. In addition 40 per cent perceived an improvement in their relationship with the fiscal authorities, although negative assessments still dominated.

On the basis of the TWG's surveys and observations the ranking of business obstacles can be summarized as follows:

1. Legal uncertainty – frequent changes in laws and regulations.
2. Bureaucracy and excessive state controls.

3. Barriers due to language and cultural differences.
4. Unsatisfactory structure of financing funds and insufficient promotion measures.
5. Poor transport infrastructure.
6. Problematic border situation.
7. Difficult relationship with the tax office and other authorities.
8. Poor quality and timing of deliveries.

3.2.10 Degree of general satisfaction of German enterprises in Poland

In the 1996 survey 11 per cent of German managers were clearly dissatisfied with their operations in Poland, 30 per cent claimed to be neither dissatisfied nor satisfied, over 50 per cent were satisfied and 4 per cent were very satisfied. This was a positive result considering that the enterprises were still in the early stages of development and still had to come to terms with the basic conditions of operating in a foreign country. The 1999/2000 survey produced the results shown in Figure 3.15.

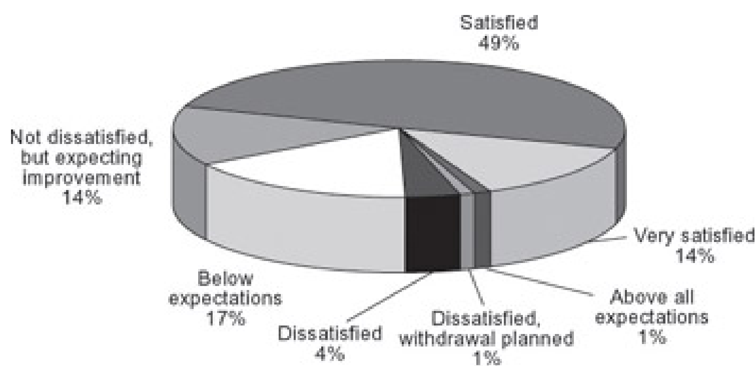


Figure 3.15: Degree of satisfaction of German investors in Poland, 1999–2000. Source: TWG.

The expectations of German enterprises regarding Poland's entry to the EU (Figure 3.16) also indicate a positive assessment of the future development of this region.

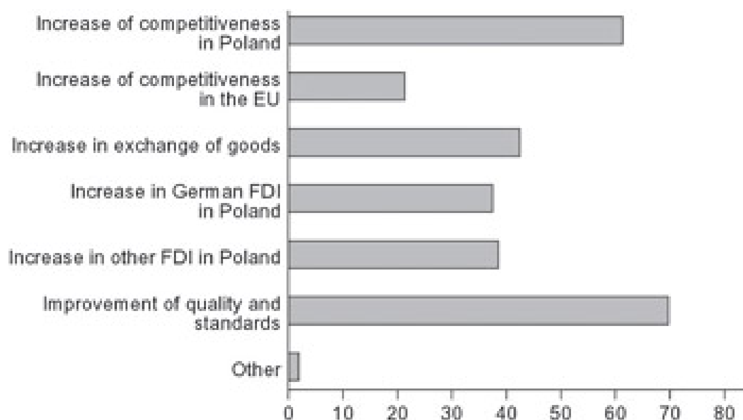


Figure 3.16: Expectations of German enterprises after Poland's accession to the EU

(number of citations). Source: TWG.

The following summary outlines the key decision parameters for German investment in Poland and the main reasons for the general satisfaction of German businesses in this market:

1. Expected economic development of and market potential in Poland.
2. Labour costs.
3. Expected effects from the entry of Poland to the EU (for instance improvements in quality and standards in Poland as well as general business expansion).
4. Regional location advantages (geographical proximity to Germany and central position in Eastern Europe).
5. Suitable human resources.
6. Growing importance of Poland as a procurement market.

[1]The data in this section are drawn from a series of empirical studies by the German–Polish organization for business promotion (TWG) on German investors and their experiences in Poland.

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3.3 Polish enterprises in Germany

Owing to the high location costs, Polish firms are still exercising restraint with regard to direct investment in Germany. Recently, however, there has been growing interest by Polish enterprises in opening branches across the border. For example the TWG has helped a textile producer and an office furniture manufacturer to establish sales offices in Berlin. Even though such moves are limited to small enterprises, predominantly in the trade, construction, maintenance and service sectors, Polish investment in the eastern part of Germany is highly welcomed. The City of Berlin, for example, has set up a competition in which a prize will be awarded to the Polish enterprise that presents the best export concept for the German market.

Direct Polish investment in Germany has so far been relatively modest for two reasons: Polish foreign engagement in general is small, and the focus has recently shifted from Western Europe to Eastern European countries. Total Polish foreign investment amounted to little more than US$550 million between 1994 and 2001. At the end of 2000 only 58 Polish companies were registered in Germany, with an accumulated capital expenditure of C=128 million, up from C=118 million in 1997 (Deutsche Bundesbank, May 2002).

Until 1997, 65 per cent of Polish foreign investment was predominantly targeted at Western countries (Britain, the United States, Belgium, Luxembourg, Switzerland and others), but now almost 80 per cent is directed eastwards, with Russia, Ukraine, the Baltic States and Belarus being the main recipients. Despite the higher risks involved, Polish enterprises seem to appreciate the comparatively low investment costs and dynamic market conditions in these countries. At least for the time being, high location and administrative costs are preventing Polish businesses from investing in Germany.

Note

1. The data in this section are drawn from a series of empirical studies by the German–Polish organization for business promotion (TWG) on German investors and their experiences in Poland.

Chapter 4: Mass Privatization as a Condition for Change: The Role of Polish NIFs

Jan Jezak

Abstract

This chapter first discusses the principles of Poland's unique programme of mass privatization – the National Investment Fund (NIF) programme, which was launched in 1995 to restructure and privatize over 500 Polish enterprises. It then goes on to consider the consequences of the programme on the enterprises concerned, including the introduction of new management systems. The final section looks at NIFs as investors of venture capital and their investment strategies for the years 2000 to 2003.

4.1 Mass privatization programmes in the countries of Central and Eastern Europe

In 1992, two years after the transformation process began, the countries of Central and Eastern Europe recognized that unconventional privatization methods were needed to accelerate the process. Capital-based privatization in these countries, which lacked capital resources, would take too long, hence the idea of mass privatization by means of vouchers, coupons or general share warrants.

The first privatization programme of this kind was proposed by two Polish economists: Jan Szomburg and Janusz Lewandowski (minister of ownership transformation in the Polish government in the early 1990s). The idea failed to gain sufficient political support in Poland, but it was enthusiastically received by Vaclav Klaus, the Czech minister of finance, and as a result the Czech Republic became the first country in Central and Eastern Europe to carry out a mass privatization programme. The latter, called ‘Kuponovká, was conducted in the years 1992 to 1993. In October 1992 privatization began in Russia, then in Lithuania, Latvia, Estonia, Belarus, Ukraine, Slovakia, Bulgaria and Slovenia. The Polish government eventually decided to implement a modified programme in December 1994 and named it the National Investment Fund (NIF) programme.

The main goal of all the national programmes was to accelerate the privatization of state-owned enterprises, which would result in a dramatic transformation of ownership structures in the CEE countries. Another significant goal was to compensate citizens who had contributed to the creation of national property during the previous decades as well as to gain their support for the difficult systemic changes and the social consequences of this. At the microeconomic level the objective was to improve the efficiency of companies through restructuring (Jezak, 1996).

The priorities, however, varied from country to country. In the Czech Republic the main aim of ‘coupon privatization’ was the foundation of new ownership structures with social compensation and corporate restructuring being of lesser importance (Coffee, 1994, p. 1). In Russia the priority of ‘voucher privatization’ was social compensation as this was expected to lead to social support for privatization in general and the inevitable systemic reforms (Radygin, 1996, p. 22). In Poland the main concern was to improve the operational efficiency of Polish companies, and the idea of social compensation and satisfaction was put aside.

The Polish mass privatization programme was based on the assumption that formal corporate privatization would bring about the necessary corporate restructuring, which demanded not only a new owner but also new management know-how. In taking this approach Poland differed from the other countries in the region, which concentrated only on the rapid privatization of a defined section of state-owned assets through general enfranchisement (coupons and vouchers). In the Czech Republic the exercise took one and a half years, in Russia three years.

A unique aspect of the Polish programme was the involvement of international consortia with a sound record in corporate restructuring. Their role was to help privatized companies gain access to optimal marketing, production and organizational techniques, international sources of capital and new sales markets. The overall programme was based on an indirect privatization model, meaning that the share warrants acquired by Polish citizens for a symbolic price could not be transferred into corporate shares, only into NIF shares. Consequently the NIFs were responsible for managing the shares of the companies included in the programme, which they did with the help of management consortia.

4.2 Structure of the NIF programme

In order to accomplish the main purpose of the programme, two institutions from developed market economies were introduced: closed investment funds and a managerial contract for a legal person (service contract for a managing company). The Act that brought these into being – the 30 April 1993 Act on National Investment Funds and their Privatization – constituted a *lex specialis* in relation to the Code of Commercial Companies, adherence to which was mandatory in Poland. Under the terms of this Act the State Treasury allotted to the National Investment Funds 60 per cent of the shares in each of the 512 state-owned companies included in the programme. Thirty-three per cent of these shares were allotted to one selected fund (the leading package), and 27 per cent were distributed in approximately equal parts to the other 14 funds (the minority packages). Up to 15 per cent of the shares were awarded gratis to employees and the remaining 25 per cent were retained by the State Treasury as a reserve (Figure 4.1).

Figure 4.1: Typical ownership structure of an NIF company. Source: National Investment Fund Program (1995), p. 11.

In legal terms the NIFs assumed the form of a public limited company. The privatized firms' supervisory boards retained control of some of the general competences specified in the Code of Commercial Companies until the first general meeting of shareholders (other than the Treasury) took place, after which the supervisory boards' position in the companies management system changed significantly.

Over time the nature of the funds altered, with the Treasury's share being reduced to 12 per cent or so, and the funds coming to resemble typical joint-stock companies, as specified in the Code of Commercial Companies. From the start it was intended that the Treasury would hold NIF shares only temporarily, and it was obliged by the Act to make its shares available to the holders of investment certificates. The latter could be exchanged for fund shares, so their holders became fund shareholders.

Thus, the NIFs functioned as closed investment funds and at the same time as stock companies that owned the shares of their portfolio companies. The quantity of these shares was limited by both the size of the fund's share capital and the nominal value of one share.

The objective of the funds, under the terms of the Act on National Investment Funds and their Privatization, was to increase their equity by raising the value of the companies whose shares they owned. According to the Act the funds could enter into agreements on the management of their property with enterprises selected by means of tender. Such agreements were concluded by 14 of the funds, but three later dispensed with the services of management

companies. At present the properties of the funds are run by either a management company or a consortium (Figure 4.2), which became possible after a recent consolidation process.

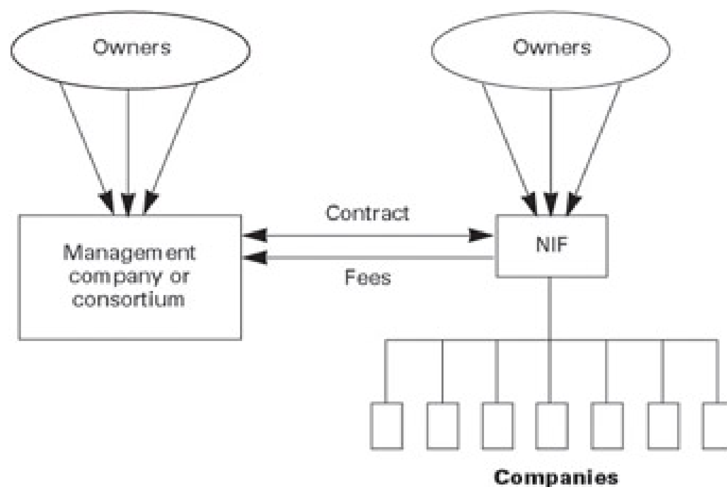

Figure 4.2: NIF structure

The task of management companies was to manage the NIF's assets in such a way as to increase the value of the portfolio companies' shares and other assets, including liquid assets. However there was an asymmetry between the obligations and responsibilities of the management companies on the one hand and the funds' statutory authorities on the other, causing many disputes and highlighting a fault in the design of the programme itself.

During the first three years all the NIFs had to focus on restructuring the companies in their investment portfolios. The scale of restructuring required is indicated by the fact that at the end of 1995, when the programme was launched, as many as 33 per cent of the NIFs' enterprises were making a loss. The distribution of weak enterprises among the NIFs was more or less uniform owing to the method of allocation.

Focusing their efforts on increasing the market value of the portfolio companies, NIFs initiated and controlled restructuring processes in these companies. They did not operate like typical investment funds that could be found in Britain or American economies but rather like restructuring funds. Acknowledging the fact that investment funds usually limit their property rights to monitoring the portfolio companies, we have to admit that it was not possible in the case of NIFs because of the need to implement radical technological, marketing, organizational and cultural changes. Trying to implement the changes in a relatively short period of time, all the NIFs had to act as 'active owners' of the portfolio companies. Considering the NIF's objectives and managerial functions, they seemed to resemble venture capital funds, which focus on the creation of development strategies and control of financial outcomes. Consequently, the portfolio companies were treated as good assets by the NIFs, as they would be treated by all active investors, as long as the companies were able to retain sufficient market value. Otherwise, NIFs sold their companies to external investors and such decisions were often only a matter of time.

4.3 NIFs as proprietors

As noted above, one of the main objectives of NIFs was to increase the value of shares of the companies for which they were responsible. This objective was met through:

- active proprietary supervision, mostly with the aim of improving the quality of management;
- ensuring access to capital by, among things, granting loans and providing credit suretyship;
- assisting with the acquisition of new technologies and the creation of new products;
- facilitating access to foreign sales networks and assisting with the development of modern marketing methods;
- assisting with finding strategic investors.

The results of the NIFs' restructuring efforts became visible after two years, as shown by a survey carried out in February 1998 among all funds, which revealed important qualitative changes in the portfolio companies' management systems. The extent of those changes is shown in Table 4.1.

Table 4.1: Management system modernization in NIF companies

Rank	Measures introduced	Number of companies in which the measures were implemented
1	Adoption of a strategic business plan	404
2	Setting up of a marketing department	218
3	Introduction of cost calculations, differentiating between fixed and variable costs	380
4	Identification of cost and profit centres	202
5	Systematic analysis of product profitability	310
6	Introduction of budgeting and budget discipline	339
7	Implementation of integrated management systems, complex computerization	145
8	Motivating remuneration systems (performance-based renumeration)	330
9	Changes in management boards: • whole management board • president • member responsible for finance • member responsible for sales and marketing	39 167 145 154

Source: Based on data in a report by the National Investment Funds Association, Warsaw, March 1998 (unpublished).

Significant progress was also noted with the introduction of new technologies and the modernization of existing machinery (in 240 companies), and there was a rise in the portfolio companies' capitalization due to investment by individual NIFs. According to the report, the total value of the NIFs' investment in their portfolio companies at the beginning of 1998 was nearly 500 million zloty: 293 million in the leading companies and 203.3 million in minor companies. These investments covered almost 30 per cent of the companies controlled by NIFs. At the same time employment levels were rationalized in order to meet the challenges of market competition. Individual and group dismissals took place in 231 companies, but additional employees were hired in 105 companies.

Progress towards the programme's ultimate objective – the complete privatization of the portfolio companies – was particularly noteworthy. The 1998 NIF report shows that two years after the companies' shares were assigned to the NIFs as many as 130 (that is, over 25 per cent of them) had been completely privatized or their privatization process was nearing the end. Considering that the programme had a ten-year horizon, this can be regarded as a remarkable success.

4.4 NIFs as investors

The funds obtained from the sale of shares in companies included in the privatization programme were used to finance the NIFs' current activities and new investments. These investments were both short term (debentures, shares of stock-exchange companies) and long term (venture capital), and in 2000 their total value amounted to 553.66 million zloty, or US$138.4 million (Parkiet, 2001, p. 16). This investment activity resulted in a significant change in the structure of the portfolios held by individual NIFs (Table 4.2). As can be seen, for the majority of NIFs new investments constituted well over 40 per cent of their portfolios, showing that the restructuring and privatization of the companies taken over from the State Treasury were advancing well and that the NIFs were able to concentrate less on restructuring and more on investment. Since 2001 venture capital investment has become one of the main strategic activities of all NIFs.

Table 4.2: Structure of NIF investment portfolio, end 2000 (per cent)

	Shares in companies taken over from the State Treasury	New investment
NIF Fund 1	59.2	40.8
NIF Drugi	65.7	34.3
NIF Jupiter	50.6	49.4
NIF Progress	50.6	49.4
NIF Victoria	66.6	33.4
NIF Magna Polonia	56.8	43.2
NIF 7	86.6	13.4
NIF Octawa	61.0	39.0
NIF Kwiatkowski	30.0	69.9
NIF Foksal	84.6	15.4
NIF Piast	89.9	10.1
NIF Zachodni	47.8	52.2
NIF Fortuna	45.2	54.8
NIF Hetman	51.2	48.8

The future course of the NIF programme has yet to be determined. Some commentators consider that the NIFs should continue their restructuring mission, others recommend that some of the NIFs be amalgamated in order to reduce their costs, and many propose that the shares of the companies taken over from the State Treasury be reduced to 8–10 per cent of the NIFs' assets. In practice the latter would mean that the NIFs would be transformed into closed investment growth funds (Figure 4.3).

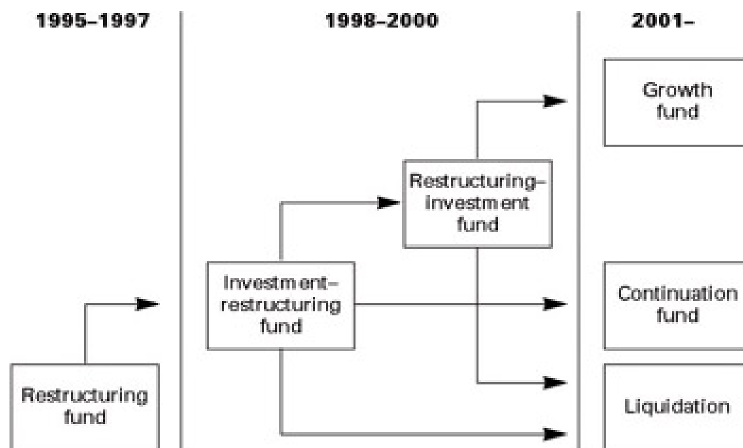

Figure 4.3: The evolution of NIFs

Notes: The table lists the names of funds as they appeared in public turnover. The 1999 amalgamation of the third and eleventh funds yielded NIF Jupiter and reduced the number of funds from 15 to 14.

Source: Based on Parkiet (2001).

Investment in new ventures does not necessarily mean investment in start-up projects. What the author refers to here are the ventures that were established before being taken over by the NIFs, were well-managed, guaranteed future high return rates but still needed sufficient investment. These were the reasons for the NIFs to exert proprietary control over them for the next three–five years.

The strategy of investment portfolio renewal arose for two reasons. The first was the completion of the NIF portfolio companies' restructuring and the second was the need to increase the NIFs' value for their new shareholders, namely national and foreign banks and foreign investment funds. Owing to the fact that capital markets (the Warsaw Stock Exchange) offered prices that were too low in relation to the book value of the NIFs' shares (including the value of the NIFs' owned liquid assets: cash flows, public companies' shares and guilt-edged securities), one of the most important goals of the NIFs was to decrease the above gap.

4.5 Conclusions

One of the goals was to attract into the programme highly professional foreign managerial teams experienced in corporate restructuring and in closed fund management. In the author's opinion the assumption was fulfilled thanks to performance-based fees (management fees and success fees) for the managing companies from Austria, Britain, France, Italy, Switzerland, Japan, Canada, the United States and Hong Kong. Their participation was a factor of the programme's success.

During the years 1995–98, in the initial period of their operations, the NIFs created value for their shareholders mainly through the intensive restructuring of the portfolio companies. This involved the introduction of modern management techniques such as value-based management and managerial accounting, as well as the identification of profit centres. Most companies introduced annual financial budgets and long-term strategic plans, following the guidelines set by their management companies. Unprofitable assets were identified and sold. Numerous companies adopted new technologies, and as a result strengthened their market position. Financial restructuring took place in companies that were facing a loss of liquidity. Additional measures included monthly monitoring of the budget and an annual review of the strategic business plan.

At present shareholder value is created mainly by selling restructured companies and investing some of the proceeds in private companies with a high rate of return. The rest of the funds are set aside to repay the loans secured from the IBRD and EBRD in 1995 to launch the NIFs' activities and support their operations in the early stages.

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Chapter 5: Privatization, Restructuring, Corporate Governance and the Behaviour of Firms in Transition Economies[1]

Josef C. Brada

Abstract

This chapter uses published case studies of firms in the Czech Republic, Hungary and Poland to investigate how firms reacted to the pressures of transition. Most firms made short-term adjustments to outputs and inputs, but fewer made strategic adjustments. Nevertheless these short-term responses influenced their ability to implement long-term strategies for survival and growth. In general, successful firms were those which strengthened their marketing function, reorganized their internal decision making and information systems, invested in human resources and created effective mechanisms of corporate governance. The shedding of workers and large investments in capital and technology were, rather surprisingly, less important features of successful restructuring.

[1]The research that forms the basis of this chapter was part of a research project entitled 'Enterprise Behavior and Economic Reforms: A Comparative Study in Central and Eastern Europe', undertaken by the Transition Economics Division of the Policy Research Department of The World Bank. I am indebted to the William Davidson Institute at the University of Michigan Business School for allowing me a period of time for reflection and the writing of this chapter.

5.1 Introduction

To a large extent, the success of the transition in East Europe depended on the ability of the former state-owned firms in the region to increase the efficiency with which they employed resources and to conform to the dictates of the market. While it is true that macroeconomic stabilization was a prerequisite for improved economic performance, without major improvements in the performance of the region's firms the best that stabilization could hope to achieve was equilibrium, characterized by stagnant output, low incomes and lack of international competitiveness. Only if productivity, profitability and competitiveness at the level of the individual firm improved could output grow, incomes increase and integration into the global economy begin.

At the start of the transition there was considerable scepticism that managers of state-owned enterprises would be up to the task of modifying the operations of their firms so as to respond effectively to the emergence of markets and hard budget constraints (Kornai, 1990; Lipton and Sachs, 1990; Phelps *et al.*, 1993). Once the privatization programmes began, concern shifted from the ability of managers to manage to the ability of the new owners to exercise adequate control over their firms through the available mechanisms of corporate governance (Boycko *et al*. 1995; Desai, 1996; Dittus and Prowse, 1994; Litwack, 1995; Stark, 1994).[2]

Unlike the macroeconomic outcomes of transition, which can be quantified by means of data on output, inflation, employment, the amount of property privatized and so on, changes in the behaviour of managers and in the way in which firms are run are less amenable to quantification (Bornstein, 2001). Indeed the changes are often so subtle that it is difficult either to establish objective criteria by which to judge change or to determine accurately whether such changes have taken place. Accepting this caveat, this chapter uses detailed case studies of a relatively large sample of firms to determine how managers and firms in three transition economies – the Czech Republic, Hungary and Poland – reacted to the transition, and to investigate whether some common patterns of behaviour were evident, particularly among firms that were judged to be adjusting successfully.

[2]For a description of privatization programmes see Brada (1996). Hart (1995) provides a useful survey of corporate governance from both a theoretical and a practical standpoint.

5.2 Sources of evidence: introduction to the case studies

The evidence on the behaviour of firms in transition economies is drawn mainly from case studies by the World Bank under its project 'Enterprise Behavior and Economic Reforms'. Two rounds of interviews were carried out in Czechoslovakia (subsequently the Czech Republic), Hungary and Poland. These countries were selected in part because transition was most advanced there when the project was designed. For each country, a local project leader was selected and a team of case study writers was assembled. These teams selected firms according to a common selection process that was designed to cover the major sectors of the economy, to include a variety of ownership forms, size and likelihood of economic survival, and to be flexible enough to allow for national peculiarities and the willingness of managers to participate in the interviews and data collection. The interviews, data gathering and presentation were carried out according to a common format.

The first round of 36 case studies was completed in late 1992. The 36 cases and a synthesis of their implications were published in Estrin *et al.* (1995). The second round of 18 cases, completed in late 1993 and early 1994, was published in Brada and Singh (1998). These cases were supplemented by eight additional case studies of Hungarian firms in 1992 (Brada *et al.*, 1994) and six additional case studies of Polish firms in 1994 (Wosinska, 1995).

The use of a common questionnaire and a small team of case writers gave a consistency of approach and an interpretive validity that permitted stronger inferences to be drawn than would have been possible with cases compiled for differing objectives and by disparate methods and researchers. The use of parallel cases from three countries also helped to guard against bias, especially as the cross-country comparisons were accompanied by efforts to match some firms across countries by sector, size or ownership type.

Nevertheless there may have been an element of self-selection in the sample because firms that were doing well in the transition were perhaps more willing to participate in the survey than those that were likely to fail. While such self-selection would pose problems for some types of analysis, the purpose of this inquiry was to identify the commonalities in behaviour that existed among firms that appeared to be restructuring successfully. Thus an overweighting of the sample towards successful firms was desirable. The sample nevertheless included firms that were liquidated or dismantled after the case studies were written, as well as firms whose future is still in doubt.

5.3 Framework for restructuring

The business strategies that any firm selects and its ability to implement them are both path dependent and reflect the firm's past environment and its business decisions and their outcomes. In transition economies, where all firms faced major and relatively similar changes in their external environment and internal organization, such path dependence was both striking and particularly important in determining how firms undertook their restructuring.

Figure 5.1 illustrates the path-dependent relationship between a firm's response to the early stages of transition and its ability to develop and implement a coherent set of measures for restructuring and survival. At the onset of transition a firm's behaviour was conditioned by its macroeconomic and business climate, by firm-specific factors such as debt, technology, dependence on foreign markets and so on, as well as by the shocks emanating from the early transition measures, including the emergence of markets for the firm's inputs and outputs, changes in managerial responsibilities and the possible imposition of hard-budget constraints.

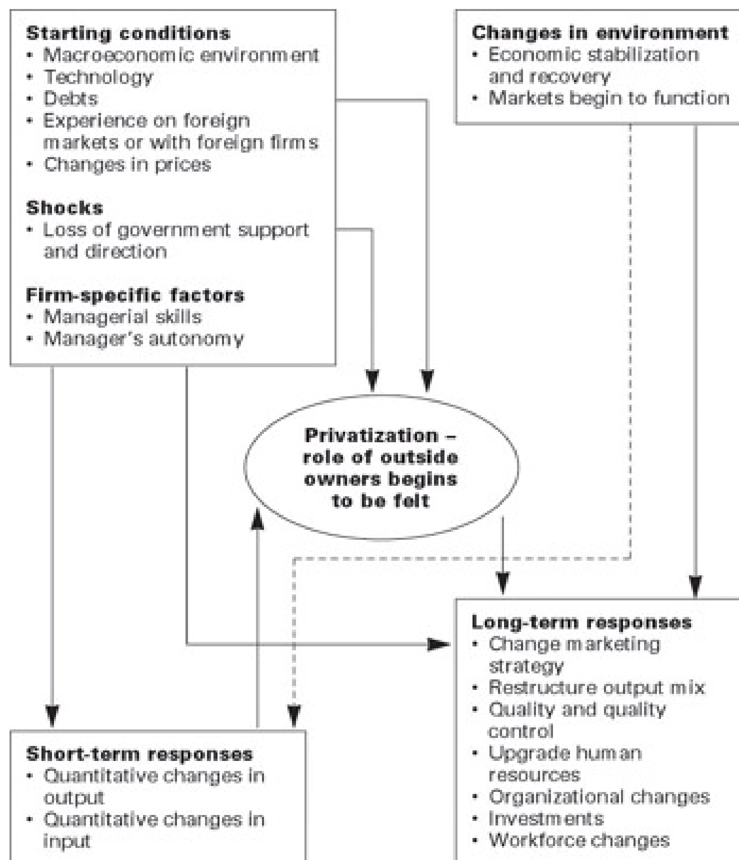

Figure 5.1: Path dependence of firms' responses to transitions

How firms responded to these short-term shocks proved to be critical for their long-term survival, in that the quality of their short-term responses determined their ability to restructure themselves in the longer term. For example an inadequate short-term response could saddle a firm with debts and strangle its cash flow, making it unlikely to be selected for accelerated privatization and rendering it unattractive to foreign investors. On the other hand the existence of business contacts between East European and foreign firms in the pretransition period often facilitated either a strategic investment by a Western firm once the privatization laws permitted it or the creation of a strategic alliance between the two firms. Thus short-term responses helped to determine who a new firm's owners would be and the degree of

autonomy they would grant to managers. They also helped to determine the access the firm would have to outside funds for restructuring and other vital resources such as skilled managers and qualified workers. At some point short-term responses would begin to cumulate into a long-term trend, so the sooner a firm was able to tailor its short-term behaviour to its long-term strategy, the more likely it was to be successful.

5.4 Short-term responses

In the early stages of transition the changes in the economic environment were so overwhelming that firm-specific factors, apart from managerial skills and autonomy, did little to differentiate the short-term responses of firms. Thus the holding of debts taken out prior to transition had a much smaller impact on firms' behaviour in the short run than had been expected because inflation sharply reduced the real value of this debt, and the explosion of interenterprise debt also temporarily eased the debt burden. Firms whose exports had gone to the CMEA (Council for Mutual Economic Assistance) suffered a particularly abrupt shock, but the magnitude of the output decline in the three countries was such that virtually all firms faced a sharp fall in demand. Moreover, despite the belief that it was the heavy industry of the region that was overdeveloped, consumer-oriented sectors such as textiles and food processing suffered comparable, if not greater, demand-side shocks. Regional factors played an ambivalent role, with firms located in distressed areas with high unemployment facing more serious obstacles but at the same time benefiting from good relations with their workers and local authorities due to the desire of the latter to keep firms operating.

While managerial skills at individual firms were important in determining how firms responded to these shocks, in the short term such skills were less important than managerial attitudes. Some managers did not view the government's transition measures as credible and therefore persevered with their old business policies or continued to work to satisfy old constituencies in their supervisory ministries. This failure by managers to accept the realities of transition and stabilization were often accompanied by efforts to resist the introduction of new ways of exerting outside influence over the firm. In part this manifested itself in managerial complaints about the inability or unwillingness of the government to protect the firm by means of industrial policies, tax breaks or trade policy. These managers also resisted changes in the way that the state exercised its role as owner, even if such changes implied greater managerial autonomy, and they also sought to resist the introduction of outside owners through privatization when this was proposed.

According to Estrin *et al*. (1995), the principal factors serving to promote short-term adjustment were the degree of autonomy enjoyed by managers and the credibility of the prospect of privatization. Managerial autonomy was related to the clarity of property rights and to the lack of workers' involvement enterprise decision making. Clarity of property rights did not necessarily mean that the firm was being or had been privatized, but rather that a credible set of new owners, domestic or foreign, was in place or on the horizon, or that the state's ownership was sufficiently well defined to prevent managers or workers from appropriating the firm or its revenues. Managerial autonomy was also strengthened to the extent that the firm's budget constraint was hardened and its financial accountability to the government, its suppliers and its creditors increased. Estrin *et al*. concludes that managerial autonomy was weakest in Polish firms because of the influence of workers' councils in the selection and retention of managers, and because of the ambiguity of property rights caused by the competing claims of workers and the state for ultimate control over these firms.[3]

Firms that were judged passive in the face of transition were those which made few or no adjustments to their levels of output and input, despite the sharp decline in demand experienced by virtually all firms and the large changes in input and output prices. Such passivity led to smaller profits or larger losses than experienced by other firms, and to the accumulation of debts, often in the form of payment arrears to suppliers, the government and sometimes even workers.

Active responses to the transition took two forms: changes in the real or productive sphere, and changes in the business sphere. Changes in the real sphere involved changes in output or inputs in response to changes in demand. The most obvious response was to reduce output. Firms also responded by altering their product mix, so that production was

concentrated on product lines with the best market potential. In some cases this also involved improving quality so as to improve competitiveness in Western markets; in other cases it meant concentrating on the lower end of the domestic market. Such changes were generally made within the limits imposed by current capacity and technology. A second production response was to alter the input mix in response to changes in the price and availability of inputs. While a few firms temporarily found it difficult to obtain necessary inputs, supply-side bottlenecks were not a major cause of output decline. Many firms also took advantage of trade liberalization to begin importing inputs from Western suppliers, who were seen as more reliable and whose higher-quality products, albeit at higher prices, were seen as lowering production costs and smoothing the production process. The fall in real wages and the rise in the price of other inputs caused labour costs as a share of total costs to fall in most firms, and this may have served to cushion falls in employment. Changes in output and employment were relatively common in the firms surveyed, in part because they were imposed by environmental factors, above all the decline in aggregate demand and the imposition, however imperfectly, of hard budget constraints. Nevertheless there were differences in the speed and extent to which firms carried out these changes, and these differences had decided effects on firms' long-term prospects.

Active responses of a more sophisticated kind, those in the business sphere, emerged in fewer firms; nevertheless a majority, particularly in the Czech Republic and Hungary, began to formulate and implement strategies for long-term survival. Such strategies involved changes in the way that these firms did business, including their internal organization and means of motivating workers and managers, the mix of business activities they carried out, their strategies to remain or become competitive, the technologies they used to produce and distribute their products, and the alliances they formed with other firms, financial institutions and government agencies. Estrin *et al*. (1995) identified firms that were undertaking such strategic responses, and they were able to link this behaviour more strongly to managerial autonomy and to the credible prospect of privatization than they could to responses in the physical sphere. However their study ended too soon to determine whether these strategies could be sustained and whether impending ownership change would introduce effective mechanisms of corporate governance.

[3]Nevertheless there were positive short-term responses by some Polish firms, as Wosinska (1995), Pinto *et al*. (1993) and Pinto and van Wijnbergen (1994) show.

5.5 Long-term responses and enterprise restructuring

The case studies in Brada and Singh (1998) and Wosinska (1995), because they were undertaken later, provide better evidence of strategic changes by firms and how these related to privatization and the introduction of new owners. Before turning to the evaluation of the long-term behaviour of the firms in our sample, two short-term responses that appeared to be vital to the success of long-term restructuring efforts must be mentioned. The first was maintaining the profitability of the firm during the early period of transition. Firms that managed to remain even marginally profitable in the first years of the transition made greater progress in their long-term transformation. Indeed these firms were not only more successful in adjusting their business strategies to the new environment, but they also had higher rates of output growth, greater profitability and greater managerial autonomy. The second response was the establishment of clear control rights. In firms where these were established early on, managerial responses were more active, more comprehensive and more successful. Indeed it could be argued that in every case where the survival of the firm was in doubt, ambiguity about ownership was a significant contributory factor. This was particularly evident in the Polish firms in the sample. In many of these, real transformation began only when the firm's corporate structure was changed to eliminate the workers' council. While this often resulted in the workers becoming shareholders, this was usually a minority shareholding and managers tended to hold the controlling, or at least a decisive, share.

Although each firm's experience was unique, a reading of the case studies quickly reveals a number of common practices among firms that can be judged as making a successful transformation to the new market environment.

5.5.1 Marketing

Every firm that can be judged as having achieved long-term viability made significant changes to its marketing activities. Common measures were to expand the sales staff and increase the marketing budget. Firms operating in command economies had little need for marketing: products for business customers went to the state-run wholesale network, consumer goods went to the state retail network and exports were usually handled by specialist export houses, thus leaving almost no marketing for firms to undertake. At the start of transition the domestic distribution systems collapsed and firms had to deal directly with customer firms and private retail networks consisting of many small sellers, all of whom required their suppliers both to produce goods and to serve as a wholesaler. The collapse of the state-run distribution channels forced firms not only to devote more resources to marketing and distribution, but also to change how they distributed their products. Some firms sought, with varying degrees of success, to develop their own retail outlets, others to form links with newly emerging wholesalers and retailers.

Most firms abandoned the export trading houses that had handled their exports in the past. This was partly due to the fact that the expertise of the trading houses was much more oriented towards the former socialist countries than it was towards the West, where producers wished to explore sales opportunities. However not all successful firms sought out foreign markets, and many relied on the domestic market for their main source of income. Foreign-owned firms enjoyed some advantages in penetrating foreign markets, but there were significant exceptions. For example the Hungarian firm Tungsram, wholly owned by General Electric, found it surprisingly difficult to break into Western markets, while the access of the Czech firm Glavunion to some Western markets was restricted by its Belgian parent (Brada and Singh, 1998). In some cases foreign owners focused the strategies of their East European acquisitions towards the domestic market.

5.5.2 Workforce reduction

While some firms reduced their labour force by as much as 50 per cent, others made relatively small cuts. Some firms' failure to eliminate redundant workers was due to outside pressure, and in other cases it was due to managerial reluctance to do so. Furthermore there was a decline in wages relative to other input costs and in labour costs as a share of total costs, which reduced the need for aggressive labour shedding. Foreign-owned firms seemed as differentiated in their approach to workforce reductions as domestic ones. In general, large cuts in employment did not seem to be the central or key element of restructuring that many observers had expected.

5.5.3 Restructuring output

There was no clear pattern in the strategies firms adopted for revamping their product mix. A small proportion of firms expanded their output assortment, but most narrowed it, eliminating lines in which they were not competitive. Given the relatively large size, broad product range and high degree of vertical integration of the typical socialist enterprise, this was not surprising.

In addition to narrowing their product lines, firms also tended to undergo a certain amount of vertical disintegration. In part this was due to the process of privatization, as enterprise units that had formed an integrated supply chain were separated into independent firms and were therefore forced to rebuild their dealings on a market rather than an intrafirm basis. There was also a tendency to spin off auxiliary service activities. Services such as the provision of company holiday facilities and medical care were common examples of this, but some firms contracted out cleaning, repair and transportation services as well.

5.5.4 Quality and quality control

One of the major areas of emphasis in virtually every successfully transforming firm was quality and quality control. This stress on quality was independent of whether the firm's product strategy was geared towards higher-quality, export-oriented production or whether its products were aimed at price-conscious domestic consumers. Also noteworthy was a relatively high reliance on outside consultants and Western quality-control technologies. This reflected both the importance attributed by managers to quality improvements and the dearth of expertise and resources for improving quality in the region. In terms of emphasis on quality improvements, domestic and foreign-owned firms did not differ in their approach.

5.5.5 Human resources

Many of the successful firms revamped their human resource practices. The introduction of changes to the remuneration system was almost universal among successful firms. This often involved widening the pay scales in favour of those with the most needed skills. This usually meant that, in relative terms, white-collar and managerial employees with skills in critical areas such as marketing gained at the expense of production workers, especially unskilled workers. Also almost universal was a shift in managerial remuneration and prestige away from managers in charge of day-to-day production towards those who made strategic decisions or were involved in finance, control, marketing and accounting. Such changes reflected the fact that under the old system strategic planning and the need to consider how to finance the firm's activities simply had not existed. Also noteworthy was the number of firms that, despite difficult circumstances, undertook programmes to develop their human capital through in-house training and education programmes.

5.5.6 Decision making

Most of the firms in our sample changed their management structures. Many separated strategic decision making from the management of day-to-day operations. Under the old regime an enterprise manager's key responsibility had been to maintain production, and thus the prestige and authority accorded to production managers had been very high. Under the new circumstances the firm's top managers had to devote most of their attention to strategic issues connected with the firm's long-term survival, and therefore lower-level managers on the shop floor were expected to make decisions about production, something to which they were not accustomed. At the same time the socialist corporate culture, which had given primacy to production, had to be changed so that the firm's business activities were not conducted to serve the needs of managers responsible for output. Instead a new culture where production reflected the needs of the marketing department and the constraints imposed by the firm's financial resources had to be created. Numerous case studies have revealed the cultural tensions these changes brought about.

There were two organizational changes that many firms implemented to bring about the new culture. One was to move towards a divisional structure, with a headquarters staff responsible for strategic and control activities and divisional managers responsible for day-to-day operations. This served to elevate the status of strategic management and to give divisional managers greater responsibility and autonomy. The other response, which in some cases was complementary to and in other cases a substitute for the divisional structure, was to organize the firm into profit centres. To some extent this too was an effort to increase the responsibility and autonomy of lower-level managers, but a reading of the case studies suggests that it was also seen as a way for top management to ascertain how viable the various units of the firm were so that they could effectively allocate investment resources.

The greater need for information about the firm's activities brought about by the market transition was also reflected in the number of firms that introduced new management information systems or extensively revamped and upgraded their old ones. The use of outside consultants in the implementation of these changes to the organizational and information systems reflected both managers' uncertainty about what their firms required and their lack of experience in implementing organizational change.

5.5.7 Investment

Lack of capital was often seen as a serious barrier to enterprise restructuring. Hence it is quite surprising that the case studies showed very different investment behaviour on the part of firms that were judged to be restructuring successfully. Lack of capital was a key problem for firms such as Glasunion and Radiotechnikai (Brada and Singh, 1998), which had been prevented from restructuring and were in danger of collapse precisely because they were unable to undertake vitally needed investments.

The amount of investment varied among successful firms but in most it was quite small. The largest investment among the case-study firms was that by General Electric in the Hungarian firm Tungsram. This served not only to modernize Tungsram's products, technology and operations but also to cover several years of operating losses, and was a classical example of the largesse expected of foreign strategic owners who acquired East European firms. However there are other examples, including Glavunion and Matra Cukor (ibid.) of foreign owners choosing not to make large investments in the capacity or technology of their East European acquisitions. Thus while foreign owners clearly had better access to capital markets than did domestic firms in Eastern Europe, this did not always result in greater investment.

In many cases domestic firms admitted to the difficulty or impossibility of obtaining credit from banks or other sources. Therefore their investments had to be financed internally. This fact underlines the finding mentioned at the start of this section that firms that were able to maintain their profitability had a much better record of restructuring than did those which suffered losses early on. While the volume of investment that self-financing allowed was not

large, it represented the difference between stagnation and movement towards survival and growth. However some firms were able to obtain outside financing, mainly from banks, and firms owned by single entrepreneurs or small groups of owners were the most successful in obtaining such funds.

The investments that firms undertook served a number of objectives. The most common was to change the product mix so that the firm's output would better reflect market demand. In some cases this involved increasing productive capacity for one or several products while the total capacity of the firm was reduced. Also common were investments to replace productive activities that had been carried out within the framework of a large, integrated enterprise in the socialist era but now belonged to smaller firm spun off from this enterprise by privatization or administrative edict, and investments to renovate and modernize production, lower production costs and, somewhat surprisingly, ameliorate environmental damage from the firm's activities. Investments designed to increase production over a broad range of products were very rare among former state-owned firms, where overcapacity tended to be the norm, but firms that had been started up by private entrepreneurs had a more appropriate scale of production and thus were willing to invest to expand as market conditions dictated.

Overall it is rather striking that investment activity was not the key element of successful restructuring, contrary to early concerns about the amount of money that would be required to restructure East European industry. Indeed relatively 'soft' measures such as human resource policies and reorganization were much better agents of restructuring than investment.

5.5.8 External organs of control

Also vital to the success of the case-study firms was effective owner control. In part this emerged as the result of actual or incipient privatization. The exception was Poland, where workers' councils tended to block restructuring and limit managerial autonomy. Many Polish cases show that legislation that exempted firms no longer owned by the state (and therefore not subject to the rule of workers' councils) from the *popiwek* (the tax on large wage increases) was critical in strengthening the autonomy of managers and thus enabling them to undertake extensive restructuring. The case studies show that workers were often willing to disband their workers' council in exchange for exemption from the *popiwek* in the expectation that, under the new ownership structure, they would enjoy higher wages. However in many cases the workers' expectations were not met because the harder budget constraints and greater managerial autonomy that resulted from this change in corporate structure and governance made large wage increases impossible.

Also evident in the case studies was a division of labour between managers and the various boards that formed the organs of corporate governance. In exceptional situations, for example when managers were replaced or prospective outside owners were being courted, corporate boards played an active and almost day-to-day part in the affairs of the firm. However under normal circumstances it was the managers who devised strategies, made the difficult decisions and set the future course of the firm. This is not so say that managers were always up to this task. There were instances of serious business mistakes being made, and the frequent reliance on outside management consultants or foreign owners for strategies and managerial inputs was perhaps indicative of the doubts that assailed managers in the region. Nevertheless the setting of strategies and the day-to-day operations of these firms was not the task of their supervisory boards.

5.6 Conclusions and future challenges

The case studies show that managers in the region, when given appropriate incentives and autonomy by the owners of their firms, reacted vigorously to the challenges facing them. The measures and strategies adopted to ensure the survival and restructuring of the firms examined seem quite consistent with what would be viewed as good and appropriate managerial behaviour in developed market economies. Thus East European managers quickly mastered the basic principles of management and applied what might be seen as textbook or common-sense solutions to the problems they faced when restructuring their firms.

Although the period of transition and restructuring is now largely over for firms in the Czech Republic, Hungary and Poland there are two important challenges ahead for managers and policy makers. The first of these is the globalization of the region's firms. In the case of foreign trade, the reorientation towards the markets of Western Europe is dramatic, as is the volume of foreign investment in the three countries. However what is still lacking is the ability of the firms in the region to project their core competences into the international market by undertaking foreign direct investment (FDI) of their own in Western Europe and beyond. Business theory stresses the need for firms to exploit their competitive advantage not only through exports but also through FDI, and both managers and policy makers in transition economies have to be aware of this.

The second challenge is to introduce corporate governance in the region. This may seem a rather bold statement, but corporate governance means neither the 'good management' of day-to-day corporate affairs nor the existence of strong outside owners. What it does mean is that outside owners of capital are willing to entrust managers with their capital (Shleifer and Vishny, 1997). Evidence of such willingness would be numerous initial public offerings (IPOs) of shares by firms in the region and the readiness of banks to lend without the compulsion of ties to past, often bad, loans to the same firms. Neither of these conditions exist. The net flow of funds has been largely from the non-financial sector to the banks rather than the opposite, and the stock markets of these countries have yet to see a real IPO. The concentration of shareholdings in the hands of strategic investors merely underlines the non-existence of corporate governance because strategic ownership is a substitute for effective corporate governance since a strategic owner is, by definition, an owner-manager, a situation that eliminates any problems of corporate governance.

Notes

1. The research that forms the basis of this chapter was part of a research project entitled 'Enterprise Behavior and Economic Reforms: A Comparative Study in Central and Eastern Europe', undertaken by the Transition Economics Division of the Policy Research Department of The World Bank. I am indebted to the William Davidson Institute at the University of Michigan Business School for allowing me a period of time for reflection and the writing of this chapter.

2. For a description of privatization programmes see Brada (1996). Hart (1995) provides a useful survey of corporate governance from both a theoretical and a practical standpoint.

3. Nevertheless there were positive short-term responses by some Polish firms, as Wosinska (1995), Pinto *et al*. (1993) and Pinto and van Wijnbergen (1994) show.

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Chapter 6: Politics and Employment Relations: The Power of Labour in Poland after the Fall of Communism

Roderick Martin

Abstract

This chapter looks at the part played by Polish organized labour in the development of the country's political and economic system. It provides an overview of the changes in employment relations after 1989, analyzes the main elements of the current system and examines the extent to which the labour movement influenced the design and establishment of the central institutions of the present political and economic system. One of the main conclusions is that the position of the labour movement in Poland was more favourable than elsewhere in Central and Eastern Europe during the years following the collapse of communism, but that it has considerably lost influence since then.

6.1 Introduction

Polish labour appeared to be uniquely powerful amongst labour movements in the countries of Central and Eastern Europe (CEE) after 1989. The sources of this power were both political and economic. Politically, the trade union movement Solidarity was of course instrumental in the fall of communism in Poland and it acquired a talismanic status inside and outside Poland in the 1980s and early 1990s. Trade union movements throughout CEE, such as the Bulgarian trade union movement Podkrepa, explicitly sought to legitimize themselves by reference to Solidarity and to model their policies and approach on those of Solidarity. Western leaders, including Margaret Thatcher (then prime minister of Britain), praised Solidarity for its role in the development of democracy. Within Poland, the overwhelming success of Solidarity representatives in the 1989 elections and the subsequent election of Lech Walesa as president in 1990 appeared to confirm the power and status of the movement. Solidarity activists occupied key positions in postcommunist governments in 1989–93 and 1997–2001, and activists also played major roles at the local level. In the late 1990s Solidarity's political weight was institutionalized in the Solidarity–AWS electoral alliance, which was dominated by trade unionists. A further sign of the strong standing of labour was that even the successor trade union movement, OPZZ, enjoyed a substantial membership, despite the unpopularity of institutions tainted with communist origins in the postsocialist period.

To evaluate the unique position of Polish labour in the postsocialist period this chapter first provides a brief account of the employment relations system(s) emerging in Poland after 1989. It then assesses the extent to which the Polish labour movement has influenced the development of political and economic institutions since the fall of communism and can therefore justifiably be seen as an exception to the overall weakness of organized labour in postsocialist CEE. A brief concluding section locates Poland in the overall trends in international capitalism.

6.2 Polish employment relations: continuities and change

The postsocialist Polish employment relations system comprised four distinct but overlapping systems that prevailed in different sectors of the economy. First, there remained elements of the socialist period, with politically oriented union leaders – both antisocialist and socialist – supported by small groups of rank and file union members. Solidarity and the OPZZ represented strong continuity with the socialist period, although of course the significance of this continuity was very different for the two movements. Labour organization in the state sector and amongst partially privatized firms reflected the decaying Socialist pattern. Second, there were elements of 'transformative neoliberal corporatism' (Iankova, 1998), in which the state sought to create interest group consensus within a tripartite framework. Governments throughout the region sought to develop neocorporatism as a means of reducing the dangers of social conflict by incorporating the potential leaders of social discontent – the trade unions – into governing structures. Although neocorporatism was less necessary in Poland than elsewhere because union leaders were already incorporated into the political system, the same motivation to reduce social conflict existed. Third, there were elements of free collective bargaining, with multi-employer or single employer union bargaining arrangements, as sponsored by the International Labour Organisation. Fourth, there were also elements of postcollectivist human resource management (HRM), associated primarily with US-owned multinationals.

6.2.1 Socialist inheritances and postsocialist continuities

The employment relations system that developed after 1989 was built upon the residues of the socialist system; it was not constructed *de novo.* This continuity was both personal and institutional. Many of the participants – managers and union officials – had played comparable roles in the socialist period, with socialist personnel giving way to Solidarity activists after 1989. There was also significant continuity at the institutional level. For enterprises that remained in state ownership the system was a slackened form of the socialist system, with a weakening of ministry control and a decline in state funding but with the state seeking to maintain control over wage determination, initially through the *popiwek* system. Employers' organizations were weak and state sponsored, even when they sought to represent owners of privatized enterprises. The initiative lay with enterprise managers, as in the late socialist period. Trade unions inherited the resources acquired during the socialist period, if with considerable controversy over their allocation.

The defining element of continuity with the socialist period was the intimate link between employment relations and politics at both the individual and the institutional level. For managers, contacts in the state apparatus were important means of securing enterprise benefits (favourable allocations for capital investment or coverage of losses, state orders, and sympathetic treatment of proposals for restructuring and privatization), regardless of the precise ownership arrangements. For trade unions the benefits of political links were even greater. Trade union members were disproportionately drawn from the state sector, where wages depended directly on the state budget. More generally a network of state contacts helped to secure financial resources to maintain employment levels. The benefits of the close links were two-way. The links between the state and enterprise managers gave the state access to, if not control over, the direct controllers of economic assets. The links between the state and trade unions enabled political groups to gain influence over a major means of political mobilization (albeit a less effective one than the Catholic Church). Trade unions provided means for political mobilization for both the postsocialist and the liberal parties, as well as leverage for individuals seeking political careers. There were close links between the OPZZ and the SLD party, whilst Solidarity played a direct role in government and – even when it decided to distance itself from politics – remained intimately linked to the Solidarity–AWS Party.

The problems posed by the close association between political parties and trade unions were acute, with the trade unions effectively surrendering their independent bargaining power. Eventually, in the spring of 2001 Solidarity decided not to support Solidarity–AWS candidates, thus contributing to the party's electoral disaster in the 2001 Sejm elections. At its fourteenth National Assembly in Poznan in October 2001 Solidarity decided to prohibit the combining of trade union and political functions. Solidarity activists believed that the political divisions imported into the movement by electoral alliances and the use of Solidarity symbols by political groupings was weakening the movement and inhibiting effective union activity in the workplace.

As in the socialist period, trade union organization continued to rely on full-time officials, if increasingly elected rather than appointed and with only limited rank and file experience in union affairs. Even during the heyday of Solidarity, institutionalized shopfloor organization similar to the shop steward system in Britain and the V*ertrauensleute* in Germany did not exist. Union officials operated in a centripetal manner, adhering to state bureaucratic procedures rather than reflecting shopfloor opinion and the exercise of enterprise-level bargaining power. Union officials were responsible to the organization that employed them, not to the members who had elected them. A major duty of union official, was cultural mobilization, to act as a transmission belt for ideological matters. The ideological content differed, of course, from the socialist period; the ideological orientation was now towards the 'market', which was not given a precise definition. Solidarity representatives were the most strongly promarket representatives in the Sejm in the early 1990s (Kitschelt *et al*., 1999, p. 327). Trade union officials had more positive views of the market than trade union members, but both showed more ideological commitment than workers employed in the private sector. For Solidarity union officials, building the market replaced building socialism as the ultimate objective.

The lack of differentiation between employment relations and politics was evident amongst officials of the OPZZ as well as Solidarity, although the OPZZ adopted a specifically 'non-political' stance, necessitated by the need to distance itself from its socialist past. Nevertheless the policies of the OPZZ were coordinated with those of the SLD. Hence the OPZZ was more compliant when the SLD formed the government (1995–97) than under Solidarity governments.

The substantial involvement of union officials in politics was not popular with union members, who believed that their economic interests were being sacrificed for political objectives. Detailed plant-level research in the electrical engineering and electronics sector showed that the majority of union members believed that trade unions should focus on employment issues, especially job security and employment protection, as well as wages. 'Society and factory employees are rather opposed to the intense engagements of trade unions in politics. They consider that the trade unions should limit themselves exclusively to filling a trade union role' (Cichomski *et al*., 1998, p. 175). According to survey evidence, in 1996 over 70 per cent of Poles believed that unions should focus on industrial relations, a figure that is likely to have risen since.

6.2.2 Transformative neocorporatism

The task of corporatist institutions was to ensure consensus amongst the politico-economic elite. Although tripartite institutions involved employers as well as the state and unions, the major supporters of tripartism were the state and the unions: in exchange for influence over social and economic policy trade unions were expected to contribute to the maintenance of social discipline and to restrain wage-push inflationary pressures. Such social discipline was a means of reducing the scope for social conflict. In Poland the tripartite commission was set up relatively late, coming into existence only in 1994 following the 1993 Enterprise Pact. Even after its belated formation the Tripartite Commission for Social and Economic Affairs did not

receive the salience accorded to it in, for example, Bulgaria.

The main tasks of the Tripartite Commission, as elsewhere in CEE, were to monitor macroeconomic trends, evaluate overall economic policy and make recommendations, especially with regard to wage policies, employment policy and social benefits. However the early experiences of the commission body were not very promising: the government did not present a comprehensive policy that employers and unions could discuss, and employers were constrained from discussing wages because of the operation of income control. Furthermore, neither employers nor the unions operated in a coherent way: employers were divided between the Confederation of Polish Employers and the Confederation of Private Employers; and there was little agreement between the OPZZ and Solidarity, the two union movements seeking to use the commission for their own political ends. The commission collapsed in 1999 when the OPZZ withdrew from participation after criticizing the government for failing to take the commission seriously. Thereupon the trade unions reverted to their previous practice of direct political engagement with the government. Throughout this period the commission had been consultative rather than executive, and the state had come to believe that the consultation process was redundant.

The commission was revived in July 2001 when legislation was passed to place it on a firmer legal foundation. The Act defined the criteria for the representation of workers' and employers' organizations, provided a timetable for the commission to express its opinion on the state budget and provided for the establishment of social dialogue committees at the regional level. The EU's commitment to social dialogue has put added pressure on the state to take the commission seriously and to developing related institutions at the sectoral and local levels, but the extent to which formal provisions will translate into effective tripartite institutions remains uncertain.

The problems for tripartism in Poland came from two directions. On the one hand tripartite structures were superfluous as direct communication channels between trade union leaders and the state existed outside the formal structures. On the other hand trade union officials had only limited influence over the members they claimed to represent. The contribution of the Tripartite Commission to the maintenance of consensus and the prevention of social conflict was therefore limited, as was the contribution of tripartism to Polish employment relations despite the commitment to social dialogue required by the negotiations on the *acquis communitaire*.

6.2.3 Free collective bargaining

The classic model of free collective bargaining involves direct bargaining between employers and trade unions, without intervention by the state. The bargaining may be between multi-employer associations and one or more trade unions, or between a single company and the unions. Where bargaining is between a single employer and trade unions it may be centralized in multiplant bargains or decentralized to the plant level. Effective collective bargaining requires disciplined employers that seek to prevent rogue employers from breaking away to negotiate more (or less) favourable terms, and strong trade unions capable of acting strategically.

Under the 1994 Labour Code two types of collective bargaining were permitted in Poland: above-company-level bargaining and company-level agreements. Multicompany agreements were registered with the Ministry of Labour and Social Policy, whilst company-level agreements were registered with regional labour inspection offices. The Labour Code was amended in 2000 to make bargaining procedures, especially at the enterprise level, easier to operate. According to the Labour Inspectorate about 10 000 company-level agreements and 114 above-company-level agreements were in operation in 2001 (NSZZ Solidarnosc, 2001). Despite the Labour Code there was only limited collective bargaining in the classic Anglo-Saxon sense and the fundamental conditions required for its success were absent.

Employers' organizations were limited, and thus the framework for multi-employer bargaining did not exist (Meardi, 2001, p. 6). There was a lack of articulation between the structure of companies, many of which were holding companies, and the possible structure of employers' associations. The great majority of agreements were at the enterprise level. These were often concluded at the initiative of management, since their registration provided a means of regularizing bargaining relationships. The bargaining process was often a formality, a means of institutionalizing relationships in workplaces where there was little collective organization amongst employees.

6.2.4 Human resource management (HRM)

The HRM model is individualist rather than collectivist. It involves individualized employment contracts, reflecting individual capabilities, sophisticated methods of employee selection, targeted training programmes, flexibility in work organization and task performance, and performance-related pay. The employee is viewed as an item of human capital, to be developed as much as an item of physical capital. The extent to which HRM practices have been adopted in Poland is unclear. There is some evidence that US multinationals have imported HRM strategies into Poland, and Meardi (2001, p. 6) suggests that both German and US multinationals have sought to develop HRM style 'flexible' employment strategies.

Team LiB

6.3 Excessive labour power?

Organized labour has exercised greater power in Poland than elsewhere in CEE. This power has been apparent both at the political and the economic level, and during the privatization process it ensured a key place for workers. Employees were given a highly privileged status in 'privatization by liquidation', whereby the privatization initiative lay with workers' councils and the majority of employees became shareholders. Employees also received privileged treatment under the mass privatization programme, with a guaranteed stake in their own enterprises. Meanwhile labour pressure delayed the restructuring and privatization of state enterprises, especially in the steel, coal-mining and railway industries. For example in 1999 trade union pressure secured very favourable treatment for coal miners under the procedures for reducing employment in the industry. Labour also exercised a mighty influence over the development of social welfare and pensions policies, with organized labour remaining strongly committed to maintaining tax- rather than insurance-funded welfare provision. As late as 1999 accusations of 'unionocracy' were specifically associated with claims that the trade unions were dominating government policy on the restructuring of the railways.

On the economic front, strikes and industrial conflict reached greater heights in Poland than elsewhere in CEE, especially in the early 1990s. In the late 1990s Polish wages were higher than anywhere else in the region except Slovenia, despite rising unemployment. For example in 1999 the average monthly wage in Poland was US$459, compared with US$356 in the Czech Republic (*Business Central Europe*, February 2000). Enterprise collective agreements were more common in Poland than elsewhere in CEE, reaching 10 900 in 1999 (Kozek, 2000). Despite the unpopularity of institutions closely linked to the communist regime, the socialist trade union movement OPZZ retained a substantial membership.

Yet there were also contrary indications of the strength of organized labour. The level of trade union membership declined, with Solidarity membership dropping from over nine million in the 1980s to 1.2 million by 1999 (Ost, 2001, p. 80). According to a survey by Solidarity, only 17 per cent of workers were members of trade unions in 2000. There was a heavy concentration of membership in the state sector, but even there only 33 per cent of employees belonged to unions. Membership was rare in the private sector (just 8 per cent) and in internationally owned firms (Solidarnosc Newsletter, n.d., 2001). Furthermore almost 75 per cent of workers, including trade union members, thought that the trade unions had proved ineffective in defending workers' interests; plant-level research in the electronics industry confirmed the limited influence of trade unions at the enterprise level (Cichomski *et al.*, 1998); and the Solidarity trade unionists in government failed to use their influence to enhance labour's position. The high degree of industrial conflict over restructuring and privatization indicated that trade unions were on the defensive in respect of state and management strategies for restructuring, not that trade union influence was dominant – union power always seems greater when management is fearful of opposition and seeks to avoid conflict. Although real wages were higher in Poland than elsewhere in the region, so too was the level of unemployment throughout the 1990s. In 2000 it reached crisis point, with over 17 per cent unemployment. Such trends were hardly evidence of labour's domination of economic policy.

The evidence for union domination of Polish employment relations is thus contradictory, and interpreting the developments involves distinguishing different types of influence and power. Trade union leaders, especially those with a history of involvement in Solidarity, were able to exert considerable influence, based on their reputations and political connections. But the interests and objectives of the union leadership and those of the rank and file members were not always identical. Union leaders had a greater interest in the process of privatization, and in institutional issues such as the role of workers' councils at the enterprise level and the development of tripartite arrangements at the national level. The ability of individual union leaders to influence political decision making did not equate with the power of organized

labour, which depended on both organizational and economic factors, especially their perceived ability to organize collective mobilization. In the economic circumstances of the early 1990s the collapse of output made such mobilization extremely difficult. However individual employees with scarce skills, such as a knowledge of foreign languages, possessed considerable power in the labour market. On this basis the Western-oriented young Solidarity activists of the 1980s became highly sought-after bankers in the 1990s. In general then, trade union leaders may have significant power whilst organized labour and labour itself is weak. Conversely individual employees may have considerable power because of a scarcity of skills, whilst trade union leaders remain weak.

How justified, then, is the view that trade unions and/or workers strongly influenced on developments in Poland after 1989? Their influence can be judged on two levels. At the political level, to what extent were political institutions under the influence of trade unions and therefore adjusted their policies to meet the objectives of the unions? At the economic level, to what extent did the power of labour exercise a constraint on management?

Labour's objectives fell into three categories: institutional, economic and broadly social. Solidarity's objectives covered the whole range as it was a broadly based social and political movement. The OPZZ formally defined its role in narrower terms, distinguishing between the economic bargaining function of trade unions and the broad political role of the SLD. At the national level the main institutional objective was the effective operation of the Tripartite Commission for Social and Economic Affairs, and at the local level it was the protection of collective bargaining rights.

As mentioned in Section 6.2.2, the position of the Tripartite Commission was reinforced in 2001 after a period of major dispute. Enterprise-level collective bargaining was legally protected in that the Labour Code provided for employer recognition of union representation and the right to conclude collective agreements. The institutional position of trade unions was reinforced in 2000 by provisions that allowed trade unionists to take time off for union duties and required employers to cover the costs of such duties, proportional to the number of union members involved. Employers were also required to deduct union membership dues. The formal institutional position of organized labour was thus strengthened.

Labour also had a major influence on the form and speed of the restructuring and privatization process. Labour's initial objective was to enhance the position of employees, and privatization by liquidation or insider privatization were seen as the best means of maintaining employment levels. While the privatization procedures largely reflected these preferences, labour's influence was not the only reason for the prevalence of liquidation and insider privatization as the interests of labour and management often coincided. Labour's objective with regard to state industries was to maintain the current employment levels as much as possible. The major industries affected were steel, coal and the railways, and in all three sectors the unions slowed the process of restructuring. Employment levels were reduced in all three sectors at a slower rate than the state had wished, and only after serious industrial conflict. However, while labour's objectives were achieved in the short term, international pressure for restructuring, especially the EU's call for reductions in employment in the coal and steel industries and the World Bank's financial incentives for reducing employment, meant that the successes were short-lived.

On economic matters, labour sought to achieve four major objectives: to maintain the minimum wage at no less than 40 per cent of the average wage; to raise the earnings of state employees to match those of employees in the private sector; to improve employment security and reduce unemployment; and to provide effective job protection for workers in the private sector, where working conditions were worse than in the state sector. Labour failed to achieve all four objectives.

On broad political matters organized labour had two major objectives. First, with regard to social welfare the unions opposed the government's proposals in 1996 for the marketization

of social welfare, which would involve the introduction of personal insurance arrangements both for pensions and for medical care. Instead the trade unions wished to use funds generated by privatization to fund social welfare provision. Solidarity argued that state assets should be expropriated rather than privatized, that is, transferred free of charge to groups entitled to receive them (Hausner, 2001, p. 224). This accorded with the socialist perspective that, since citizens had been responsible for building up the assets they should receive the benefits from their reassignment. Although Solidarity's view was endorsed in a national referendum, the low turnout caused the results to be disregarded. Labour did manage to achieve a modification of the welfare proposals, but without reducing the government's commitment to a more market-oriented social welfare system.

The second union objective was EU membership, which was strongly supported by the majority of organized labour as it was believed that membership would provide greater economic security. However, in contrast to the situation in Western Europe, Polish employers were hesitant about EU membership as they feared increased competition.

At the sectoral and enterprise levels, the collapse of demand in the early 1990s, rapid inflation and high unemployment inevitably created economic conditions that weakened the trade union movement. In the early 1990s the special relationship between organized labour and political parties partially protected employees in the state sector and in enterprises undergoing privatization. However the unions were not able to protect the jobs of employees in the private and international sectors, where union membership was uncommon. Union recognition was rare in the newly emerging private sector, and even where unions were recognized they were unable to protect workers when companies ran into difficulties – as happened at Daewoo's motor assembly plant.

6.4 Conclusion

Is the position of labour uniquely different in Poland from elsewhere in CEE (or Western Europe)? In the short run the answer is yes, in some ways, but in the long run it has to be no. In the short run the political and symbolic importance of Solidarity has ensured a more favourable position for labour in Poland than in other parts of CEE, and labour's position in the privatization and restructuring process has been stronger than elsewhere.

The institutional objectives of organized labour were largely achieved in the early 1990s. However it is easy to exaggerate its successes, especially in the economic sphere. Although earnings were higher in Poland than in the Czech Republic and Hungary, the level of unemployment was also higher. In general the major determinant of the power of labour is the level of product demand – when demand is high the power of labour is greater. High demand may be due to the merits of the product itself, to scarcity, to restrictions on competition or to other institutional influences. Some sectors of the Polish economy experienced high levels of demand in the 1990s, for example financial services. However the demand for the output of the highly unionized manufacturing sector and for basic utilities was weak. Although unemployment was high, this had less effect on the power of organized labour because of the limited substitutability of labour. While the fall in demand in the early 1990s led to the collapse of labour influence, political connections provided some protection, especially for institutional interests.

By the beginning of the twenty-first century Poland had become integrated into international capitalism. This was evident in the pattern of trade, with heavy dependence on exports to the EU, and in the increased flow of international capital. Foreign direct investment grew more slowly in Poland after 1989 than, for example, in Hungary, partly because of the perceived difficulties of dealing with Polish labour. However by 2001 the absolute level of FDI was greater in Poland than in its CEE neighbours, reflecting its larger population, although in per capita terms FDI remained below the level in Hungary. International capital was attracted by the size of the Polish domestic market, which was more than double that of its nearest competitor, and by its strategic geographical advantage as a route to Russia, with its oil and natural gas. Poland, like the CEE countries in general, was increasingly attractive as product markets were reaching maturity in Western Europe, for example for motor vehicles. However by 2001 Western firms were beginning to recognize that the degree of product market competition in Poland was starting to match that in Western Europe. The high profits that had been achievable in the early 1990s were disappearing – the risk premium was becoming smaller. In such circumstances countries in the CIS and South-Eastern Europe became more attractive, as reflected in changes in the policies of international financial institutions. For example in 2001 the European Bank for Reconstruction and Development (EBRD) gave higher priority to investment further east than Poland. Hence as Poland became a more 'normal' capitalist country it lost some of its attractiveness for international capital.

Polish unions believe that the best defence for their members is rapid incorporation into the EU. This view may well be correct as the days of the 'Polish tiger' may prove to be short-lived.

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Part II: The Beiersdorf Case: Radical Change from a Production-Oriented Conglomerate to a Market-Driven Consumer Goods Company

Chapter List

Chapter 7: Case Study: Beiersdorf-Lechia SA, Poznan

Chapter 7: Case Study: Beiersdorf-Lechia SA, Poznan

Susanne Blazejewski, Frank Claassen, Wolfgang Dorow and Heinz-Jürgen Stüting

7.1 Introduction

7.1.1 The context: FDI in transition economies

Foreign direct investment has been a major driving force behind the economic transformation of Central and Eastern European (CEE) countries since the early 1990s, although it has followed different paths in different countries, often due to heterogeneous privatization schemes. The economic relationship between Germany and Poland – two of the most populated states in Europe, with 81.2 million and 38.7 million inhabitants respectively and correspondingly high market potentials – has been particularly close (see Chapter 1 on the development of the close political, economic and cultural links between Germany and Poland). With Poland's anticipated accession to the EU in 2004 these two neighbouring countries will account for more than one quarter (approximately 122 million) of the total EU population after the first round of eastern enlargement.

Germany is not only Poland's most important trading partner, but since the early 1990s it has also been one of the top three providers of foreign direct investment (FDI) to the region, with consistent growth rates (see Chapters 2 and 3). Its large market potential makes Poland especially attractive to international consumer goods industries. The generally stable and increasingly favourable legal, political and economic situations since the mid 1990s have also reduced the risk of direct investment in Poland, be this a greenfield or an acquisition. The acquisition of a Polish, often state-owned, operation has frequently been followed by full-scale organizational change aimed at integrating the new affiliate into the investor's international corporate strategy and preparing the subsidiary's structures, systems and employees for the demands and challenges of Poland's increasingly competitive and dynamic market.

The story of Beiersdorf-Lechia in Poznan is an excellent example of successful cross-border direct investment and illustrates many important aspects of large-scale change management in transition economies. An in-depth description and analysis of its operations will reveal not only the dimensions of decision making and alternative management actions in such a dynamic environment but also the problems, traps and pitfalls of complex turnaround projects. This will provide a framework for future change management processes in this region and other parts of the world.

7.1.2 The case study

In 1997 the Beiersdorf group, producer of the world's top all-purpose skin-care cream, Nivea, reacquired its former subsidiary – at that time named Fabryka Kosmetyków Pollena-Lechia – in Poznan, which had been expropriated by the Polish state in the wake of World War II. There followed a remarkably swift and successful turnaround of this state-dominated, production-oriented conglomerate into a lean, highly profitable, market-driven fast moving consumer goods company. This chapter traces the development of the organization during the years of fundamental change between 1997 and 2002. It focuses on the instruments of change management employed by the new management team and conducts an in-depth analysis of their consequences for the strategy, structure and culture of Beiersdorf-Lechia.

Section 7.2 outlines the history of the Beiersdorf group and Pollena-Lechia, and provides an

overview of the developmental stages the latter went through between 1997 and 2002. The main part of the study (section 7.3) considers in turn the strategic, structural and cultural changes introduced by the new management team at Pollena-Lechia after its takeover by Beiersdorf. In the course of the case study the reader is referred to other chapters in this book that provide important insights into crucial features of the case study, such as the political and economic context, strategic issues, the development of human resource management systems, and problems of leadership and organizational identity in Polish corporations. These references are intended to provide a better understanding of certain aspects of the study and to put the specific strategic, structural and cultural issues at Beiersdorf-Lechia into a more general picture of management challenges in complex change processes.

7.1.3 Data collection

The data for the case study were collected from numerous sources in order to achieve triangulation and gain insights into the transformation process from various perspectives. Between December 2000 and May 2002 we conducted a series of interviews and had numerous opportunities to observe organizational processes at the company in Poznan. Structured and non-structured interviews were conducted with the general manager of Beiersdorf-Lechia (a German expatriate and the key agent of change), German and Polish members of the board, Polish middle managers, Beiersdorf-Lechia employees, former employees who had left during the change process and the CEO of Beiersdorf International, as well as an external consultant of Beiersdorf-Lechia to obtain an outside perspective on the change process. The atmosphere of trust and openness that prevailed from the start was invaluable during the interviews and observation phases. It also facilitated informal interactions that helped us to gain insights into the underlying processes of power and the interests and values of individuals, which in our view are crucial to the understanding of organizational change. Written material such as internal memos, reports, correspondence on the acquisition of the company and the negotiations with unions, and other archival material from before and after the acquisition was generously made available to us. All interviews were conducted and all written material analyzed by at least two researchers to ensure that the findings and interpretations were as objective as possible.

7.2 Steps of transformation from a state-owned collective conglomerate to a market-driven, fast-moving consumer goods company

7.2.1 Beiersdorf International

The history of the Beiersdorf group goes back to 1882, when the Hamburg pharmacist Carl Paul Beiersdorf registered a patent for a sticking plaster. In 1890 Oskar Troplowitz acquired the company and developed it into a thriving business. Its prime product, snow-white Nivea, was invented in 1911 and it was the first skin-care cream in the world to be produced on an industrial scale. In line with Troplowitz's strategy of international expansion, in 1925 Beiersdorf established a subsidiary in Katowice, Poland, which in 1929 was relocated to a new site in Poznan. During the 1930s this subsidiary, then named Pebeco Polskie Wyroby Beiersdorfa SA Poznan and employing more than 130 people, was the largest production facility in the Beiersdorf group.

Troplowitz also established subsidiaries and production sites in England, Austria, Argentina, Denmark, Mexico, Russia, the United States, France and Australia, and by 1932 more than 14 per cent of the company's sales took place outside Germany. However because Troplowitz was of Jewish descent, between 1933 and 1945, it became more and more difficult for Beiersdorf to conduct its business, abroad as well as in Germany. He therefore decided to split up the corporation into autonomous national companies – each holding the national brand rights for Nivea, Hansaplast and tesa – to prevent the German authorities from seizing the business as a whole.

After the war the Troplowitz family returned to Germany to rebuild the company. However, many of the international subsidiaries could not be recovered and remained national property, often as compensation for damages caused by Germany during the war. The subsidiaries in Central and Eastern Europe were seized by the newly established socialist governments and converted into state-owned, centrally planned collectives. The national brand rights were often retained by the collectives, so that the collective in Poland continued to produce under the brand name Nivea.

Despite the loss of its international affiliates Beiersdorf reaped the fruits of the postwar German economic miracle and turned into a profitable, fast-moving consumer goods company (Table 7.1). Today the Beiersdorf group has subsidiaries in 86 countries worldwide and is one of the top 10 international cosmetics companies. Its main brands are Nivea, Iesa, Hansaplast and 8x4. The Nivea product line has demonstrated enormous development potential during recent decades and is considered to be the top cosmetics brand in 15 countries in Europe. In 2001 alone Niveás sales grew by 17 per cent to C=2.5 billion.

Table 7.1: Development of the Beiersdorf group since 1932

	Sales (all divisions)		**Employees**		**Affiliates**
	Germany	**Outside Germany**	**Germany**	**Outside Germany**	**Outside Germany**
1932	11.9 million	1.9 million			
	Reichsmark	Reichsmark	1267	585	13
1949	DM 29.1 million	DM 0.9 million	1182	0	0
1960	DM 171 million	DM 57 million	3808	1269	6
1975	DM 535.4 million	DM 512.2 million	6063	11 013	28
1990	DM 1591.4 million	DM 2361.3 million	6081	17 842	58
2000	C=1217 million	C=2899 million	6421	16 590	86
2001	C=1256 million	C=3286 million	6429	17 749	86

Source: Beiersdorf AG.

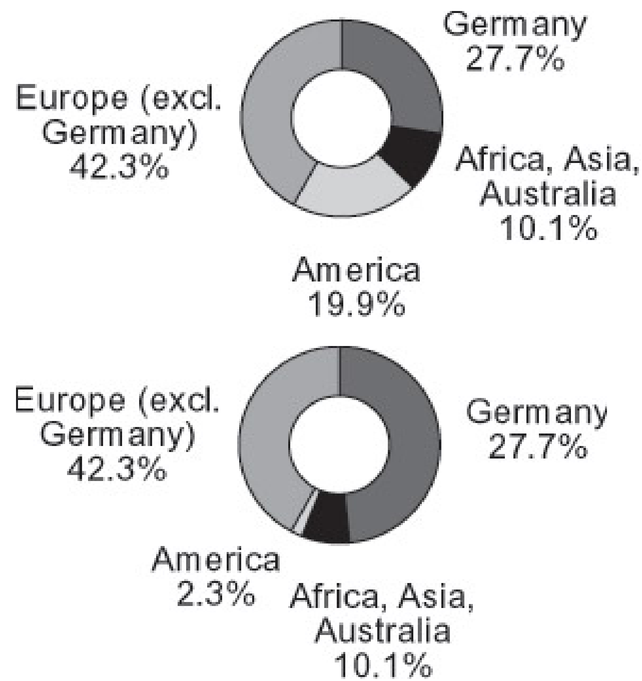
Extensive internationalization has only been on the agenda since the 1990s, when CEO Rolf Kunisch took the group beyond its traditional European market into Asia and the Americas. Since then it has developed into a real global player, with 73 per cent of sales taking place outside Germany in 2001. Central and Eastern Europe and the Asia-Pacific region, particularly Japan and the United States, have been identified as key areas for growth in the future.

Box 7.1: Beiersdorf's international consumer goods strategy

Nivea is the biggest and most dynamic skin-care brand in the world, with global sales of C=2458 million in 2001 and a breathtaking growth rate of 17 per cent in 2000–1. Now in its one hundred and twentieth year, the Beiersdorf group is one of the fastest growing consumer goods companies in the world. It increased its consumer goods sales by 10.3 per cent to C=4542 million in 2001 (Nivea sales have in fact quadrupled since 1991).

Our growth basically comes from:

- Innovation and brand extension: we invest 2 per cent of sales in R&D. Innovations such as Q10, and Nivea line extensions like colour cosmetics, and men's skin-care products significantly contribute to our growth.
- Market share improvement: the quality of sales is reflected in the continuous increase of product categories across all countries where our brands are market leaders or at least among the top three.
- Regional expansion: Within the last five years we founded several companies particularly in Eastern Europe or Asia. International sales are now responsible for nearly 73 per cent of our business and will continue to be a major contributor for growth from within.



This international success rests on basic principles held by Beiersdorf affiliates all over the world:

- Our long-term aim is the sustainable development of our business internationally.
- We concentrate our activities and resources on a limited number of core global consumer brands such as Nivea, Eucerin, Hansaplast/Elastoplast Futuro, la prairie, labello, 8 x 4, Juvena, atrix, tesa.
- We compete internationally on superior perceived quality, innovation and controlled brand extension – not on price.
- While new product launches and marketing strategies are globally coordinated and integrated, local responsibility for their execution lies with our national and regional general managers all over the world. As a result, in many countries our global brands are perceived as traditional local brands.
- Whenever possible we base our growth on our own strengths, resources and initiatives. We only acquire other companies when they particularly fit our brand portfolio and brand strategy, as in the case of Beiersdorf-Lechia in Poland (1997) and Florena (2002).

Uwe Wölfer, Member of the Board of Management, Beiersdorf Group, Cosmed Division.

In the decades after World War II, Beiersdorf's internationalization strategy was long dominated by its attempt to consolidate the international rights to its leading trademark, Nivea, in order to ensure coherent global development of the brand by the Hamburg headquarters and avoid costly licensing fees. However due to the political situation the company was unable to reach an agreement in the Central and Eastern European countries, where its subsidiaries had been expropriated by the socialist authorities. When reacquisition of the brand rights or a joint venture agreement proved impossible, Beiersdorf tried to maintain a profitable export business with the Nivea product line, mostly under a pricey licensing arrangement (see Chapters 3, 8 and 16 for market entry strategies and FDI in Poland). In some countries this meant that two different Nivea creams were being sold, for example in Poland there was the local product manufactured by the former Beiersdorf affiliate

and the international brand imported by the Beiersdorf group. In Western countries Beiersdorf did manage to reacquire the brand rights (Table 7.2), but only after long and tedious negotiations. For example it was not until 1992 that Smith & Nephew, the brand right holder in Britain and the Commonwealth states since 1945, agreed to sell the trade mark to Beiersdorf.

Table 7.2: Reacquisition of global Nivea brand rights after World War II

1952	Netherlands
1956	Switzerland
1958	Argentina and Brazil
1963	Mexico
1966	Denmark
1968	Finland
1974	France
1973	United States
1977	Hong Kong, Malaysia, Thailand, Singapore, Gibraltar, Malta, Cyprus, Bermuda, Bahamas, Jamaica, Barbados, Trinidad
1985	Norway
1992	Canada, Britain, Ireland, South Africa, Australia, New Zealand, India, Pakistan, Israel

Source: Beiersdorf AG.

The fall of communism in Central and Eastern Europe (CEE) in 1989 offered Beiersdorf its first real chance since 1945 to reestablish full global ownership of its most precious brand. This was the main reason for entering CEE during the 1990s. Low labour costs, a major reason for much foreign investment in CEE, were not considered relevant since the group's quality focus and capital-intensive production meant that it would not benefit greatly from the moderate labour costs in the region. Wherever possible Beiersdorf terminated its licensing agreements, reacquired the brand rights and established its own facilities, mainly for distribution purposes (Table 7.3).

By 1996 Poland remained the only country worldwide where the Beiersdorf group had been unable to regain possession of its leading brand or establish a working agreement with the local producer and trademark owner: its former subsidiary Fabryka Kosmetyków Pollena-Lechia in Poznan. After years of unsuccessful negotiations to regain possession of the brand name, Beiersdorf's new CEO, Rolf Kunisch, decided to disregard the organization's long-standing anxiety about large-scale acquisitions and to adopt a new approach to the 'Polish problem'. He set up an internal team of experts to study various alternatives, including the option of buying the entire company in Poznan, with its more than 1500 employees, outdated technology and three unrequired production sites. In 1997 the group duly reacquired its own former subsidiary and immediately launched a process of change management. Since 2000 Beiersdorf-Lechia has been one of the group's top ten affiliates worldwide.

Table 7.3: Expansion into Central and Eastern Europe

Prior to 1989	Export of international Nivea products; licensing agreements with local producers in CEE
1991	Subsidiary established in Hungary
1993	Reacquisition of brand rights in Romania, subsidiaries established in the Czech Republic and the Slovak Republic
Since 1995	Slovenia, Bulgaria, Croatia, Romania and other South Eastern European countries managed by Beiersdorf Austria
1997	Subsidiary established in Slovenia; acquisition of Pollena-Lechia SA, holder of the brand rights in Poland
1998	Subsidiary established in Russia
1999	Subsidiary established in Romania
2000	Subsidiary established in Croatia
2000–2	Subsidiaries established in Estonia, Latvia and Lithuania, managed by the Beiersdorf Nordic group (Scandinavian countries)
2001	Subsidiary established in Bulgaria; new affiliate in Ukraine, transformed into a Beiersdorf subsidiary in 2002

Source: Beiersdorf AG.

7.2.2 Pollena-Lechia prior to acquisition

Under the socialist system Fabryka Kosmetyków Pollena-Lechia, the sole owner of the Nivea brand right in Poland, was part of a collective that consisted of five subunits with partly overlapping production lines in cosmetics, soaps and detergents. In Poznan Pollena-Lechia, which was still operating in the premises of the former Beiersdorf subsidiary, produced and distributed its own version of skin care under the label Nivea Krem as well as Poland's best-selling toothpaste (Colodent), baby care products (Bambino), and other cosmetics products under various brand names.

As in most socialist countries all aspects of planning and production were determined by the state and governed by state regulations. The central planning administration decided on product lines, volumes, prices and export quotas – often regardless of economic considerations. The organizational structure was typical of a collective conglomerate with deep vertical integration. The drive for self-sufficiency and autonomy was also manifest in the establishment of a crèche, an in-house medical service and the maintenance of several holiday homes for workers.

The structure of the company reflected the lack of a functioning market: the company's few customers were state-owned (GS, Spolem, Ruch) and production volumes were prescribed for each. As late as 1997 customers were still collecting directly from the production ramp, so the company did not need a marketing department or a sophisticated sales force. The administration department, though, was enormous as even in the 1990s its electronic data processing capability was utterly inadequate. Likewise manpower, as in most socialist conglomerates, was not in short supply. Efficiency was not a prime consideration and the company employed more than 1500 people, predominantly in operations. Overstaffing was accompanied by low motivation as wages were not linked to performance and sanctions – for example dismissal – were not applied. Low productivity and lack of cost consciousness and innovation were only offset by the absence of market forces – only in a planned, short-supply economy such as Poland's before the velvet revolution of 1989 could the Polish Nivea, whose quality was well below Western standards, remain a thriving brand used in almost every

Polish household.

After 1989 Pollena-Lechia witnessed enormous changes in its environment as the political system in Poland moved towards democracy, markets were liberalized overnight, institutions were dismantled and international competition slowly but relentlessly gathered force. In 1995 Pollena-Lechia was turned into a state-owned stock corporation as part of the Polish mass privatization programme. The State Treasury held 25 per cent of its shares and 15 per cent were given to the employees, mainly as a concession to the workers' councils and mighty unions (see Chapter 6 for a discussion of the unions' power). A National Investment Fund became the majority shareholder and thereafter corporate governance changed considerably.

In December 1994, 15 National Investment Funds (NIFs) had been established by the Polish Ministry of the Treasury as joint-stock, limited liability companies to act as a conduit between state ownership and full privatization (see Chapter 4 for details of the NIF programme). Their main task was to handle the privatization of 512 state-owned companies, which constituted approximately 10 per cent of the Polish manufacturing industry. The principal goal of the NIFs was to achieve maximum growth in the value of their assets.

With NIF 8 as the majority shareholder job security at Pollena-Lechia was no longer the most important objective. The change of ownership structure and orientation, together with economic and institutional upheaval in the company's environment put substantial pressure on its top decision makers. Pollena-Lechia proved unable to adjust its strategies, structure and culture to this pressure, and both external and internal factors severely limited the management's ability to act. Figure 7.1 shows the main internal and external impediments to management's scope of action.

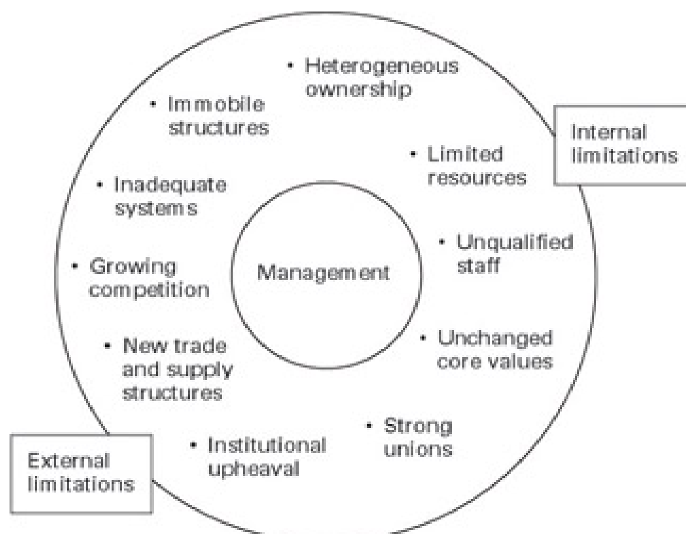


Figure 7.1: Managerial scope of action at Pollena-Lechia prior to the acquisition

The ownership structure was one of the main factors preventing the management from adjusting its strategies and structure and starting a full-scale transformation of the company (for a discussion of how managerial passivity and unaltered ownership structures inhibited firm development in CEE, see Chapter 5). Despite the formal privatization of the company, no clear directions were given for its future development because the power held by state and employee shareholders was sufficient to delay the urgently needed workforce reduction. Another problem arose from the constantly changing trading structures. The company's three main customers (state-owned trading agencies) had been dissolved, and the hundreds of newly established, small-scale firms that stepped in to fill the vacuum required a different sales approach and were hardly ever profitable. In addition, while large international traders had entered the Polish market, Pollena-Lechia had trouble responding adequately to their specific demands. At the same time international and local competitors were aggressively

attacking Pollena-Lechiás markets, and due to its lack of sales expertise and market knowledge the company was becoming more and more vulnerable. Furthermore the huge workforce was becoming a heavy burden, but because of the huge influence of the state and the unions (OPZZ and Solidarity) this burden could not be reduced. This was also the reason why the old organizational structure was kept in place. Even in 1997 Pollena-Lechia was still producing its own packaging on the premises, and had a 69-person security staff, a crèche and an inefficient medical service. As the company still operated three production sites in different parts of the town, which put a considerable strain on logistics, even the outdated transportation department remained in service. In 1997 more than 350 people were still employed in non-core activities such as maintenance, security and social services.

Resources other than staff also became a problem at Pollena-Lechia. Although the company had nominally produced a profit, this had been only true on the surface because its marketing expenses had been next to zero, compared with an average of 20–30 per cent of sales in the industry as a whole. Furthermore investment in technology had been stalled for decades. The company was still run on 31 different software programs, which made it impossible for management to obtain a clear picture of operations and finances. Sales statistics, for example, were unavailable to production planners and basic accounting figures had to be added up manually because the computer system did not allow for the integration of data from different departments. Information deficiencies also restricted the company's ability to adjust its production plans. As it hardly ever conducted any kind of consumer research, had no knowledge of current market conditions and no valid information on sales it failed to prune out unprofitable products and concentrate its scarce resources on brands with some potential. On the contrary, it added new brands and product lines to its already abundant portfolio.

The company's inability to adjust to the changing environment can be largely ascribed to the failure of the company's new owners to replace at least some of the executives. Even the long-serving director stayed in office. Consequently the socialist-era norms, values, interests and know-how that prevailed among the board members remained unaltered. Managers who had been trained to think in tons rather than zloty and for decades had paid no attention to costs and the needs of customers proved unable to adjust to the requirements of modern brand management in an internationally competitive environment. Indeed the need to change had not even occurred to the management since the company was – nominally – still making profits and owned a number one brand in Poland. Even if the company did make some adjustments to its announced goals – for example formally stating its customer orientation – it did so only to please the NIF or prospective foreign investors.

This inability to go beyond the *status quo* was accompanied by a failure to develop effective instruments to steer employees' behaviour. Again the management's lack of know-how and experience in the new setting, coupled with the weakening of its power by strong unions and the heterogeneous ownership structure, severely curtailed its ability to influence the workforce, whose main aim was to keep everything as it was. Only on rare occasions did the management set out to achieve some change. Immediately after privatization, for example, all salaries were raised, but this had no effect on motivation or performance as the management later admitted. In addition the organizational structure was altered to include a marketing and an enlarged sales department. However the newly created positions were taken up by employees with hardly any understanding of marketing or modern sales systems, except for a few days' training. With no budget to speak of the marketing department was utterly ineffective. Although Western consultants drew up strategies for restructuring, production planning and marketing, Pollena-Lechia was unable properly to implement any of the suggested changes. All the instruments available to the management thus remained nothing but cosmetic paperwork, leaving Pollena-Lechia with a severely constrained radius of action and unable to cope with the dynamics in its surroundings. As a Beiersdorf manager later observed, '1997 could have been 1977 – practically nothing had changed'. The company simply ignored the transformation of the business environment, and therefore slowly but

steadily lost its strategic, structural and cultural fit with its situation. Only its well-established top brands – Nivea cream and Colodent toothpaste – were preventing it from falling into serious trouble.

7.2.3 The acquisition process

From 1945 the postwar resumption of Beiersdorf's activities in Poland was dominated by the political situation which made it impossible to regain the Nivea brand rights from the socialist rulers. Even after 1989 all attempts to acquire the rights from Pollena-Lechia or to establish some kind of cooperative venture failed. The management at Pollena-Lechia opposed any form of partnership with the Beiersdorf group and the employees – many of whom were shareholders and supported by the still powerful unions – feared that foreign investment might result in the loss of jobs. In 1995 Beiersdorf was still limited to exporting its international brands to the growing Polish market for cosmetics, so it decided to establish a sales office in Warsaw to facilitate this export strategy and to appoint a general manager to control marketing and distribution.

When Pollena-Lechia became part of the mass privatization programme in 1995, this seemed to offer the ideal chance to reacquire the Nivea brand rights in Poland. However, even though the NIF in charge of the company followed a different agenda from the state-controlled management, Beiersdorf's offer to buy the rights failed once again. Instead the company and its brands were only to be sold in their entirety. At that time Beiersdorf's strategy in Poland was hindered not only by external factors but also by its policy of not acquiring additional production sites or large numbers of surplus personnel. In the early 1990s middle management in Hamburg had come up with a variety of strategies to resolve the 'Polish problem', had failed to obtain the support of the Beiersdorf board. Insecurity, hesitation and awareness of the difficult Polish–German history (see Chapter 1) were also major obstacles to a bold strategic move. As a result, even after Pollena-Lechia became part of the mass privatization programme Beiersdorf continued its strategy of exporting to Poland.

As noted earlier, when Rolf Kunisch was appointed CEO he took a personal interest in the Polish problem and discarded all previous reservations about large-scale investment in Poland. As the acquisition of the Nivea brand rights alone seemed impossible and any further negotiation useless, it was decided to buy the entire Poznan corporation, including its unneeded production capacity and 1500 employees. The Nivea brand was of such importance to Beiersdorf that considerations such as what to do with the company after takeover, how to cope with its unqualified employees and outdated production facilities, and how to turn it into a profitable affiliate were, for the time being, relegated to the background.

In October 1996 Beiersdorf made its first bid to acquire the majority stake in Pollena-Lechia. At the same time the plan to set up a Beiersdorf Warsaw sales office was abandoned. For a controlling majority of a Polish company – and that was the only point of interest for the board of management in Hamburg – Beiersdorf needed 66.66 per cent of the shares or voting rights. Beiersdorf decided to set 70 per cent as the negotiating target but in the long run it aspired to a 100 per cent holding (see Chapter 5 on the importance of majority ownership structures for transformation success). The negotiating partner was the manager of the leading NIF since it held the majority of shares – the management of Pollena-Lechia, due to its increasingly weak position, was not involved in the talks.

Even though there were hardly any other serious international bidders for Pollena-Lechia as the brand name of Nivea would have been of limited interest to them, negotiations with the NIF were difficult. The main problems arose from Beiersdorf's dependence on the whims of one negotiating partner, the manager of the leading NIF, and the lack of rules for the negotiating process. A social plan, for example, was said to be unnecessary, but five days before the final agreement was signed it suddenly became of utmost importance. Apart from that, dealings with the Polish authorities, especially in the Poznan area, were smooth and

friendly, which was to some extent due to the popularity and good reputation of both the Nivea brand and the Beiersdorf corporation in Poland. The required agreement with Pollena-Lechiás in-house unions on employment and social conditions was completed within seven days. The final settlement was struck in September 1997 and contained the following main elements:

- A commitment to purchase the entire company, with an investment of DM180 million (DM140 million for the acquisition of existing shares, DM40 million for the issuing of new shares).
- A promise to develop the company, including the construction of a new CEE production centre in Poznan.
- The provision of employment guarantees in accordance with common practice in Polish privatization projects.
- A guaranteed price of zloty 256 for each share.

As a first step Beiersdorf acquired 25.6 per cent of the shares of the minority shareholding NIFs (Table 7.4). By injecting 72 million zloty into the company in late October 1997, Beiersdorf increased its share to 42.7 per cent of the capital and – by issuing multiple voting rights – a safe majority of 70 per cent of the votes. Soon afterwards many of the remaining shareholders were tempted by Beiersdorf's rather generous share-price offer, and in 1998 the Treasury – in a momentary need of financial resources – sold its shares. By 2002 Beiersdorf had secured 99.99 per cent of the shares, and the guaranteed price of 256 zloty was still in place for the remaining 107 privately held shares.

Table 7.4: Capital shareholding structure (per cent)

	12/1995	9/1997	10/1997	12/1997	8/2002
Beiersdorf group	–	–	25.6	42.7*	99.99
Leading NIF	33.0	33.0	33.0	25.5	–
Other NIFs	27.0	35.0	9.4	8.6	–
State Treasury	25.0	25.0	25.0	19.4	–
Employees and others	15.0	7.0	7.0	3.8	0.01

Source: Beiersdorf-Lechia SA.

In November 1997 the company was renamed Beiersdorf-Lechia SA, Poznan, and two German expatriates were appointed members of the board of management, one in charge of marketing and sales and the other in charge of finance, managerial accounting and human resources. The new supervisory board met for the first time in December 1997. It was dominated by Beiersdorf managers and no longer included employees' representatives. For the Beiersdorf group the Polish acquisition not only completed its hold on the worldwide Nivea brand rights but also reaffirmed the company's position as a global player in the cosmetics industry.

7.2.4 The years of fundamental change

Within two years of the acquisition of Pollena-Lechia the new management had achieved a

complete turnaround of the company and converted it into a profitable, market-oriented, consumer goods company of international standard.

After negotiation and acquisition in 1996 and 1997, the year **1998** was one of fundamental change. The process of transforming the immobile giant into a profitable Beiersdorf subsidiary had been expected to be slow and tedious, but as Table 7.5 shows, much was accomplished in a short time.

In January 1998 Beiersdorf Hamburg dispatched to Poznan a German team consisting of a head of sales, a marketing manager, a manager for Tesa and a controller to support the two German managers already in Poland. The Polish members of the board of management (in charge of logistics, production and the technical department) and the chairman of Pollena-Lechia since 1979 were kept in place for the time being in order to maintain a notion of stability in a company that awaited major changes.

The team immediately set to work on a strategy for the Nivea relaunch in April 1998, developed a sales and marketing concept and secured a competent logistics partner. A distributors' conference in April 1998 set the stage for a new start for Nivea in Poland. Nivea Krem, packaged in a plastic container, would be the only Nivea product to be manufactured in Poland – the other 60 products would be imported from international Beiersdorf affiliates. The production programme of Pollena-Lechia was reviewed and nearly 100 products were eliminated from the portfolio. Some potential was seen in the Bambino range and Glycea, a hand cream with an approximately 60 per cent market share in Poland. The prewar soap factory was closed and the end of the year brought the profitable sale of the toothpaste business to Colgate-Palmolive.

Table 7.5: Main areas of change

1997	**1999**
Pollena-Lechia SA	Beiersdorf-Lechia SA
• Production driven	• Sales/marketing driven
• Sales: 205 million zloty	• Sales: 400 million zloty (estimated)
• 1500 employees: 70% female, 30% male; 70% blue collar; 30% white collar; average age42 years	• 400 employees: 50% female, 50% male; 50% blue collar, 50% white collar; average age33 years
• Local orientation (Polish language)	• International orientation (English)
• More than 20 brands and 202 products	• Four brands and 135 products
• 400 customers	• About 100 profitable customers
• Marketing: three employees, minimum budget	• Marketing: 12 employees, huge marketing investment
• Sales force: 40 sales employees, one key account manager	• Sales force: 102 sales employees, six key account managers
• Top-down decision making	• Allocation of responsibility and accountability
• 31 non-integrated software programs	• Integrated SAP/R3 system
• Very few PCs, copy machines or fax machines; analogue telephone exchange	• State-of-the-art equipment for every workplace; ISDN telephone exchange

Source: Beiersdorf-Lechia SA.

In March 1998 the team addressed the necessary workforce reduction. Union officials consented to the release of 350 employees, and the German board members came up with a voluntary redundancy scheme that would mainly favour older, long-serving employees. Contrary to all expectations, in June more than a thousand (rather than the planned 350) employees took up the offer and the management had to consider closing down whole parts of the company due to understaffing. Nonetheless, only employees in key functions such as personnel administration and maintenance were asked to postpone their departure in order to keep the company running as the German management saw the exodus as a chance to speed up the transformation of Beiersdorf-Lechia, a transformation that had to happen sooner or later in any case. The salaries of the remaining employees were more than doubled, on average, and a new system of employment contracts was implemented in the autumn, starting with the crucial sales force personnel. An opening clause in the collective agreement at Beiersdorf-Lechia, which formally is still in place today, allowed for the circumvention of overly restrictive regulations on remuneration.

The year **1999** was a time of consolidation, human resource development and the introduction of new organizational structures. After a full year of trying to establish a cooperative working relationship among the German and Polish board members, Beiersdorf ceased trying to integrate the former executives and gradually replaced the board members with its own selected executives. Even the Polish president of the company, who in the interests of stability and Beiersdorf's corporate values of consensus and friendliness had been left in charge after the takeover, was replaced by the former vice-chairman in October 1999. The middle management also went through a process of consolidation as most jobs could be filled by young and energetic people with potential. A training scheme for all employees, especially the 250 former Pollena-Lechia workers who had rejected voluntary redundancy in favour of a future with the Beiersdorf corporation, focused on the improvement of general management know-how, communication and language skills. Since Beiersdorf's internationalization in the 1990s English had been the chosen working language.

At the same time the marketing, accounting, finance and human resources departments were restructured to meet the requirements of a market-driven consumer goods corporation. The sales force was doubled, sales regions and responsibilities were redefined and new pricing and bonus systems were introduced. The installation of the SAP/R3 information system, which replaced the 31 non-integrated software programs, was completed in only seven months. Plans for a new factory of international Beiersdorf standards to produce Nivea cream for all the CEE countries were pursued with vigour and construction started in February the following year.

Consolidation continued into 2000 with several projects to support the transformation of the organization from a production-driven to a market-driven operation. A corporate vision was formulated, a newly designed personnel development programme was put in place and the remuneration system for all white-collar employees was converted into a variable pay scheme. The streamlining of the organization continued with the contracting out of services that lay outside Beiersdorf-Lechiás core business, such as security and medical care.

The structural and strategic transformation of Pollena-Lechia into a standard Beiersdorf subsidiary was completed in 2001, and since then Beiersdorf-Lechia has been one of the Beiersdorf group's top ten affiliates worldwide. It is among the three largest producers of cosmetics in Poland, with the turnover of Nivea products alone increasing by 500 per cent in just four years, rising from €17.5 million in 1997 to €88 million in 2001. Nivea has become the top brand in the Polish market for deodorants, body lotion, face cream and sun cream. Baby-care products were introduced in 2001 and in only a few months attained third position in their market. According to Beiersdorf's CEO, Rolf Kunisch, the CEE region will remain a prime growth area and a motor of innovation for the organization's global network. In October

2001 Beiersdorf-Lechia opened a state-of-the-art factory for Nivea products on the outskirts of Poznan. With a capacity of up to 12 000 tons per year, the factory will supply the entire CEE region, including Russia, with Beiersdorf cosmetics and may even export Nivea products to Western European markets in the future (for a discussion of Poland as a platform for CEE expansion, see Chapter 16).

7.3 Key areas of change management

We shall now look more closely at the three core elements of the change process at Beiersdorf-L changes, adjustment of the organizational structures, and the development of a new leadership s culture.

7.3.1 Strategy: relaunching Nivea in Poland

When the German management team arrived in Poznan in 1997 they did not have a fixed chang strategy in their pockets. Beiersdorf did not believe in a 'one fits all' recipe for turnaround manage planned change processes. It did, however, believe in its managers' ability to assess the situatio develop suitable courses of action to make the Polish venture a success. The high degree of dec autonomy granted to the team reflected this decentralized approach and allowed them to take ad momentum of change that built up rapidly after the takeover.

While the team had no fixed master plan they did not arrive unprepared. In addition to extensive action and decision-making autonomy, they brought with them a well-established international br Nivea. For the Polish subsidiary, this strategy had a single objective: to achieve the successful re Poland and within five years make it the top cosmetics brand in this market of 38.7 million people the part played by 'dominant logic' in corporate success in transformation economies). This focus approach functioned as an anchor for all activities at Beiersdorf-Lechia, or as the German genera the time, it was the 'spearhead to conquer the Polish market'. From the beginning, therefore, the objective and a 'guiding star', and all activities and decisions were aimed at this single goal. The was therefore able to give the turbulent and sometimes chaotic change process an unmistakable

The anchoring of all activities and decisions on the Nivea relaunch strategy served two other imp First, by acting as a focal point for both management and employees it helped to reduce the com change process, which naturally affected everybody in the company. For the German managers provided a framework for decision making. It helped them to cut through the jungle of Pollena-Le troubles, incomprehensible product mix, lack of comprehensive planning, confusing organization everyday communication problems.

Second, as with the domino effect, once the first domino was tipped (the Nivea strategy), others (Figure 7.2).

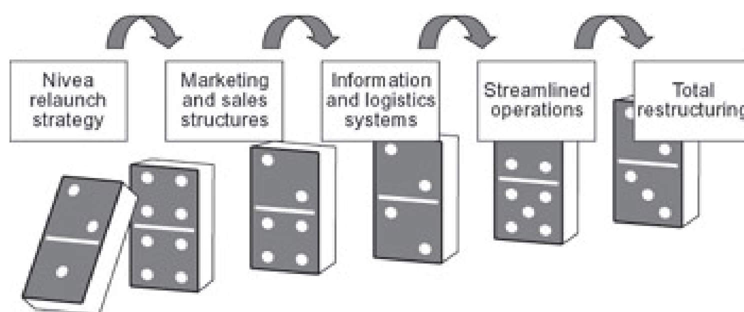


Figure 7.2: The Nivea relaunch strategy and its consequences

The Nivea relaunch first required the establishment of an effective marketing and sales organiza for the importance of a clear marketing orientation for successful corporate transformation). Imm acquisition Beiersdorf personnel took control of all decisions on marketing and sales and channe according to the new strategic direction. The marketing budget was immediately raised from alm international industry standard of 20–30 per cent of sales. The next step was to establish a stron department and to enlarge and train the sales force, without which the distribution of the introduc be impossible. To this end Beiersdorf had already started negotiations with a logistics firm in Nov

The streamlining of production was also dominated by the decision to concentrate on the core Ni
scale product pruning led to termination of the traditional washing powder and soap production a
toothpaste line. While the latter was profitable and had been the top selling brand in Poland for d
the clearly focused Nivea strategy.

When Nivea had been successfully relaunched in summer 1998 the management turned its atter
structural and cultural problems of the company (see Sections 7.3.2 and 7.3.3). All subsequent c
were and still are tied to the Nivea anchor and the company's strong marketing orientation.

Box 7.2: Developing the Nivea strategy for Poland

Building brands is the core competence of Beiersdorf AG in Hamburg. A truly global brand, Nivea
sales of over C=2500 million and has been growing at double-digit rates for the last ten years, a
in the world's branded consumer goods business. Beiersdorf's subsidiary in Poland became a me
Beiersdorf family only in 1997 but today is one of the top ten affiliates worldwide. How was this do

1. First, by adopting the worldwide Nivea strategy. Nivea strives to establish market leadersh multipurpose cream market (Nivea cream and Nivea soft) followed by the body-care mark lotion), the skin-care market (Nivea Visage and Nivea Vital) and the markets for sun lotion hair-care products and so on. Being number one in each segment is profitable and provid confidence to move into new fields. This model has been successfully used in many coun worked in Poland.

2. Second, by adapting this strategy to Polish needs. Poland was unique in that Nivea Krem Polish culture for over 50 years. On average almost every Polish person buys one unit pe unit consumption in the world. Beiersdorf-Lechia did not attempt to replace this unique bra quality and packaging and continued to sell it at a very popular price. It continues to provi fundamental trust and a solid basis for future growth. This did not happen without challeng marketing groups. It is to the credit of the Polish management that they persevered and co colleagues to adapt the strategy to their needs.

3. Third, by developing a strong performance. The success of any global company depends successful marketing concepts or ideas and to exploit them quickly in other countries. Per of these ideas is extremely important as the consumer sees, demands and buys performa This involves the product itself, its packaging and shelf positioning, friendly and convincin language and motivated sales people. For the consumer, all these are far more visible tha therefore they are critical to success. The Beiersdorf-Lechia people understand this and th successfully in Poland. It is also important to note that we now have a very young and ent Polish employees – training and learning with them is an exciting experience for the older and for the international Beiersdorf management team. With the strategy at work and all E learning together 'on the job', motivation builds success and drives further success.

Dr Rolf Kunisch, CEO, Beiersdorf AG.

7.3.1.1 Elements of the Nivea relaunch strategy

Products For the 1998 relaunch, Beiersdorf introduced 60 products from the global Nivea range
market (see Chapter 9 for the application of marketing and international brand strategies in CEE)
comprised most of the skin-care products at the core of the brand, plus key products in the perso
including deodorant and bath products (Figure 7.3). All but the traditional Nivea multipurpose cre
always been produced in Poznan, were imported from Beiersdorf production sites in Europe. Ma
had already been exported to Poland before the relaunch, but poor distribution, high licensing fee
marketing had prevented large-scale success. The relaunch represented a new start for Nivea in
provides an overview over the development of the product programme since 1997.

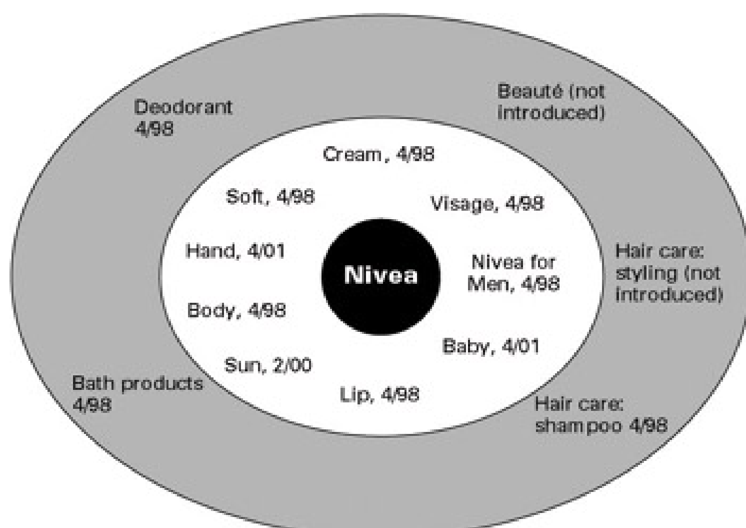


Figure 7.3: Introducing Nivea skin care and personal care products in Poland

Table 7.6: Growth of selected Nivea products (thousand zloty and percentage of total Nive

	1997		***1998***		***1999***		***2000***	
Creams	45 903	(87%)	54 512	(45%)	79 497	(39%)	86 988	(34%)
Body care	–	–	8020	(7%)	13 552	(7%)	13 386	(5%)
Sun care	–	–	–	–	–	–	9417	(4%)
Baby products	–	–	–	–	–	–	–	–
Hand care	–	–	–	–	–	–	–	–
Visage	–	–	10 044	(8%)	14 160	(7%)	27 505	(11%)
Lip care	1785	(3%)	1755	(1%)	4624	(2%)	6960	(3%)
Nivea for Men	–	–	6437	(5%)	18 080	(9%)	24 030	(9%)
Deodorants	–	–	21 807	(18%)	47 105	(23%)	53 189	(21%)
Hair care	–	–	5440	(5%)	6646	(3%)	8214	(3%)
Bath products	4898	(9%)	12 343	(10%)	22 608	(11%)	28 248	(11%)
Total	52 586	(100%)	120 358	(100%)	206 272	(100%)	257 936	(100%)

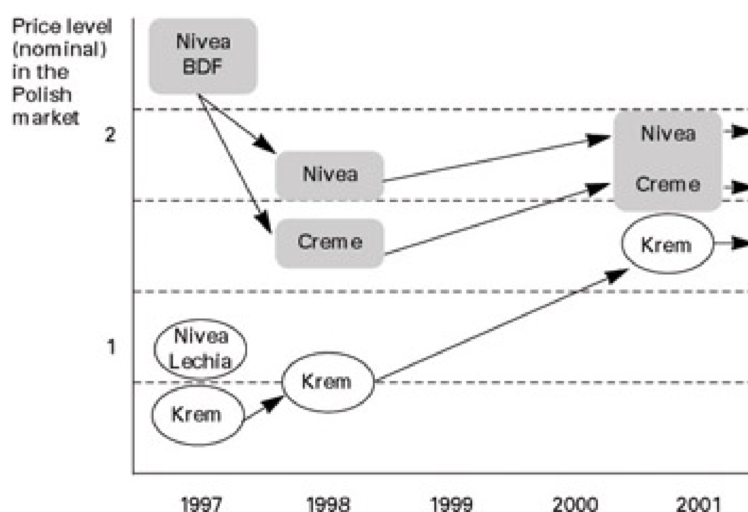
Source: Beiersdorf-Lechia SA.

As stated earlier, the standard Nivea cream was already well established in Poland and had beer interruption since the 1920s. When Beiersdorf's Polish subsidiary was expropriated in 1945, Poll the market with a Polish version of the product called Nivea Krem. Due to the lack of technical in socialist countries the recipe increasingly deviated from that used in the West, and the product w

containers rather than the familiar blue aluminum tin. Nonetheless Nivea Krem was highly succes
bloc and Pollena-Lechia produced and sold up to 33 million units a year. This continuity of the br
huge advantage in the relaunch as the brand awareness of more than 90 per cent spilled over to
introduced products and helped to establish a market for body milk and deodorant, which had no
Polish market. The only problem was that with the launch of the international range Beiersdorf-Le
versions of its main product category: the locally produced Nivea Krem in the plastic container ar
Nivea Creme in the blue tin. Beiersdorf decided to deviate from its international strategy and kee
the market. Surprisingly a negative effect on total multipurpose cream sales was avoided (Box 7.
versions of the product have been manufactured at the new plant in Poznan. While they are now
formula they are still sold in different packages.

Box 7.3: Nivea Krem and Nivea Creme in the Polish market

Immediately after the acquisition of Pollena-Lechia in 1997 a serious marketing problem became
were two Nivea ranges on the Polish market – the Pollena-Lechia Nivea range and Beiersdorf's g
had been exported to Poland under a licensing agreement with Pollena-Lechia. In March 1998 th
Lechia management withdrew the entire Pollena-Lechia range but Nivea Krem, which was compa
and the most popular cosmetic product in Poland. In April 1998, when the company relaunched it
international range, Nivea Creme was sold at a price just below level 2 and the Polish Nivea Krem
cent of the price at the lower nominal level of 1 (see graph). The need for price harmonization wa
by step, with three price adjustments per year, the gap was gradually closed.



Throughout this process the company was able to maintain total sales at a satisfactory level, with
Krem falling and that of Nivea Creme and Nivea Soft rising (see table). While there was a minor d
volume sold after 1997, this can be explained by the fact that just before it was sold Pollena-Lech
pushed products into the market in order to improve its corporate profits for 1997. Thereafter con
turned from multipurpose creams to body lotions, including Nivea body milk, which was launched
market in 1998.

Sale of Nivea multipurpose creams in Poland (percentage of total sales volume)

Table

	1997	1998	1999	2000	20
Nivea Krem	100	81.93	64.87	60.85	58
Nivea Creme (Beiersdorf)	0	5.79	10.61	13.55	14
Nivea Soft (Beiersdorf)	0	12.28	24.52	25.60	26
Total sales volume (= 100%, in tons)	2805	2313	2263	2184	21

Heinz-Jürgen Stüting, General Manager, Beiersdorf-Lechia SA

By 2002 most of Beiersdorf's international product categories had been introduced into Poland. T
Nivea Beauté (the colour cosmetics range) and Nivea hair styling. Once these two lines have be
launched, Beiersdorf-Lechia will be completely integrated into the international Beiersdorf networ
plans.

Price Before the acquisition prices in the centrally planned economy, and therefore at Pollena-Le
based on volume and weight of the product concerned. This led to the situation where large-volu
sold at a higher price than face cream, due to the latter's small packaging size and low weight. W
Beiersdorf this practice was changed immediately to conform to Beiersdorf's standard European
ensure comparability of prices across borders. Again the existence of two versions of Nivea crea
interesting challenge to this rule (Box 7.3).

Distribution At the time of acquisition Pollena-Lechia had around 400 customers, mainly mediun
trading companies, many of which were hardly ever profitable for Pollena. Beiersdorf quickly deci
number to 100 profitable customers, all of which would have to generate a sales volume of 2.5 m
per year (see Chapter 10 for trade structure development in Poland). Area sales managers woul
needs of smaller customers. In 2002 international chains accounted for 40 per cent of Beiersdorf
customers, with Polish trading partners accounting for the remaining 60 per cent. Compared to th
France (98 per cent international and 2 per cent local trade) the globalisation of Polish retail struc
moderate level (30 per cent and 70 per cent).

The fragmented retail structure in Poland (120 hypermarkets and 120 000 small local shops at th
acquisition) necessitated the establishment of a large and efficient salesforce at Beiersdorf-Lechi
sales personnel was more than doubled within the first few months, from 41 to 108 employees. T
introduced key accounting to cater to the large international trading firms. In addition it reduced t
regions from 10 to four, invested heavily in staff training and introduced a variable pay system fo
early 1999 (see Box 7.4 for details of the reorientation of the salesforce).

Box 7.4: Introducing a new sales system for Poland

The Nivea relaunch in April 1998 clearly required a reorientation of the salesforce at Beiersdorf-L
company was to compete with other international companies in the region. The key areas of char
following table.

	Prior to 1998	**Reorientation**
Product portfolio	Polish brands, low price level	International Nivea bands
Sales orientation	Production-orientation, push strategy	Customer-orientati strategy
Sales strategy	Non-existent	Clear strategic guic adjusted yearly
Trade focus	Traditional local trade	International and lo
Market coverage	About 3000 stores in major areas	About 5500 stores Poland
Salesforce	41	108
Remuneration	Low wages, turnover-based premium system, no upper lower limit	Above Polish avera performance-basec and lower limits

As part of the preparations for the Nivea relaunch in April 1998 several measures were taken to a reorientation of the salesforce at Beiersdorf-Lechia:

- Introduction of performance-related terms and conditions.
- Assessment of the potential of all customers and the elimination of non-profitable ones.
- Development of a sales concept for international trade in Poland.
- Introduction of sales guidelines conforming to Beiersdorf's international standards.
- Salesforce training for new products, pricing and terms and conditions.
- Development of special relaunch offers and distribution bonuses.
- The holding of a national sales conference.

The company regularly adjusts the pricing and terms and conditions systems, and prepares deta regional and customer bases. In 1999 it completely restructured the sales department, added coi key accounting and trade marketing, and again increased the number of sales personnel.

Several factors were instrumental in the rapid and successful turnaround of the salesforce at Bei

- Thorough and early planning of all the measures involved.
- Clear and direct explanation of the reorientation to all those affected.
- Rapid and rigorous implementation of all measures.
- Close and continuous cooperation and coordination with the sales managers from the start (organization, head of key accounts).

Only two major problems arose during the process. After the acquisition the Polish director of sal responsible for field organization and traditional trade while the German director of sales took res international trade and the reorientation of the salesforce. This separation of tasks and responsit sales directors with equal rights but fundamentally different working methods, training, languages backgrounds provoked a considerable amount of misunderstanding and disputes over competen coordination. This considerably slowed the process of change in the sales department until the P company.

The second problem arose from insufficient attention being paid to the different technical and cul
the Polish employees. Many of the standards transferred from the Beiersdorf group simply did no
context. The sales reporting system, for example, was initially rejected by the Polish salesforce, \
working independently and in the absence of integrated sales planning. It was quickly realized th
had to be partially adjusted to the local conditions and that a longer time was needed for its full ir

H. Freihorst, Director of Sales and Member of the Board of Management,

Beiersdorf-Lechia SA

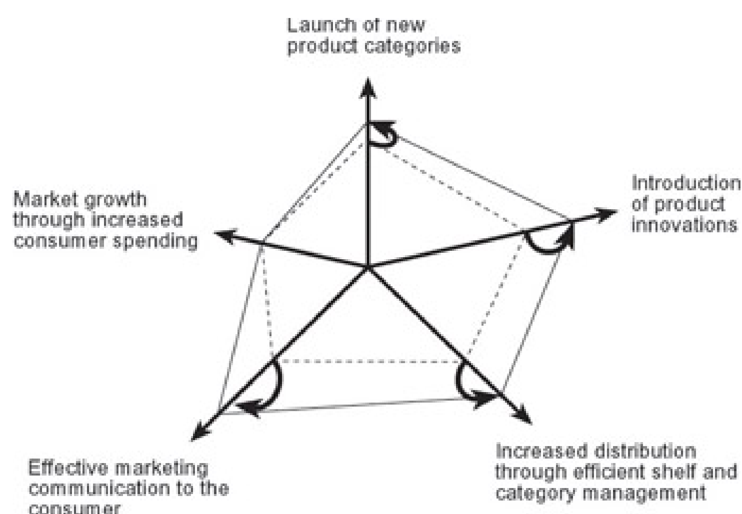
Distribution was taken over by a Dutch–Polish logistics firm in the Poznan area. The latter was m
the handling of orders, warehousing and transportation, and since 2000 it has been connected to
Lechia SAP system to ensure close data integration. Pollena-Lechiás transportation department
after the acquisition.

Communication Whereas distribution required a local approach, communication policy had to fo
international strategy to ensure coherent global development of the Nivea brand. The marketing
therefore drew on the experience of the corporate marketing department at the headquarters in H
advantage with Beiersdorf-Lechiás communication strategy was that it was able to capitalize on t
the Nivea brand name in Poland. Brand recognition, when surveyed in 2000, was just below the

Whenever necessary the standardized international campaigns were adjusted to the local conditi
While the images in printed and television advertisements were taken from the standard portfolio
copy went far beyond simple translation. Since many of the products to be introduced, such as bo
deodorants, were not in common use in Poland, explanations about their application and argume
to be incorporated into the advertisements when the products were launched. All adjustments to
advertising campaigns were made by the Polish affiliate of the corporation's international advertis
ensure both the culturally localization of the material and coherent execution of the international
selection, the timing of the campaigns, promotional activities and sponsorships were also conduc
subsidiary.

Box 7.5: Effective marketing communication – the key growth drivers for the Nivea brand

The Nivea marketing strategy in Poland has the clear objective of attaining the top market positic
category, or at least second or third place. Of the five growth drivers identified in the figure below
is able to control four. Total market growth through increased consumer spending depends to a l
macroeconomic developments in Poland.



With regard to the four controllable growth drivers, the launch of new product categories has bee
fell swoop by introducing the full international Nivea range. Product innovation is an ongoing proc

intention of the Polish affiliate to be completely synchronized with the international launch plans f distribution and improved distribution quality remain a key focus of the sales organization. This ca upgrading shelving space, increasing the number of facings, improving the quality of shelf placen attractive point-of-sale and ensuring effective category management.

The main growth driver for Nivea, which is challenging but highly effective, is successful commun consumer via the right advertising mix and a balanced weighting of each media. At Beiersdorf-Le the total marketing budget is invested in running advertisements on TV, in newspapers, magazin hoardings and occasionally the cinema. While television spots dominate, advertisements in the c complement and support television campaigns for specific product categories. In addition, since r consumers do not decide what to purchase until something catches their eye, 'below-the-line' act promotions, consumer contests, attractive leaflets and in-store promotional staff are becoming in important. In-store promotions have proved particularly successful when consumers need advice and performance.

In 2001 Beiersdorf-Lechia started to sponsor activities that fit the Nivea brand values. Modelled c successful venture in Germany, Beiersdorf-Lechia became a sponsor of the Polish national life sa (WOPR), while its sponsorship of Polish school sports clubs under the 'Nivea Blue Sails' progran recovery of an underfunded Polish government project for young sailors.

Table 7.7 summarizes the results of the relaunch and the marketing activities at Beiersdorf-Lechi international brand strategy, a locally adapted marketing mix focusing on communication and an policy aimed at full market coverage, since 1998 Beiersdorf-Lechia has attained high market sha product categories. Multipurpose creams, including Nivea Creme and Nivea Krem (see Box 7.3), cent market share in Poland. Since the relaunch body milk, deodorants and the skin-care line Niv more than doubled their shares. All Nivea product categories remain top ranking in their respectiv Beiersdorf's aspiration to the top leadership position throughout the world.

Table 7.7: Percentage of market share and market position of core products

	1998		***1999***		***2000***		***2001***
	Market share	***Position***	***Market share***	***Position***	***Market share***	***Position***	***Mark shar***
Multipurpose cream (Kreme, Creme, Soft)	72.8	1	76.2	1	79.0	1	79.2
Nivea body	7.0		11.9	2	20.5	1	24.4
Nivea deodorant	–	–	6.1	9	10.0	2	11.2
Nivea Visage	–	–	3.3	11	6.2	1	7.7
Nivea for Men	–	–	7.1	7	6.7	3	8.2
Bambino baby care	21.5	1	19.9	2	19.5	2	20.6
Glycea handcream	39.0	1	38.0	1	33.0	1	28.4

Source: Beiersdorf-Lechia SA.

The traditional Bambino baby range and Glycea hand cream are the only two non-Nivea brands t their continuously strong market position, remain from the pre-1998 Pollena-Lechia product portf however, Beiersdorf-Lechia introduced the corresponding Nivea lines (Nivea Baby and Nivea ha even execution of the international Beiersdorf brand strategy. With the help of strong advertising campaigns the company is trying to shift customers from the local to the international products, a also attracting additional customers for its baby and hand-care products.

Beiersdorf-Lechiás total sales (Figure 7.4), which also include non-cosmetic brands such as Han plaster) and the tesa line (adhesives) rose continuously from C=49 million in 1997, just before th Beiersdorf group, to more than C=90 million in 2001. Table 7.8 provides an overview of Beiersdo compared with its main international competitors.

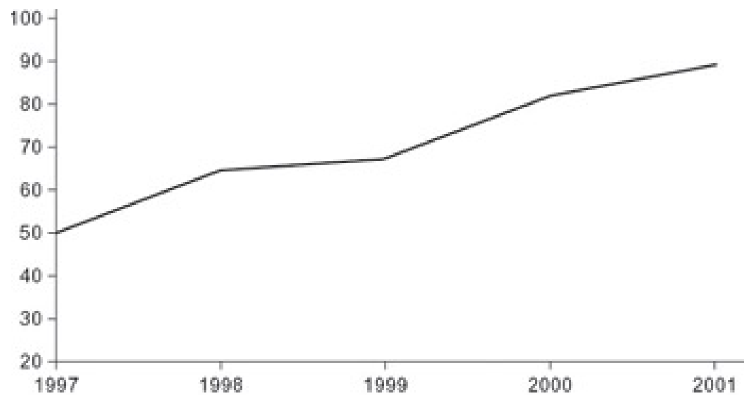


Figure 7.4: Beiersdorf-Lechia SA, total sales, 1197–2001 (C=million). Source: Beiersdorf-Le

Even during the stagnation of the cosmetics market in 2001, Beiersdorf-Lechia and its leading br continuously improved their overall competitive position. Besides Beiersdorf-Lechia, in 1999–200 increased its total market share – by 0.96 per cent compared with Beiersdorf-Lechiás 4.73 per ce years. All other international competitors, even leading global multinationals such as Procter & G failed to maintain their sales volume at the 1999 level. Yet it is important to note that nearly 50 pe Polish cosmetics market is still held by a multitude of small local companies. This fragmentation characteristic of the retail sector, where there is a large proportion of tiny local retailers (70 per c per cent international). However, it is to be expected that international branded consumer goods strengthen their market position in the future.

Table 7.8: Sales value and market share of international competitors in the Polish cosmeti (thousand zloty and percentage of total cosmetics market)

	1999		2000		2001
	Market share	**Position**	**Market share**	**Position**	**Market share**
Beiersdorf-Lechia of which	263 834	8.99	338 810	11.60	398 938
Nivea	207 887	7.08	288 991	9.89	347 387
Unilever	286 972	9.78	216 708	7.42	205 662
Coty	217 774	7.42	213 244	7.30	175 314
L'Oreal	145 075	4.94	161 421	5.53	171 612
Cussons	206 691	7.04	163 143	5.59	160 966
Schwarzkpof	201 202	6.85	157 768	5.40	147 511
Procter & Gamble	168 111	5.73	139 160	4.76	144 246
Colgate-Palmolive	131 426	4.48	141 836	4.86	137 908
Others	1 314 456	44.77	1 388 643	47.54	1 365 207

Please note: The total cosmetics market includes only the categories in which Beiersdorf-Lechia (aftershave, shaving products, bodycare, sun care, shampoo, bath products, lip care, face care a

Source: Beiersdorf-Lechia SA.

7.3.2 Structure, staff and systems at Beiersdorf-Lechia

At the time of acquisition the organizational structure and systems at Pollena-Lechia were utterly the marketing-oriented strategy of Beiersdorf-Lechia. The organizational structure was dominatec focus and non-core functions such as transportation, maintenance, administration and employee 7.5).

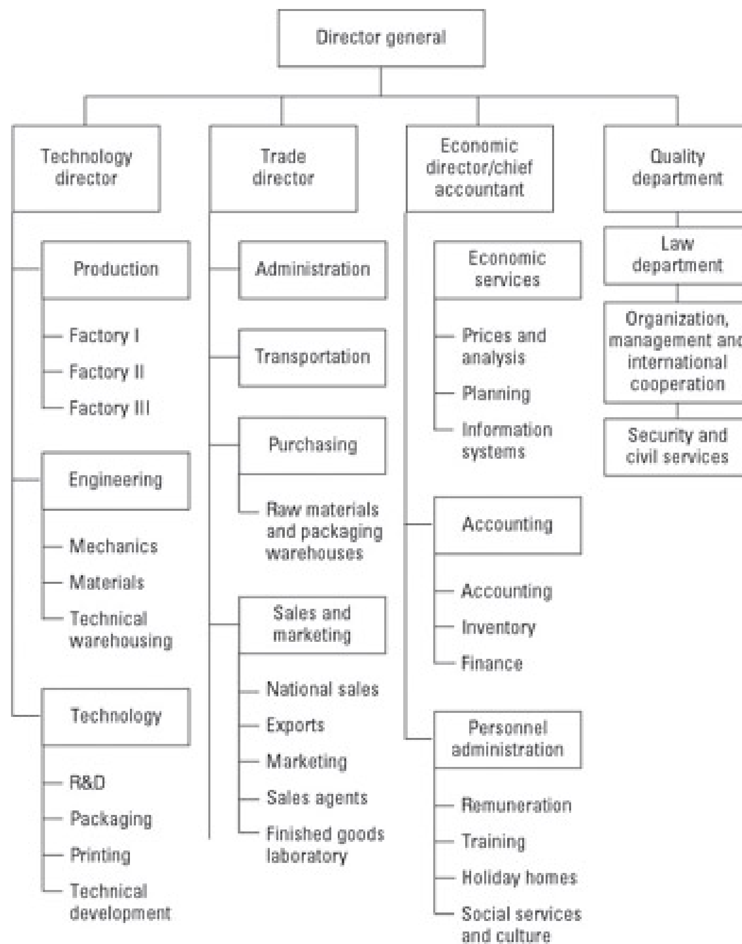


Figure 7.5: Pollena-Lechia organizational structure, 1997

Communication and decision making were hampered by the numerous hierarchical levels and cu
delegation. All decisions – even regarding the subsidized price of milk, which was available to em
company's shop – had to be approved by the board of management. Each morning the latter held
conference to discuss daily production volumes and operational problems. Communication techn
inefficient: where they were in place, personal computers were of little use to the management be
were not interlinked and data had to be manually processed from various PC print-outs to obtain
sales statistic.

Like many other CEE conglomerates, the company was chronically overstaffed (1500 employees
age of 42 years – see Table 7.9 for a detailed breakdown). Even worse, motivation was low and t
qualifications required for a modern consumer goods business – such as marketing skills and ma
– were lacking. According to one Beiersdorf manager involved in the acquisition process, the 'de
incompetence was astonishing'. Training was practically non-existent and the remuneration syste
geared to the planned-economy principle of preferential treatment for blue-collar workers, did not
performance. The confusing variety of bonuses and rewards, also a legacy of the old days, did lit
system any more transparent or fair.

In 1997 Pollena-Lechia was still a closed system. Despite the market pressures that emerged aft
largely ignored the country's rapid political, social and economic changes and had not moved an
Beiersdorf manager observed, 'Pollena-Lechia was not a Polish company of the 1990s – it was a
The management had simply disregarded any disruptive factors such as increased competition a
internationalization of trade, and had deliberately turned a blind eye to what was obvious to any c
urgent need for radical change.

Upon their arrival the two German managers immediately recognized this fact, but they realized t
around such an inflexible structure would consume all the time and energy needed to organize a

relaunch in 1998 (see Section 7.3.1). Instead of attempting to restructure the various department tedious negotiations with the Polish executives – not to mention the unions and the nearly 1500 e seemed intent on maintaining the *status quo* – they opted for an innovative way of dealing with th without the loss of precious energy. Contrary to the common recommendations of the change ma literature, they decided to remain detached from the non-reformable system at Pollena-Lechia. A 'In our view reform of the system was obviously impossible. So there was no need and no use in trying to understand the internal wiring of the system or conduct a detailed analysis from the insic months the Polish chairman and the majority of the Polish board members were left in charge an structures remained unaltered. The two Germans were hardly visible to the bulk of the employees regarded as consultants working at the outer rim of the company.

Rather than interfere with the company's established processes and structures the Beiersdorf ma added a structure of their own (Figure 7.6), tailored to the new marketing-driven strategy and witl by qualified, highly motivated personnel who were either handpicked from the existing workforce from leading Polish universities or international companies operating in the Poznan area. With th Beiersdorf established a completely new marketing department to handle the Nivea relaunch. A l salespeople were transferred to the new sales department and provided with flexible contracts. L personnel department in place, Beiersdorf established its own human resources project group to the handpicked former Pollena-Lechia workers and recruit new employees according to the expa marketing- and performance-oriented selection criteria. Often, as with the implementation of an ir information and logistics system, the new structures were kept well hidden within project groups, the foundation for the replacement of the old Pollena-Lechia organization. This shadow structure inexorably gained influence, mainly because all resources and crucial information from Beiersdor channelled into it by the two German board members.

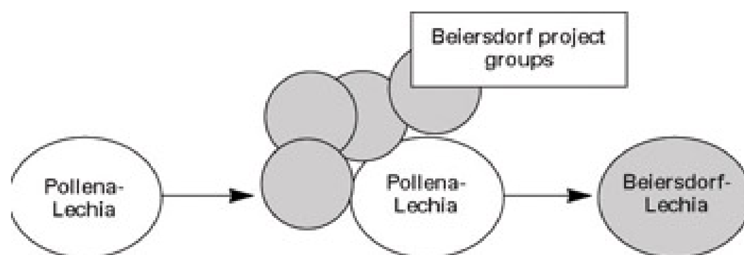


Figure 7.6: Tunnelling the structure

In the meantime Pollena-Lechia was doing business as usual. The Polish managers still held the conferences to discuss production volumes, the administration was still crunching numbers with (hopelessly outdated software programs, and the personnel department still occupied itself with a included several dozen types of bonuses that differed for each month and each worker. Producti Nivea Krem was also left untouched, thus providing the market with 33 million containers a year a turmoil of readjustment and restructuring that usually occurs during a company's postacquisition radical changes were introduced without interrupting daily business, that is, without running a ter jeopardizing market share.

The double structure was kept in place until it became clear that the Nivea relaunch had been su bubble of former Pollena-Lechia was allowed to burst. However, as discussed briefly in Section 7 this burst was not part of the plan which was slowly to deflate the now unnecessary and bloated l Pollena-Lechia. In early summer 1998 the German team designed a voluntary redundancy packa employees. On average, depending on age and length of employment, workers who volunteered would receive 40 000 zloty compensation, which was far above what the Polish state required in According to Polish labour law workers were only entitled to one to three months' severance pay or seniority. The package was especially attractive to older female workers because they would a advantage of the Polish early retirement programme for women.

The very generous redundancy pay also contributed to a generally positive response by the Polis cases of large-scale lay-offs was usually more critical. Beiersdorf also benefited from the stable c

regional labour market at that time – unemployment in the Poznan area was only 1.5 per cent, sc redundant employees could expect to find a new job easily. Some decided to use their redundan own business, and Beiersdorf supported these projects by offering tools, small machines and car down transportation department at very low cost.

The voluntary redundancy scheme unexpectedly turned out to be a key factor in the rapid turnarc Lechia: on the last day for sign-up in late June 1998, instead of the 350 planned volunteers, more attracted by the generous severance pay – decided to leave the company. While this was equiva the workforce the Beiersdorf team did not try to hold anybody back, apart from certain engineers replaced at short notice and were needed for the construction of a new production site. Instead th this unexpected development as a chance to speed up the process of change at Beiersdorf-Lech necessary structural changes earlier than planned. By the time the last volunteer left the compan the new structure was fully in place – far ahead of schedule.

The new organizational structure mirrored the marketing and sales orientation of Beiersdorf-Lech Compared with the structure of Pollena-Lechia prior to the acquisition (Figure 7.5), the Beiersdorf considerably reduced the levels of hierarchy and eliminated non-core functions such as transport services, logistics, maintenance, packaging production, research and development (which was c Hamburg headquarters) and the numerous social services provided in the socialist times (see Ch importance of shedding auxiliary functions in transformation processes).

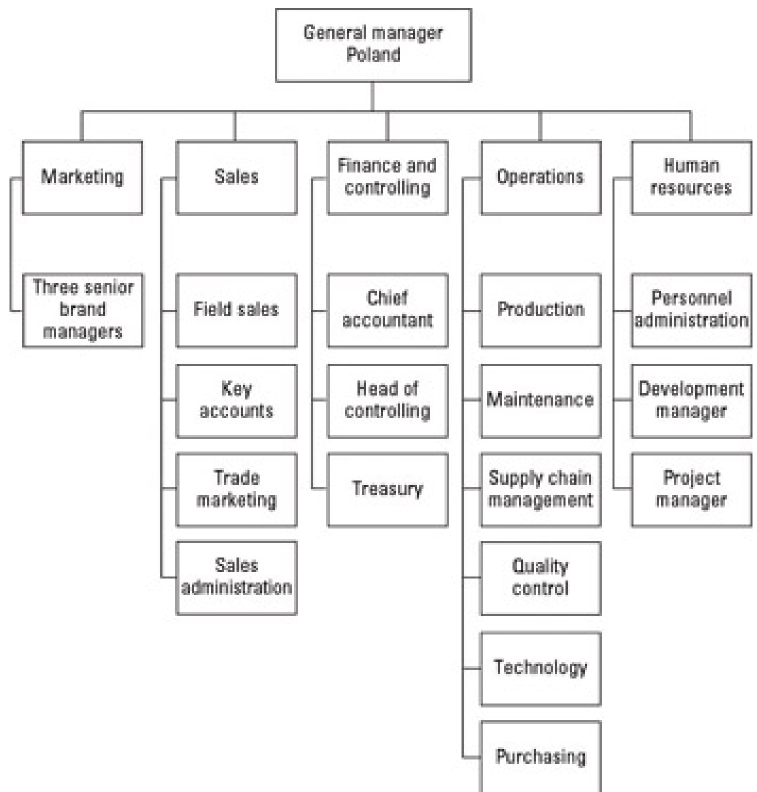


Figure 7.7: Beiersdorf-Lechia organizational structure, 2001

7.3.2.1 Personnel selection, training and development

For the employees who had opted to remain with the company the new structure meant a total re tasks, responsibilities, decision-making authority and communication and reporting procedures. T managers developed comprehensive human resource management procedures to support the st strategic changes and to facilitate the reorientation of the workforce.

Reorientation started with a thorough selection process for new employees. The selection criteria

closely linked to Beiersdorf's corporate objectives and its organizational values: a strict emphasis individual responsibility and accountability, direct communication and teamwork. For the first two general manager personally interviewed all applicants to ensure that their values and attitudes w Beiersdorf's international corporate culture. 'Change through exchange', guided by clear selectio opinion a crucial factor in the rapid and radical turnaround of the company.

With regard to the qualifications of the existing workforce, the technical know-how of those who r Beiersdorf-Lechia was generally high. Like many other CEE countries, Poland had always had a technical education system. Therefore Beiersdorf was able to focus its training efforts on manage project management, teamwork and communication, which had not been developed at Pollena-L part of the university curricula. In 1999 Beiersdorf ran a workshop for Polish managers, concentr motivation, communication with employees and other basic management skills. A formal training been in place since summer 2000. It consists of a three-level management programme and a pro programme for all new employees. The latter, which focuses on subjects such as corporate citize culture, professional presentation and communication skills, and conflict and time management, i local organization. The management training programme concentrates on continuous change an such as how to initiate change, how to cope with change, change and conflict, and motivating for from the start intensive coaching by German managers has been provided to Polish employees v potential. Management training is accompanied by a course in English, which is the official langu Beiersdorf group and therefore vital to the integration of Beiersdorf-Lechia personnel into the inte network.

Through the careful selection of recruits and target-oriented training programmes, Beiersdorf-Lec the internal development of managerial potential. Eager young graduates are able to rise to the r manager in less than two years, which would be inconceivable in most of Beiersdorfs' West Euro the same time attractive career prospects, high wages and social benefits are prerequisites for re managers. Experienced managers are still rare in Poland and the rate of fluctuation is comparati when a promising employer happens to be located in Warsaw. This situation has led to the devel Beiersdorf-Lechia Young Professional Programme, in which talented students at leading Polish b enter the company part-time during their final year at university. Sophisticated training on and off integration into the Beiersdorf internal international exchange programme makes the programme those with managerial potential. In this way Beiersdorf-Lechia is building up its own pool of mana become independent of the volatile managerial job market in Poland.

7.3.2.2 Remuneration

At Pollena-Lechia the pay structure was determined by a collective agreement between the state employees and the company. In addition, as a legacy of the socialist era a large array of social b provided to the workers, including child care, in-house medical treatment, an annual sports festiv holiday accommodation – most of which were discontinued upon the takeover by Beiersdorf. Non still relatively low in 1997, even for management (Table 7.9), and eight years after the velvet revo dominated by socialist principles such as preferential payment for blue-collar workers. An engine earned as much as 4875 zloty in 1997, whereas the manager of the toothpaste brand had to con mere 1000 zloty. Wage rises were rare even after privatization in 1995. Nonetheless the membe management decided to boost their own salaries 'considerably', as a German manager laconical

After the acquisition all wages were raised at once, often by more than double. The head of engi around 12 000 zloty, as did managers and chief accountants. At the same time Beiersdorf starte accords which generally had been under collective agreement into individual, performance-relate Chapter 12 on remuneration and Chapter 6 on the abolition of collective labour agreements in Po received individual contracts upon entry. Then, the agreements with top-level managers were ad would subsequently pass on their experience to their subordinates.

Beiersdorf-Lechia used the system by Hay (a leading provider of international remuneration data position in the organization. The application of Hay's standardized method enables interfirm com considerably when fixing wage levels in dynamic labour markets such as that of Poland. In Polan mainly international private corporations take part in the system, so its database provides a good

wage levels at comparable companies in Beiersdorf-Lechiás area. The new management of Beie
to take the entire Polish labour market as a benchmark, especially since young Polish high-fliers
extremely mobile and would quickly switch jobs from Lodz to Krakow to Warsaw for marginally be
basis of the Hay database, Beiersdorf-Lechia decided to pay an average remuneration that lay al
paid by 75 per cent of all registered companies offering comparable positions.

With the introduction of the Hay system Beiersdorf-Lechia had to assess all the jobs in the compa
detailed job descriptions based on selected criteria, including level of know-how, problem-solving
degree of responsibility required for the position in question (see Chapter 12 for a fuller discussio
This resulted in the assignment of a certain number of Hay points to each position, which in turn
classification of distinct job classes. The database now provides detailed, annually updated data
and the total amount paid for each job class, the so-called 'market reference salary'. The base sa
Lechia comprises the monthly fixed salary plus all fixed additional payments, such as the Christm
addition, and depending on individual and company performance, Beiersdorf-Lechia adds a varia
employees' remuneration. EBIT (the company's earnings before interest and tax) and an assessi
performance (ranging from below standard to excellent target achievement) form the basis of the
payment. Individual target setting and performance appraisal are conducted twice a year for each
By the end of 2002 all management levels – from the top level down to junior brand managers –
this remuneration system.

Since the details of the criteria used to evaluate the various positions are available to all, and bec
managers at the company have involved all management levels in the development of the remun
the start, it is perceived as being both transparent and fair by those affected. It also clearly reflec
orientation and cultural values of the Beiersdorf group as a whole. Beiersdorf has also introducec
benefits that are highly valued by the Polish employees. Since 2000 the company has provided a
medical care package for employees and their families, housing loans, an employees' holiday fur
holiday homes and sporting facilities. Unlike the previous social provisions, however, these servi
company-owned but are procured on the open market to ensure efficiency and low costs.

7.3.2.3 Information and communication systems

The new employment and organizational structures at Beiersdorf-Lechia were complemented anc
up-to-date information and communication system. In 1997 Pollena-Lechia had been using as ma
integrated software programs which had allowed for no kind of systematic control or planning. Wl
data had been available had to be gathered manually from numerous sources. Consequently whe
requested a due diligence report before the acquisition, Pollena-Lechia had been unable to supp
data as sales per product, the profit contribution of each product category, or average salaries. F
this lack of data prices had been calculated on a cost and volume basis only. Planning and forec
virtually nonexistent. A Beiersdorf manager later characterized this situation as 'bizarre'.

Immediately after the takeover Beiersdorf supplied state-of-the-art technology to employees who
had access to a personal computer or even a simple fax machine. Whereas at Pollena-Lechia cc
been slow and hierarchical, the introduction of modern tools such as e-mail supported Beiersdorf
direct and fast communication across hierarchies and departmental boundaries. In 1999 the intro
integrated ERP-software for all business processes facilitated not only control and planning proce
corporation, but also coordination with Beiersdorf-Lechiás external logistics associate, who was c
system.

Not only the results of the technological change but also the implementation process can be cons
The project team was selected from a pool of young graduates who had only recently entered the
highly motivated and eager to learn. Together with their more experienced coaches from the Han
these young professionals completed the task in just seven months (including two months of prep
61.2 per cent of the allotted budget. This was 70 per cent cheaper than the first Beiersdorf SAP-I
and faster than the introduction in any other company affiliate. The Poznan project became the m
Beiersdorf subsidiaries worldwide.

The results of the radical systemic, structural and human capital changes at Beiersdorf-Lechia ar

7.9. Compared with the situation at Pollena-Lechia in 1997, by 2001 the average age of employe
considerably and the average salary of white-collar workers had nearly tripled. Furthermore, over
predominantly young – staff benefited from a higher education, thus providing invaluable new ski
the future development of the company. At Pollena-Lechia only 7.7 per cent of employees had gr
university and on average were ten years older. The systematic restructuring of the organization
administrative personnel by 50 per cent and production workers by more than 83 per cent, althou
volumes rose continually. At the same time the enlargement of the marketing and sales staff refle
orientation of the company's new strategy.

Table 7.9: Human resources at Beiersdorf-Lechia, 1997 and 2001

	1997	**2001**
Number of employees	1500	400
Female – male ratio	70–30	50–50
White – blue collar ratio	30–70	50–50
Average age	42	33
Employees with higher education (per cent)	7.7	38.8
Average salary, white collar (zloty per month)	1641.36	4868.37
Average salary blue collar (zloty per month)	1296.6	2428.61
Share of contracts based on collective agreement (per cent)	100	43.93
Union membership	840	120
Average absenteeism (days per month)	3.84	1.12
Training	Only functional training	Training programmes levels, focus on man (749 hours per year i
Number of employees in production	646	108
Number of employees in administration	110	56
Number of employees in marketing	3	20
Number of employees in sales	40 sales employees, key account manager	102 sales employees account managers

Source: Beiersdorf-Lechia SA.

The complete reorganization also produced impressive economic outcomes. It not only contribut
the Nivea relaunch in 1998 (Section 7.3.1), but also raised labour productivity from C=33 000 of a
head in 1997 to C=230 000 in 2001, better than the Beiersdorf group's international average.

7.3.3 Towards sustainable success: leadership, interaction ar organizational culture

Sections 7.3.1 and 7.3.2 addressed the question of what the management of Beiersdorf-Lechia a
the years of transformation. This section looks at *how* they did it. How did they manage to turn ar
organization and lay the foundations for sustained success when the management of Pollena-Le
unable even to initiate a change process? What were the characteristics of management style du
rapid change process? What was the role of power and how was it used to achieve the rapid trar
company? What was the relationship between power, leadership style, organizational culture anc

One of the key factors in successful change at Beiersdorf-Lechia was the fact that the expatriate
intuitive sense of timing and sequencing. During the first two years after the takeover the manag
establishing a new framework for action (Figure 7.8). Only when this was in place did they addres
adjusting the culture of the organization (see Chapters 5 and 13 for more on organizational ident
change in CEE companies). The entire change process was dominated by these two clear foci.

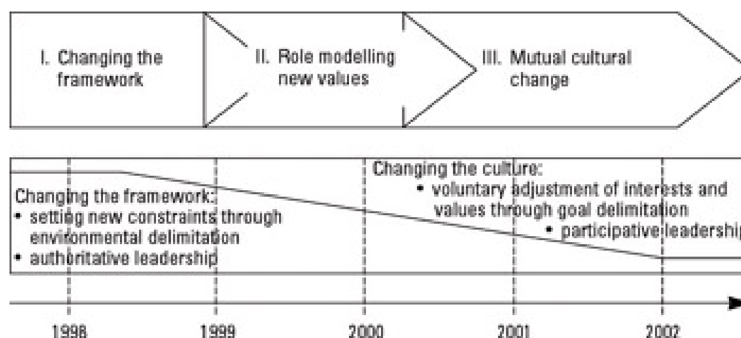
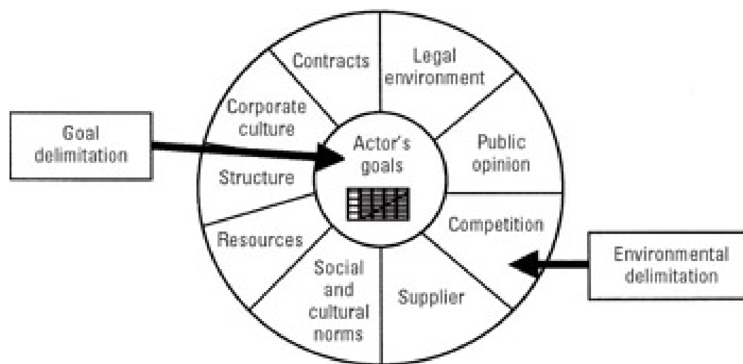


Figure 7.8: Phases of change at Beiersdorf-Lechia, 1998–2002

The process of change consisted of three phases, each of which was characterized by a differen
and a particular managerial style according to the focus – changing the framework or changing th
discussed earlier, these phases did not follow a fixed master plan but emerged during the course
opportunities arose and events unfolded (see Chapter 14 on the need for such an approach durir
organizational changes). Due to the complexity and dynamics of the situation in Poland, and part
Pollena-Lechia plant, detailed planning and adherence to the step-by-step change programme w
the management literature were considered infeasible. Management recognized the need to take
spot and close to the problems at hand. It also encouraged experimentation, unorthodox approac
and error when the situation did not allow for tried and tested solutions. The following analysis of
three stages of change – the crucial *how* of successful change management at Beiersdorf-Lechia
organizational politics model (Box 7.6), which enables a systematic description of the managerial
political processes behind rapid and radical organizational transformation in a dynamic environm

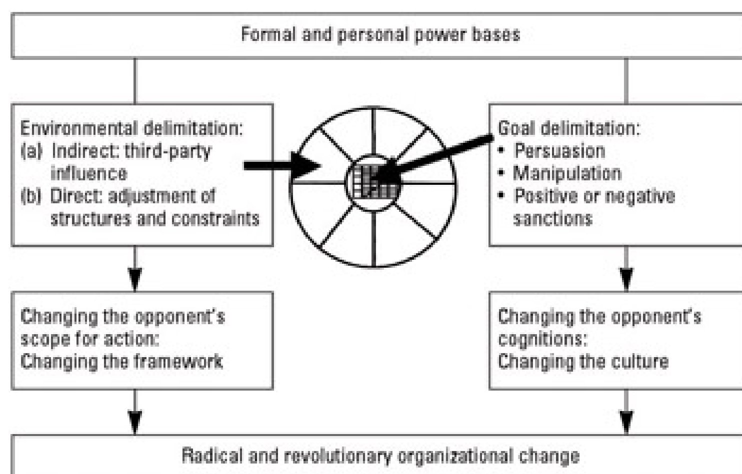
Box 7.6: Conceptual framework of the organizational politics model

The organizational politics approach links values, interests and power as central elements of org
behaviour and organizational change. Stakeholders are modelled as exchange partners who, de
individual interests and access to power bases, offer pledges (performance, services) in exchang
rewards (nominal payment, social benefits). The perspective of organizational politics is, howeve
internal dynamics of the organization. Via the concept of the scope for action (see figure below),
(institutional, cultural, competitive) are introduced as constraints an individual behaviour.



The organizational politics framework

For analytical reasons we distinguish between two types of (bounded) rational decision making b
the organization: (a) a goal-setting process (policy making) where, for example, the CEO or, thro
joint decision making, the board of directors formulates the objectives of the firm, and (b) a proce
these objectives against collisions of interest. The safeguarding of interests requires (1) direct st
communication such as persuasion, manipulation and the pronouncement of positive or negative
delimitation), (2) limiting of the opponent's scope for action (environmental delimitation) by exerci
changing structural or physical constraints on the opponent, or indirect action through third partie
opponent's interests towards the top management's objectives. Both direct and indirect strategie
possession and application of power means which can be either formal (reward, coercive, legitim
personal (referent or expert power).



Organizational politics and change

In this concept organizational change can only be put into effect when management successfully
interests by influencing the exchange partner's behaviour through goal delimitation or environme
(direct or third party). Goal delimitation may include persuasion, manipulation and the prospect o
negative sanctions to achieve a voluntary change in employees' goal criteria or the value they att
the maintenance of the *status quo*. One method of environmental delimitation is to alter employe
include a new set of tasks and incentives that are consistent with the strategic objectives of the c
this core phase of the process top management tries to extend its own scope of action by putting
exchange partners. As already stated, exchange partners can be internal actors (employees) or
(suppliers, government agencies) who may limit the organizational drive for change but may also
transformation efforts of the firm.

The model allows for the change process to be participative (for example involving employees in
authoritative (exercising formal power to achieve compliance). The speed of change will depend
applied to limit the exchange partner's scope for action. Positive and negative sanctions, for exa
rapid transformation but they may be costly and ineffective in the long run. Persuasion may have

effects if individuals voluntarily change their goals, but it is tedious and slow and requires a persc
Instruments for guiding behaviour, such as incentive schemes, must be ongoing so that the desir
continue routinely after the core phase of the change process. If, for example, incentives are only
nature (for example rewarding cooperation among change project groups only during the core ph
eventually fall back on their prior positions and behave according to their original interests, thus r
of the change process.

Further reading

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7.3.3.1 Changing the framework

Until late 1999 the process of organizational change at Beiersdorf-Lechia was clearly dominated
direct environmental delimitation. All the initiatives and actions of the management team were dir
the employees' behaviour and scope for action. A great advantage of environmental delimitation
the necessary resources and power structures are in place – it leads to rapid behavioural change
promises speedy realization of strategic objectives. Changing the framework was a prerequisite f
the successful relaunch of Nivea in Poland in spring 1998. It was also a precondition for the sust
development of the company because only a new framework for action could provide the platforn
change of values and norms, that is, for the emergence of a new organizational culture (phases I

The new framework was also a prerequisite for the incorporation of Beiersdorf-Lechia into Beiers
network (Figure 7.9), but in the meantime the company was exempt from the demands made on
affiliates. At the time of takeover Beiersdorf granted the German managers in Poland unlimited ti
Poznan operation into a fully fledged Beiersdorf subsidiary. They were also given a high degree c
decision making and interference by the Hamburg headquarters was kept to the minimum. Visits
interested managers from Hamburg or the organization's international subsidiaries required the p
the responsible Beiersdorf board member and the head of the expatriate team in Poznan. Only a
establishment of the new framework for action was Beiersdorf-Lechia accepted as a full member
international family.

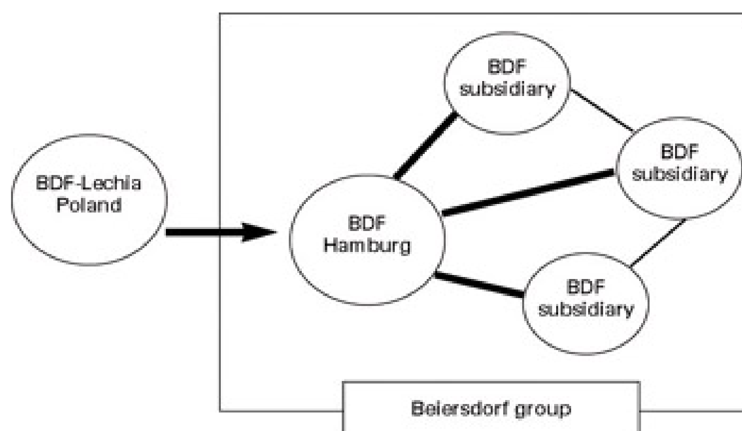

Figure 7.9: Integration of Beiersdorf-Lechia into the international corporate network

A visit by Beiersdorf CEO Rolf Kunisch at the end of 1999, after the new IT system had been ins
conclusion of the first phase of change management at Beiersdorf-Lechia. The management the
to making the company an exemplary, top-class subsidiary with above-average productivity, and
regional centre of competence for the entire Beiersdorf network (see Chapter 15 for a discussion
MNC subsidiaries in CEE). In 2002 Beiersdorf-Lechia was in fact selected by headquarters as a
Beiersdorf group's European production system in charge of coordinating international productio
programmes.

A variety of instruments were used to achieve the new action framework. First of all, the transfor
organizational structure and the introduction of a new human resources management system (S
involved the assignment of new functions and responsibilities to all members of the organization.
regrouped into new departments and teams and received new working contracts with radically re
competences and incentives, which effectively created new constraints on and challenges to ind
new corporate strategy (Section 7.3.1), which focused on the Nivea brand, defined a different dir
employee and forced them to adapt their working routines accordingly. The new product portfolio
technologies, pricing system and quality requirements upset the usual working practices and set
the behaviour of employees.

Employees who were unwilling or unable to adjust to the new procedures chose to leave the com
voluntary redundancy scheme was announced in spring 1998 (Section 7.3.2). New recruits to the
personally selected by the head of the expatriate team. Most of them had just graduated from lea
universities, and because they had not been exposed to the old practices and routines of Pollen
easily into the new operational framework and adjusted quickly to the novel management style a
procedures.

The expatriate managers enhanced and strengthened the new framework by developing support
percepta. Immediately after the acquisition the buildings and offices were redecorated in a light,
style that corresponded to the core values and characteristics of Beiersdorf and its main brand.
to the working environment immediately signalled to all members of the organization the scope a
changes to come at the company. So not only strategy and structure but also the physical enviro
and brought into line with each other. The equipping of employees with state-of-the-art office tec
perceived as a further sign of the commitment of the Beiersdorf group to its subsidiary in Poland.

The new treatment of employees as key assets of the company had already been made manifes
increase in nominal wages, but this was then complemented by various non-financial incentives:
company received the same high-class medical insurance package, sales people were provided
of car as members of the board of management, and everybody who went on a business trip for
entitled to the same category of accommodation and travel standards. These seemingly minor el
framework played an important part in the company's success as, together with the new organiz
employment contracts, they sent unambiguous signals about the company's norms and values.

The management style during the environmental delimitation phase was predominantly non-parti
about the organization's framework and the setting of new constraints for employee behaviour w
Beiersdorf managers alone, and employees could either accept the new constraints and adapt th
behaviour accordingly, or take up the offer of voluntary redundancy. By opting for this leadership
deliberately avoiding close involvement and difficult discussions with long-term managers and e
from Beiersdorf was able to push through the first phase of the change process with speed and
clear cut top-down approach the expatriate managers maintained a policy of constantly informin
They always announced their decisions early on and to all those affected, so that employees ha
prepare themselves for the changes and when necessary voice their own opinions on the topic.
communication also helped employees to gain a sense of direction in the turbulent process of tr
develop some trust in the words and deeds of the new management (see Chapter 11 on leaders
and Chapter 13 on leaders' role in changing the organizational identity).

Changing the framework required the German managers to have a large formal power base (Bo
acquisition of the majority of shares by the Beiersdorf group and the provision of 72 million zloty
site, as well as funds from the sale of the toothpaste operation in 1998, bestowed the expatriate

considerable reward, legitimate and coercive power, which they used extensively to redraw the s
the employees. Only when the financial means and the majority ownership of legal rights had bee
they able to reformulate all contracts, redesign the incentive scheme and completely alter the wo
is important to note that these measures had been largely unavailable to the managers of Pollena
had been seriously inhibited by the heterogeneous share ownership structure and limited financia
(Section 7.2.2).

7.3.3.2 Changing the culture

Changing the organizational framework through environmental delimitation was the first importan transformation of Beiersdorf-Lechia. However while this achieved a rapid adjustment of employee barely touched their basic values, interests and attitudes. Yet genuine radical change required th core values and the underlying partly unconscious basic assumptions, that is of the organization new framework for action in place, these issues moved centre stage. In the view of the German r evolution of values required a platform, a supportive skeleton for their development, and this plat before turning to the question of corporate culture. Therefore, although cultural issues were impli the beginning of the transformation process because the acquisition had brought together not on German and Polish cultural backgrounds but also the organizational cultures of two fundamentall companies, Pollena-Lechia and Beiersdorf, they were not on the expatriate management's agen

Managerial instruments applied in cultural change processes were fundamentally different from t the first phase of transformation, the phase of constructing a new framework for action. Whereas constructing a new framework was dominated by the coercive instruments of environmental delin of cultural change necessitated instruments of goal delimitation such as persuasion and commur 7.6). Changes of values come about only through long-term cognitive processes of reflection anc require voluntary acceptance of the new norms. These communication processes, however, nee supported by the organizational framework. Incentive systems, structures, working procedures, t responsibilities and competences have to correspond to and sustain the cultural change process routinization, internalization and a stable anchoring of the new set of values within the organizatio

While changing the frame required a basis of formal power (see Section 7.3.3.1), changing the c personal, expertise and referent power in order to effectively communicate the new set of organi Beiersdorf-Lechia management, besides controlling the financial means and property rights to pu environmental delimitation process, also had the communicative skills, charisma, personal autho sensitivity to be credible and accepted as agents of cultural change.

The cultural transformation process at Beiersdorf-Lechia consisted of two interlocking phases wi different sets of cultural change instruments (Figure 7.10).

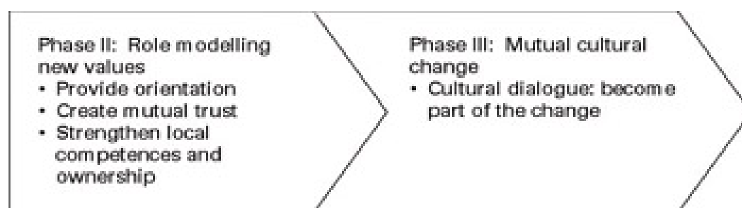

Figure 7.10: Elements of cultural change at Beiersdorf-Lechia

In phase II, cultural change efforts were dominated by the expatriate management's personal ide system of mutual values. All instruments employed at that time were influenced by their own basi their socialization as long-term employees of the Beiersdorf group. They included the expatriates the organizational culture through selecting and supporting the 'right' employees according to the and through communicating and living their own set of core values and norms. This phase of cult clearly dominated by the foreign managers and a one-way conveyance of values and norms from as the still ongoing second stage of cultural change at Beiersdorf-Lechia, evolved after the mana their attempt at changing the company's values system from the top had led to only partial succe needs bi-laterality, real dialogue, a mutual commitment to and development of a new, joint value

members of the organization. This realization also necessitated an adjustment of management st
management in phase I of the transformation process had been predominantly autocratic, in pha
manager switched roles. Instead of acting as a 'frontline executor', attacking all problems person
limited himself to giving key directions and keeping control of the organization's course. Phase III
another redefinition of roles: the expat team had to learn to hold back and restrict themselves to
coaching and sponsoring the mutual cultural development process at Beiersdorf-Lechia and conc
responsibility for the cultural dialogue to other members of the organization. The following paragr
changes of managerial roles over time and their consequences for the process of cultural change

Provide orientation Providing orientation was the first important step towards the cultural redire
company. In light of the dynamically changing environment in Poland as a whole and the turmoil
Lechia after the takeover, the clear and uncompromising strategic focus of the management tean
helped the Polish employees to gain a sense of direction, order and perspective. For both manag
employees the single-minded concentration on the Nivea relaunch and its anchoring on the interi
strategy brought all the actions and thinking of the company's members onto the same track. Thi
the ground for the future development of a shared corporate vision, and immediately after the Niv
expatriate managers initiated a mission development programme aimed at a similarly straightforv
for the long-term growth of the company. They conducted a series of workshops in the summer c
with the formulation of a mission statement that was to be disseminated and implemented throug

The expectations of the managers, however, were not realized. The messages in the mission sta
take roots, and follow-up efforts by the managers were limited to single departments, which opera
strategic vision only for their specific field. Hence there was no company-wide acceptance of or n
to the mission statement. As a consequence, during 1999 and 2000 orientation was mainly provi
example of the German managers, who functioned as role models for the employees, especially
oriented recruits who had come straight from university, were responsive to Western lifestyles ar
unable to find suitable guidance in their personal environment.

The values perpetuated by the German managers were naturally dominated by their own cultural
them already had had considerable work experience at other Beiersdorf affiliates or at the Hambu
and were firmly rooted in the international corporate culture. The core elements of the Beiersdorf
these managers included strong identification with the core brands of the company, which were s
a set of strong values, such as lifelong caring, harmony, honesty and mutual respect. These valu
be held by the people who worked with these products on a daily basis. The corporate culture als
deference and friendliness in all internal and external interactions, a long-term orientation and co
fellow humans. Thus loyalty, trust and open communication were cornerstones of the value syste
basis of decentralization, individual accountability and the encouragement of personal initiative, i
experimentation among Beiersdorf employees.

The management at Beiersdorf-Lechia personally demonstrated open, non-manipulative commun
motivation, commitment to the Polish company and the need to take ownership of one's projects.
role models was considerably increased by the fact that there were six of them – the largest tean
by Beiersdorf on a single project. The Beiersdorf Journal and the Beiersdorf Intranet were used a
channels to disseminate information on Beiersdorf's norms, practices, objectives and values, anc
regularly carried stories of exemplary employee behaviour. This written material provided added
German managers' effort to provide orientation for the Beiersdorf-Lechia employees during that c
organizational upheaval and cultural transition, as did constant communication with other membe
international network needed to ensure international coordination of the organization's brand stra
and marketing.

Create mutual trust The second important element of cultural readjustment at Beiersdorf-Lechia
mutual trust between the new management and the employees. Trust lies at the heart of Beiersd
system as it is firmly believed that trust creates reciprocal trust, thus fostering a culture of mutual
accountability. Projects at Beiersdorf are not simply assigned, they are entrusted to a project tean
Poznan project was entrusted to the German management team, hence the absence of a prefixe
the turnaround and minimal control of the local operations by headquarters. From the beginning t
strove to extend this notion of trust and mutual dependence to the employees at Beiersdorf-Lech

A key means of creating trust and reliability was and remains the management's open, direct, una
communicating. Whereas at Pollena-Lechia hierarchical formality had dominated interactions bet
and superiors, the Beiersdorf managers avoided indirect communication and manipulation, and t
misunderstandings from the start. For example they were quick to share precarious information v
members of the board of management about the sale of the toothpaste operations to Colgate-Pa
This unexpected openness was perceived as critical in creating an air of predictability and confirr
of communication at Beiersdorf-Lechia. It was equally important that the German managers strov
words with their deeds at all times.

A further building block in the creation of trust was Beiersdorf's large financial commitment to the
and the early announcement of a major investment in a new production plant, which provided a c
long-term orientation of the German shareholder. This commitment considerably reduced the em
insecurity about the company's future and increased their confidence in the management team's
The establishment of long-term relationships with local suppliers and the community, for example
Poznan marathon, also helped to inspire trust among the employees, as did the introduction of a
system which was perceived as being both fair and transparent. The company's caring attitude tc
as manifested in the provision of an all-inclusive medical package and the personal interest the g
took when an employee was ill or had family problems were an additional sign of commitment.

Symbolic changes also served to reduce the distance between the new managers and the workf
of the board introduced a first-name policy, top managers and sales agents were allotted the san
and model of car, and informal, out-of-office departmental meetings were organized to encourage
across hierarchies. Several managers coached their direct reports to engage in open communica
direct feedback, and to challenge their superiors' decisions when these were deemed questionat
Lechia employees had not been accustomed to questioning managers' behaviour. Both sides ha
all costs and regularly adopted circumvention strategies when a problem came up, rather than cc
Beiersdorf-Lechia mutual trust and openness were seen as core elements of the future organizat
key factors in successful and sustainable change.

Strengthening local competences and ownership The third key element supporting the chang
strengthening local competences, accountability and sense of ownership among the members of
culture of trust, it was believed, could only lead to corporate success if it was coupled with suitab
ability to handle responsibility. If they lacked confidence in their own competence employees wou
and avoid risks which in turn negatively affected their ability to complete the projects entrusted to
development of employees' skills and competences was therefore perceived as vital to cultural cl
Lechia.

From the perspective of the Beiersdorf managers, even the experts coming from Pollena-Lechia
incompetent when it came to basic managerial skills. For decades Pollena-Lechia had heeded or
qualifications of its staff, and the fact that even the most minor decisions were made by the boar
resulted in a serious lack of independent decision-making ability and accountability among emplc
crucial managerial skills required by Beiersdorf were virtually non-existent at the company at the

Furthermore, as discussed in Section 7.3.2.1, the young university graduates recruited after the a
received no training in management skills such as communication, workforce motivation, conflict
general leadership. Accordingly in late 1998 the company established a training programme for n
and at the same time potential high-fliers were assigned their own teams and projects in order to
risk-taking, responsibility and leadership. Members of the German team were always available fo
advice. They encouraged experimentation and individual initiative and, in line with the corporatec
the unavoidable failures that resulted from the trainees' lack of experience. The new incentive sc
new practices through the provision of performance-related pay. Increasingly this was accompan
the expatriate team's leadership style towards management by objectives, although target setting
and irregular until 2001 and was limited to handpicked individuals who had demonstrated a readi
and personal responsibility.

Slowly but surely the growing competence of the local managers and employees reduced the dis
and the German team, and power and expertise became more and more decentralized. Importar

the building of the new factory in Poznan and the introduction of key accounting in the sales depa
characterized by real partnership and close teamwork between local, expatriate and headquarter
installation of the integrated information system provides another good example. The team respo
the system predominantly consisted of young university graduates who on average had spent on
company. They rightly interpreted the assignment as a clear sign of trust from the Beiersdorf mar
perception that they were taken seriously by the board managers boosted their self-confidence a
resulting in the project being completed in just seven months. Supported by consultants from Bei
the young and enthusiastic team members not only accomplished their task in less time and at lo
planned but also developed into real experts in this kind of project. They not only gained the app
Beiersdorf group but also served as role models for their colleagues in Poznan, coaching others
management and promoting the new Beiersdorf-Lechia values in respect of teamwork and projec
sign of affirmation of Beiersdorf-Lechiás accession to the international Beiersdorf family, in 2002
members became the first employee of the Polish subsidiary to be sent out to work in the interna
network.

Cultural dialogue Despite the successes described above, a number of problems arose in the c
the change process at Beiersdorf-Lechia. Management–employee discussions and an informal s
managers in May 2001 revealed the following. Employees and managers alike described the wor
company as too slow, inflexible and formal, and still dominated by hierarchical or status consider
successful Nivea relaunch in 1998 and the tensions caused by the strategic and structural turnar
Lechia, which had put a strain on all employees by demanding complete flexibility and willingness
was now a growing tendency for rigidity. This was accompanied by increasing departmental egot
isolationalism on the part of the recently consolidated working groups in sales, marketing and pro
there was an obvious need to promote interdepartmental cooperation and widespread acceptanc
change. In addition the survey confirmed the German managers' suspicion that the vision and va
incessantly espoused since the acquisition had not taken root. As noted earlier, the message of t
statement formulated in 1998 had never really penetrated all levels of the organization. It was ha
internalized, outside the circle of those who worked directly below and in close cooperation with t
this level the old values – formal communication, strong hierarchical orientation and patriarchic le
dominated. The core elements of the Beiersdorf corporate culture (direct and open communicatio
accountability) that had been visible among employees during the IT project and the introduction
accounting system were limited to single individuals and had not reached the majority of the staff
the problems of cultural change management and Chapter 11 on the difficulty of changing manag
CEE).

Obviously the values lived and demonstrated by the German team had only resulted in superficia
changes to the organizational culture, and were mainly limited to those who had been in close co
models on a daily basis. These young managers had apparently been unable to pass on the norr
their own teams, because while openness and accountability reigned in their relationship with the
managers, with their own subordinates they had not been able to overcome the formal, authorita
style that had been prominent in socialist times and had been imprinted on them during their prim
schooling and university education. What were the reasons for this?

First of all, in phases I and II of the cultural change process (changing the framework and role mo
the initiative had been largely one-sided, that is, promulgated and dominated by the German mar
While the undisputed need for clear directions and rapid decisions had called for an autocratic le
during phase I, this had unintentionally been carried over into the second phase because those e
become accustomed to this style (which had appeared to differ little from the authoritative leader
prevailed before the takeover) had not followed the management's change of direction. From the
managers' espousal of openness and participation had amounted to words that had not been ma
this had not been helped by the fact that at times some of the managers had indeed tended to sli
(phase I) role of dominating agents of change, particularly in the event of difficult business situati

The opportunity for sustained cultural change only came about when the management team reco
necessity of turning their one-sided, top-down cultural transformation initiative into a mutual ende
forced them to reflect on and eventually readjust their own value system. Hence phase III of the t
Beiersdorf-Lechia differed from the two previous phases in that it involved a sincere willingness b

relinquish some of their long-standing values and way of behaving in order to facilitate for the dev
corporate values through a process that would involve all employees. This required not only refle
adaptation of their leadership style, but also the ability to handle and encourage challenges by su
concede power to other levels of the organization.

In July 2001 the management duly initiated a project to formulate and develop a set of jointly sha
factors (KSFs) for the company, which in contrast to the mission statement devised in 1998 woul
from the top but derived from open discussions involving all members of the organization. This fo
the board of management and in the team set up to run the project to define and take on new rol
The general manager, who was accustomed to directing and dominating all processes at Beiersc
force of personality and expertise, chose the role of project sponsor. That is, he would remain in
interfere only when asked to do so by the team members, and generally limit himself to providing
Responsibility for conducting the project was delegated to a cross-departmental team drawn from
management and promising employees. An external consultant familiar with Beiersdorf would ac
team members. He was also put in charge of mediating the conflicts that might arise between the
top management because of the unusual allocation of roles and competences. The entire proces
and transparent, and no expected outcomes were defined as their absence would create a sense
project by the team members and avoid the redelegation of responsibilities. The only boundaries
of the task – the formulation of key success factors for Beiersdorf-Lechia – and rough deadlines
based orientation.

As was to be expected, the project was not without its problems. At times everybody slipped bac
and when the general manager, as the sponsor of the project, attended team meetings, the team
treated him as the chief decision maker, withheld their own ideas or criticisms and tacitly concede
the process to the board. In such situations the external coach was immensely helpful in rearrang
functions, and encouraging the project members to hold their ground against their superiors and
assigned responsibilities. In addition, while the project had been designed to cross departmental
hierarchies, communication was sometimes dominated by considerations of status and position.
the continuing existence of the unsuccessful mission statement, which despite never having take
perceived as inhibiting the openness of the KSF process.

The eventual formulation of ten key success factors in April 2002 was seen as crucial for the futu
the company, but it turned out not to be the only important result of the project. For all those invo
process had been at least as important. The participants had learned to reflect on, define and ev
practice new roles and tasks within their organization, and they were now equipped to discuss th
with their superiors, take responsibility for projects with company-wide relevance, bring together p
departments and hierarchical levels and successfully steer them towards mutually agreed targets
competences were also in line with elements of the international Beiersdorf value system, therefo
cultural integration of Beiersdorf-Lechia into the international corporate network.

The crucial learning process did not stop there. The KSF team has recently defined 30 related pr
intervention from the board – that should help with the development and implementation of the ke
throughout the organization. Employees from all levels and departments of the company can app
project groups, where they will be coached by members of the core KSF crew. Again, the objecti
are not predefined. The goal is not only to operationalize the key success factors but also to casc
levels of the organization the experience of ownership, teamwork and personal learning, which in
resulted in reflection on and adjustment of the team members' attitudes, behaviour and basic ass
to phase II, where values were more or less prescribed from the top, employees now have the op
experience the positive effects of open discussions, real participation and successful completion
they themselves have planned and managed.

At the same time the change of attitude and managerial style among the German managers has
more visible. Employees at Beiersdorf-Lechia perceive it as a clear sign of the general manager's
commitment to change that he has started to conduct his presentations in Polish instead of Engli
language of the Beiersdorf group. He is constantly striving to alleviate the distance between expa
developing a joint language that is not the one of the German board members. Another unmistak
change and clear commitment to a real dialogue between the German and Polish members of th

the replacement in summer 2002 of the German director of sales and director of operations by tw who share the new values of accountability, openness and partnership. The willingness to chang changes on both sides can be seen as the first step towards the creation of a genuinely shared c that will complete the radical transformation of the Poznan subsidiary and ensure the sustainable company.

Box 7.7: Six points to remember in change management

- *If the need for change is obvious, there is no reason not to initiate change immediately*. It is aware that hesitancy may develop among the team made responsible for leading the change yourself. Act at the first sign of resistance, for example when you hear questions such as 'sh now?' 'Why can't we wait?' Is it really necessary?'
- *Once started the process must be driven at maximum speed to keep up the momentum*. Ne speed of change once the process is rolling, and focus on keeping in the right direction.
- *It is absolutely vital to initiate and carry out the process in all areas of the company at the sa* cannot be conducted function by function or department by department. Today's business p functions simultaneously and change must have a positive effect on the management of all
- *Clear, crisp, straight and honest communication with the members of the organization is cru of change management as it creates trust and instils an air of predictability*. Misunderstandir misinterpretations and lack of communication are the biggest enemies of the change manag create unnecessary uncertainty and anxiety among those who will be affected by the change
- *Managing the human factor when interacting with those who are affected by change or have can test your patience and tact to the limit*. It may sometimes be difficult to communicate dir but even in situations of stress and anger, fairness to fellow human beings is a must. So rep repeat until you are understood, but never cave in.
- *Be aware of the fact that the unexpected can happen at any time and you must have some it*. Initiating and managing change tends to swallow all your resources, but if you do not keep doomed to fail.
- *Take time to change yourself!* As a change manager you are 'in the trenches'. You have to but make sure you allow time for reflection on a change of your role. You will have to let thin responsibilities and turn into a real leader.

Heinz-Jürgen Stüting, General Manager, Beiersdorf-Lechia SA Poznan.

Box 7.7 summarizes the key lessons learned from the company's successful radical change proc

7.4 Conclusion

This chapter has analyzed in detail the case study of a successful organizational transformation in CEE. The aim has been to provide a reference point for the development of the decision-making process, the concrete steps necessary to implement the resultant decisions and the pitfalls and problems that are invariably encountered in complex change management projects. It has also drawn attention to alternatives for action that are available to managers, and the connection between actions taken – that is, the employment of selected instruments of change management – and their consequences for organizational development, especially in respect of the pace and magnitude of change. At Beiersdorf-Lechia the initial concentration on environmental delimitation and authoritative leadership (Section 7.3.3.1) enabled rapid transformation of the action framework for all members of the organization. Once the new framework was in place, the moves to change the company's culture and encourage participative management eventually resulted in full-scale transformation of the company, which, by virtue of addressing core values and deep, underlying assumptions, went far beyond mere structural and strategic adjustments.

Changing the framework and changing the culture as the two core elements of organizational transition have, however, a number of limitations as well as preconditions for their successful application to which we would like to draw the reader's attention:

- Changing the framework by adjusting constraints on individuals' scope for action (environmental delimitation) is associated with relatively high costs, and a short-term orientation, and requires a large power base. While a new framework for action is able to change the behaviour of employees, this might not be sustained, thus necessitating constant monitoring and re-enforcement of the desired behaviour.

- Changing the culture through goal delimitation measures stands a better chance of being sustained in the long term because it tackles underlying values, norms and cognitive maps. The creation of trust and a shared corporate culture considerably reduces the transaction costs of information dissemination and coordination within the organization. Changing the culture, however, requires an extensive personal power base and the development of genuinely open dialogue among all organizational members, which in turn depends on conviction, persuasion and voluntary acceptance of a revised set of personal values and goals. In the case of Beiersdorf-Lechia, the dispatching of a large group of experienced and culturally sensitive expatriates who were also willing to reflect and eventually question their own values and attitudes was a key factor in the success of the transformation.

- The choice of suitable change management instruments and the sequencing of the transformation phases depends heavily on the individual situation and context of each corporation in transition. The specific set of circumstances at Beiersdorf-Lechia and the dynamically changing environment in Poland at the time of takeover in 1997 necessitated the establishment of a totally new framework for action that might not have been, for example, compulsory in the case of organizational change in an institutionally more stable West European economy. Furthermore at Beiersdorf-Lechia the resources (formal and personal power bases) required to change the framework and culture were readily available. This is not the case in CEE companies that lack the stock of resources, managerial skills, popular product lines and strategies of a large international parent company such as Beiersdorf. The latter's successful global brand strategy functioned as an anchor for the entire change process at Beiersdorf-Lechia (Section 7.3.1), and the uninterrupted presence of the Nivea brand in the Polish market since the late 1920s was of considerable advantage to the development of the Poznan subsidiary.

- Preconstructed master plans or 'one size fits all' recipes for change management are

inappropriate and potentially dangerous for transforming organizations. Not only does the availability and applicability of change instruments depend on the internal resources of the corporation, but in transition economies such as Poland managers also have to cope with the additional problem of a constantly changing external situation that demands continuous adjustment to economic or legal constraints within the company's environment. The managers at Beiersdorf-Lechia were keen to seize the chance to accelerate the pace of organizational change whenever an opportunity arose. They were conscious of the need to step back regularly from the sometimes turbulent transition process in order to reflect on situational changes and adjust their actions accordingly. They were also able to change their own norms, attitudes and assumptions when the situation demanded mutual cultural adjustment.

Even though each change management project requires individually tailored strategies and managerial instruments, the framework developed for Beiersdorf-Lechia in Poznan is suitable for wider application. The detailed analysis provided in this chapter allows for the identification of general structures and relevant criteria for decision making with regard to the selection, evaluation and sequencing of instruments for change in transition economies in CEE and other regions of the world. The success of Beiersdorf-Lechia shows that the right choices were made in this regard as this former state-owned, production-oriented conglomerate is now a market-oriented, dynamically growing subsidiary that ranks among the top ten affiliates in the international corporate network of the Beiersdorf group.

Part III: Strategic Concepts for Continuous Change in Transformation Enterprises

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Chapter 8: Market Entry Strategies and Competitive Advantages in Poland

Jutta Emes

Abstract

The dynamically changing economic environment in Central and Eastern European (CEE) and the expected integration of some of the CEE countries into the European Union offer new business opportunities for Western companies. This chapter addresses the question of how to operate successfully in CEE markets, and particularly in Poland. Dunning's eclectic paradigm serves as conceptual framework for the analysis. It is shown that in order to gain and maintain competitive advantage in Poland, Western companies will have to plan their business strategically and choose an optimum market entry strategy. The latter involves a complex decision-making process that is examined in this chapter with the help of findings from an empirical study conducted by the author.

8.1 New chances for competitive advantage in Poland

The future enlargement of the European Union (EU) by up to 13 member states[1] will offer new opportunities to Western companies that choose to operate in these countries. From an economic perspective, special attention has to be paid to the markets of the future members. The first Central and Eastern European (CEE) candidate states will be integrated into the EU by 2004. Poland is expected to be among these entrants, provided no unforeseen difficulties emerge in respect of the required budget stabilization and economic consolidation.

With a population of 38.6 million Poland is the largest economy to apply for EU membership. Although currently facing a recession, which is ascribed to internal problems, Poland is considered one of the most successful transition economies. The ‘shock therapy’ programme implemented during the past decade has changed the economy to a market system and privatized numerous state-owned companies. Today the private sector accounts for more than 70 per cent of economic activity. On the whole Poland offers an attractive sales market for West European companies (Manrai *et al.,* 2001; Tewes, 2001) but in order to capitalize on this a systematic strategical approach is needed by new entrants and established companies alike.

Against this background, the key question of our research is how foreign companies can gain competitive advantage in the Polish market and thus reach the position where customers perceive their products and services as superior to their competitors’ offerings, that is, of better quality or better value. To answer this question we shall first outline the concept of strategic planning. Then a theoretical foundation is derived from John Dunning’s ‘eclectic paradigm of international production’ (Dunning, 1988, 1993, 1995), which enables in-depth analysis of competitive advantages and strategy parameters. As the CEE markets, which were isolated until the late 1980s, provide a unique opportunity to test theories of internationalization (Peng and Heath, 1996, p. 493), the results of a survey of market entry behaviour by Western companies in CEE are used to validate our theoretical findings.

[1]The applicants include Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Malta, Cyprus and Turkey. Most applicants are expected to complete their contractual negotiations by the end of 2002. Turkey, however, will not be able to start membership negotiations until certain reforms have been implemented (Auswärtiges Amt, 2001).

8.2 Strategies for the Polish market

Successful foreign market entry requires a systematic and long-term strategic approach and enta
numerous managerial decisions. Due to the complexity of international operations it is often hard
recognize the interdependence of the various stages of market entry and each tends to be dealt
in a fairly isolated way in the international marketing literature (for an overview see Schuh, 2000,
138). Only a few approaches, such as Dunning's eclectic paradigm, which will be discussed in th
next section, offer an integrated framework.

This section first outlines the conceptual framework for market entry and then – since a thorough
examination of the related risks and opportunities forms the basis of any market entry strategy –
present situation in Poland is analyzed.

8.2.1 Strategic planning and decision making for market entry

Careful planning is fundamental to any company's future success abroad. This entails the
construction of an internationalization strategy that covers all the markets to be served and provi
overall guidelines for market entry decisions. Some of these guidelines cannot always be rigidly
adhered to as multinational enterprises (MNEs) often have to adjust their market entry tactics to
characteristics of the prospective host country. Consequently the exploitation of new geographic
markets requires a refinement of the overall strategy.

The various facets of strategic planning are shown in Figure 8.1. First, comprehensive analyses
environmental situation and the company's SWOT position (strengths, weaknesses, opportunitie
threats) generate the necessary data to begin the planning process. A company's competitive po
will be determined by its own resources and factors specific to the host country. For example if a
company has certain skills resulting from its R&D activities it might exploit these in foreign marke
realize economies of scale and scope due to a larger market size, and host-country economic fa
such as low wages will enable comparatively inexpensive production. Moreover a clear definition
the goals and objectives of market entry is essential and should correspond to the general vision
the MNE.

Figure 8.1: Strategic planning of market entry

The development of the market entry strategy involves defining the relevant market and the mark
segment, determining the timing and form of entry and deciding on a product strategy in terms of
differentiation versus standardization. All of these factors are interdependent and decisions on th
have to be made more or less simultaneously. A strategy aimed, for example, at securing first mo
advantage cannot be realized with a market entry form that needs preliminary time for developme
such as the construction of a new subsidiary. Similarly, if a company plans to enter several mark
the same time it probably will not be able to differentiate its products or services but rather will ha
offer a more standardized package. Similar interdependencies exist for alternative combinations
the strategy parameters.

The degree to which competitive advantage can be achieved depends particularly on the form of
chosen, that is, exporting, the establishment of wholly owned subsidiaries or engaging in coopera
ventures such as licensing, franchising or joint ventures. Cooperative entry requires activities suc
searching for, evaluating and choosing suitable partners, as well as decisions about the individua
organization of the venture.

Finally, all of these strategic decisions have to be implemented and thereafter subjected to perma
evaluation and control in order to identify shortcomings and improve the market entry concept.
Altogether, this general overview places emphasis on the systematic and situational character of
international marketing cycle. As an environmental situation analysis of the Polish market is
fundamental to this concept, it will be examined more closely in the following paragraph.

8.2.2 Risks and opportunities in the Polish market

Enterprises that are planning to engage in business in Poland first have to collect relevant data in
order to assess the risks and opportunities. Whereas little statistical data could be obtained when
markets opened after the fall of the Iron Curtain, in the course of transition and European integra
more and more has become available to Western companies.

While Poland's eventual accession to the EU will more or less guarantee economic stability and w
ease the conducting of intra-European business, there is still a chance that the present members

negotiations will fail and accession will be postponed. When it does join the new risks will include greater competition, especially from low-cost Polish competitors, who might even expand into Western markets. In general country risk assessment involves measuring the likelihood of chang the business environment that will reduce the profitability of doing business in the country concer by, for example, increasing operating costs or reducing the value of assets. One of the most pop measures of country risk is the BERI index (Business Environmental Risk Intelligence), which includes figures on corruption, bureaucratic delays, the risk of expropriation, rules of law and so mainly consists of three data sets: a political risk index, an operations risk index, and remittance repatriation factor ratings, which together enable a composite score to be calculated (Backhaus Meyer, 1985).

Nowadays CEE country risk analysis is greatly facilitated by data collected by financial institution governmental organizations in relation to the planned EU enlargement. Ascertaining which CEE states are likely to be the first to join the EU is aided by a new risk measurement instrument developed by the German DGZ Deka Bank: the Deka Converging Europe Indicator (DCEI), whicl measures the convergence progress using macroeconomic data and institutional convergence indicators. The DCEI is based on a scoring model that leads to four indicators (real economic convergence, institutional convergence, monetary convergence and fiscal convergence) and thu some ways resembles the BERI index.

Table 8.1: Deka Converging Europe Indicators, 2010

	Total	***Real economic convergence***	***Institutional convergence***	***Monetary convergence***	***Fiscal convergence***
Czech Republic	78	85	70	95	65
Estonia	77	70	80	75	85
Hungary	77	80	80	70	80
Slovenia	76	95	85	65	65
Poland	72	60	75	80	75
Lativa	70	60	70	75	75
Slovakia	67	45	75	80	75
Lithuania	66	35	70	90	85
Bulgaria	51	30	55	70	60
Romania	40	45	50	15	75

Notes: Within the parameters of 0–100 points, status as of January 2002.

Source: Adapted from Hornung, (2002), p. 15.

The constituents of the DCEI are shown in Figure 8.2. The choice of performance figures for real economic convergence and institutional convergence corresponds to the overall EU membership criteria of 1993, as defined in Copenhagen. All five Maastricht criteria are covered: inflation, inter rate and exchange rate are part of the monetary convergence indicator, while budget balances a public liabilities relate to fiscal convergence. Each of the items in the four groups of indicators an general DCEI are ranked from 0 to 100, the latter indicating full convergence or conformity to EU average (Hornung, 2002, p. 15).

Real economic convergence:
- Gross Domestic Product (GDP) per inhabitant
- Agricultural sector's share of GDP
- Unemployment rate
- Trade volume with EU (share of total trade)

Institutional convergence:
- Economic policy
- Financial system
- Legal framework
- Number of closed chapters

Monetary convergence:
- Inflation
- Interest rate (capital market)
- Exchange rate
- Increased loans

Fiscal convergence:
- Budget balance (percentage of GDP)
- Public liabilities (percentage of GDP)
- Foreign liabilities (percentage of GDP)
- Private sector (percentage of GDP)

Source: Adapted from Hornung (2002), p. 15.

Figure 8.2: The four pillars of the DCEI. Source: Adapted from Hornung (2002), p. 15.

The DCEI figures for 2001 are shown in Table 8.1. As can be seen, Poland ranks fifth after the C Republic, Estonia, Hungary and Slovenia. According to these DCEI figures and a progress report the European Commission on the EU membership negotiations, the 10 CEE candidates are well their way to becoming full market economies. However they are not yet considered able to withst the competitive pressure that exist in the EU.[2]

With regard to the constituents of the category 'real economic convergence', unemployment and inflation have risen considerably in recent years in all applicant countries but Hungary and Slove The Polish unemployment rate rose from 13.0 per cent in 1999 to 15.0 per cent in 2000 and an estimated 17.1 per cent in 2001. However in terms of inflation Poland appears in a more positive having increased from 7.3 per cent in 1999 to 10.1 per cent in 2000, the inflation rate fell to approximately 5.5 per cent in 2001 (Ludwig, 2002, p. 14). While none of the CEE countries has managed to stabilize its public budgets, the European Commission has been particularly critical Poland's efforts. Poland's evident decline in economic growth is a result of mistakes in its econo policy, especially its failure to synchronize fiscal and monetary policy. The stabilization of public budgets is regarded as crucial by the Commission if markets are to be encouraged and investors confidence won. The Commission disapproves of the way in which competition law is practiced i the applicant states – almost without exception they are not able effectively to control the amoun allowances and antitrust laws (FAZ, 2001b, p. 15). There are also problems with industrial standardization, the protection of intellectual property, mutual acknowledgment of job qualifying degrees, and the non-existence of regulatory authorities for the telecommunication sector.

The differences in economic wealth between the EU and the applicant countries did not reduce i 2001. As shown in Table 8.2, the economic profiles of the 13 applicants differed quite markedly. Whereas Poland's per capita income amounted to only 39 per cent of the EU average, Slovenia scored higher than Greece, which was already an EU member. (Per capita income reflects the countries' economic development in terms of absolute economic performance.) GDP compositio also of interest in that a disproportionately large agricultural sector hints at structural defects. As indicated in Table 8.2, the size of the agricultural sector varies considerably between the countrie concerned. With 18.8 per cent of the working population employed in the agricultural sector, Pol obviously has structural problems. The government failed to conduct the necessary reforms (Gre *al.,* 2001, p. 192; Hare, 2001) and the agricultural sector has a strong backlog. Poland's structur problems also include marked differences between rural and urban areas. The former are disadvantaged in many respects, for example in terms of educational and medical services, wate supply, sewerage provision and communication infrastructure. Even though the EU financial aid has already been granted has not yet been utilized, the funds that will be paid after joining the E already integrated into reform project plans. Moreover the quoted GDP growth of 4.0 per cent in is misleading, since this figure dropped to just 1.0 per cent in 2001 and is expected to stay at thi level in 2002. This means that Poland ranks last of the EU applicants with regard to economic development (Ludwig, 2001, p. 14; FAZ, 2001b, p. 15; Dietrich, 2002, p. 12). Although it made excellent progress in the early 1990s, during the past few years it has suffered an economic downturn.

Table 8.2: Economic profile of applicants for EU membership, 2001

	GDP in purchasing power equivalent value				Agriculture	
	C= billion	C= per inhabitant	Per capita income* (%)	GDP growth in 2000 (%)	Share of value added (%)	Share of employme (%)
Bulgaria	44.3	5 400	24	5.8	14.5	n.a.
Estonia	12.1	8 500	38	6.9	6.3	7.4
Latvia	15.6	6 600	29	6.6	4.5	13.5
Lithuania	24.3	6 600	29	3.3	7.6	19.6
Malta	4.6	11 900	53	5.0	2.3	1.9
Poland	337.9	8 700	39	4.0	3.3	18.8
Romania	135.4	6 000	27	1.6	12.6	42.8
Slovakia	58.3	10 800	48	2.2	4.5	6.7
Slovenia	32.0	16 100	72	4.6	3.2	9.9
Czech						
Republic	135.1	13 500	60	2.9	3.9	5.1
Turkey	433.3	6 400	29	7.2	14.6	34.9
Hungary	117.0	11 700	52	5.2	4.8	6.5
Cyprus	12.4	18 500	83	4.8	3.8	9.2

*Percentage of EU average.

Source: Quoted from FAZ (2001b), p. 15 (original in the *Eurostat* from national sources).

In spite of the challenging political and economic situation depicted above, Poland can offer Wes companies numerous opportunities (Hare, 2001). When it eventually joins the EU its economic g is likely to be higher than that of the existing member countries, and the transition process has created a dynamic that should continue for some time, providing a good basis for growth. In orde capitalize fully on this economic potential, companies must choose the right strategy, the theoreti underpinnings of which are discussed in the following section.

[2]The non-CEE candidates Malta and Cyprus are in a much better position and are the only applicants to meet all the requirements of a functioning market economy (FAZ, 2001b, p. 15).

8.3 Dunning‘s eclectic paradigm of international production

Dunning's paradigm addresses the sources of competitive advantage for international operators. Compared with local competitors, a company operating abroad is faced with several disadvantages, such as lack of information, poor or no access to distribution channels and so on. In order to beat its competitors the company must be able to offset these disadvantages with competitive advantages by combining the various comparative advantage[3] identified during the first stage of the strategic planning process: the environmental and SWOT analyses. Dunning distinguishes between transactional, locational and firm-specific (ownership) advantages. The intensity and constellation of these determine both the choice of market entry strategy and the subsequent success of the MNE. The eclectic paradigm thus addresses all the interdependent factors in international operations in a systematic way.

The basic structure of the eclectic paradigm is depicted in Figure 8.3. A central assumption is that countries' factor endowments and economic and political institutions differ. This leads to a situation of market failure in which opportunities emerge to convert these failures into competitive advantages. Market failures can have structural or transactional causes that influence the nature of the advantages enjoyed by MNCs. Structural market failures arise from factors that are external to the company while transactional market failures relate to the company's operations. For example, the shortages in the communist era were related to structural market failures, while a Western company's ability to produce quality goods and services economically shows its ability to overcome transactional market failures.

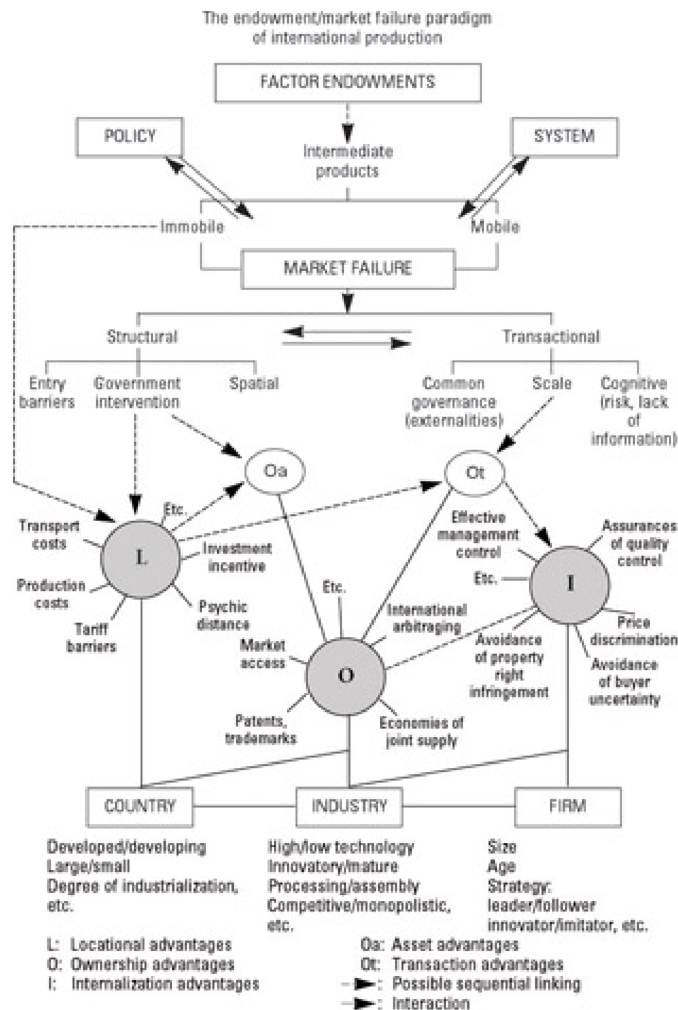

Figure 8.3: Dunning’s eclectic paradigm. Source: Dunning (1988), p. 12.

A core use of the eclectic paradigm is to determine the most appropriate form of market entry. Various partial theories, for example those of macro resource allocation and organizational economics, are included in the analysis (hence the term ‘eclectic’), so Dunning’s approach can explain more than partial theories are able to when applied alone (Dunning, 1993, p. 76). Furthermore the inclusion of trade theory, location theory and theories of competition enables conclusions to be drawn about the strength of certain categories of advantage for an MNE.[4] These categories, or ‘OLI configurations’, are the ownership advantages of the analyzed company (O), the location advantages of the host country (L) and internalization advantages (I) (see Figure 8.3 for details of these).

Ownership advantages are competitive advantages that result from a company’s special technological or managerial know-how. It is usually more difficult for foreign companies to enter a market than it is for domestic firms, and the larger the spatial, cultural and linguistic distance between the home and host country, the greater the difficulty. (This difficulty is easier to overcome for Westerners in Poland than, for example, in Russia and other countries further east due to the long tradition of Christian culture in Poland.) In order for a foreign company to succeed its ownership advantages must outweigh the obstacles of being foreign. Dunning divides ownership advantages into asset advantages (Oa) and transaction advantages (Ot). Oa advantages relate to specific assets that are not available to competitors, such as patents, while Ot advantages arise from the organization of transactions (Dunning, 1988, p. 2).

Table 8.3: Relationship between form of market entry and strategic advantages

	Direct investment	**Export**	**Licensing**
Ownership advantages	Yes	Yes	Yes
Internalization advantages	Yes	Yes	No
Locational advantages	Yes	No	No

Locational advantages are based on economic differences between nations. These country-specific advantages (such as lower labour costs in Poland) can be exploited by producing in the locations in question. Dunning outlines the importance of distinct factor endowments of different countries. In contrast to neoclassical approaches, he removes the restriction of immobile factors and allows intermediate products and know-how to be transferred across borders.

Internalization advantages can be achieved by coordinating international transactions. As a result of market failures, different forms of organization involve different transaction costs (Dunning, 1993, p. 66). Internalization advantages are therefore important when there is an incentive for a company to exploit a competitive advantage on its own (that is, by exporting or setting up a wholly owned subsidiary) rather than selling or leasing it to someone else (licensing).

The final combination of OLI advantages is determined by certain attributes of the company (for example firm size and strategy), the industry (for example intensity of technology) and the country (for example degree of industrialization). Depending on which of the three advantage categories exist in a particular case, Dunning recommends a particular form of market entry (Table 8.3). Foreign direct investment is recommended when all three advantage categories are positive. If there are no locational advantages an export strategy is preferable. If there is no incentive to profit from ownership advantages by producing inside the firm and there are no internalization advantages at all, licensing the production to a foreign company is the best solution. This leads us to the following hypothesis, which will be empirically tested in the next section: the economic competitiveness of the host country and particular firm-specific ownership and internalization advantages have a strong bearing on the appropriateness and likely profitability of the various forms of market entry, and thus on the actual market entry decision of a company.

[3]Comparative advantages can easily be obtained by any company. However in order to gain competitive advantage firms must achieve uniqueness through an advantageous combination of activities. (This argument is consistent with Michael Porter's view of successful strategies; see Porter, 1996.)

[4]Hymer's (1976) monopoly theory, for example, provides an appropriate basis for analyzing ownership advantages. Partial theories on the problem of location can be found in international trade theory (for example Ricardo, 1911; Ohlin, 1931; Heckscher, 1966) and location theory (as outlined in Tesch, 1980). Internalization advantages can be analyzed on the basis of transaction cost economics. See Müschen (1998) and Müschen and Meyer (1999) for further explanations.

8.4 Market entry strategies for Poland, empirical evidence

After the opening of the former communist CEE states many Western companies seized the opportunity to enter a new market with 330 million consumers, but they did so in different ways. In order to identify basic patterns of strategic behaviour and to test the above hypothesis, the main results of a survey of 102 Western companies operating in Poland and other CEE markets are discussed below. While the sample consisted of enterprises from different sectors, all the persons interviewed were in charge of international sales or related departments. In Section 8.4.4 we shall revisit the Beiersdorf case (Chapter 7) as it provides example of successful market entry by means of foreign direct investment.

8.4.1 Motives for market entry

Based on the eclectic paradigm, the main goal of our research in CEE was to identify the key reasons for firms' choice of market entry strategy, especially in respect of advantageous combinations of the OLI factors. The first step was to ascertain the motives for Polish market entry. The working hypothesis was that motives are determined by OLI categories and that companies with different motives for market entry choose different entry strategies in order to strengthen their competitiveness. Accordingly the interviewees were asked to assess the importance of various motives for entry into Poland. Subsequently attitude dimensions were determined by means of a principal axis factor analysis. Figure 8.4 shows the results for four factors (in accordance with the Kaiser criterion; Cattell, 1966, p. 247) and the corresponding factor correlations.

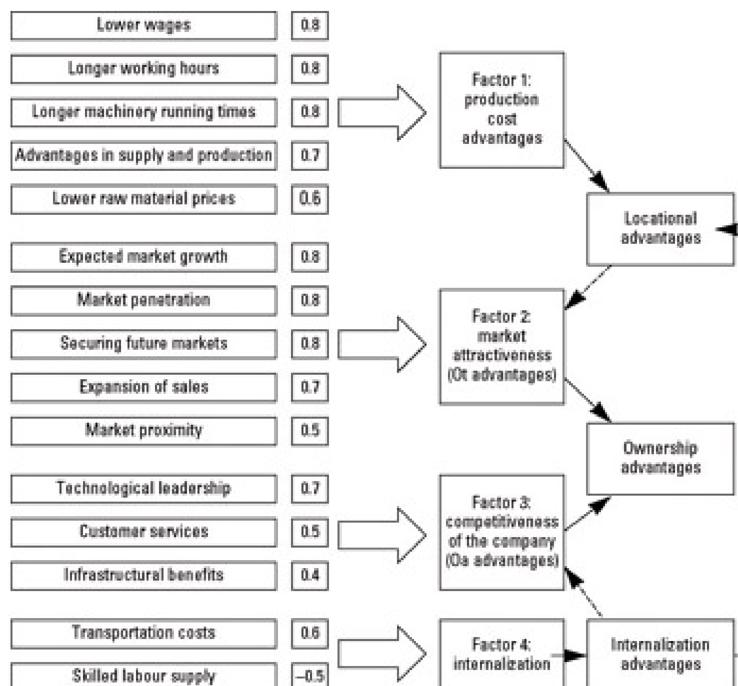

Figure 8.4: Empirically tested OLI motives for CEE market entry

Factor 1 – production costs advantages – consisted of wages and supply-side issues. The second factor – marked attractiveness – concerned expectations about the sales potential of the Polish market and the opportunities it was perceived to offer. In factor 3 – competitiveness of the company – a company's competitive advantage in technology and its customer service facilities were of particular importance to many of the firms in the sample. The items that made up the fourth factor – internalization – were inversely correlated in our

results in that transportation costs were positively valued if production was conducted in the West for export to the East, while a skilled labour supply took precedence if production took place in the East.

In terms of Dunning's approach, production cost advantages and market attractiveness can be equated to Dunning's locational advantages (L). Variables such as sales expansion and market growth (market attractiveness) might result in economies of scale and hence are also transaction-specific ownership advantages (Ot). The items in factor 3, competitiveness of the company, can be seen as ownership advantages (Oa), and internalization advantages (I) are revealed in our data on the fourth factor. Therefore the first part of Dunning's paradigm and of our hypothesis can be confirmed: there are three determinant factors in or major motives for market entry – ownership, locational and internalization advantages. The relationship between motives for entry and form of entry is examined in the following subsection.

8.4.2 Forms of market entry

Figure 8.5 shows the forms of market entry chosen by the sample enterprises. With a share of 65 per cent, export strategies were the most common way of starting business in a CEE country, followed by the establishment of a wholly owned subsidiary (60 per cent) and cooperation with host-country firms (48 per cent). Only 15 per cent acquired a business abroad. The majority of the cooperative ventures (65 per cent) were joint ventures, the rest consisting of licensing or franchising arrangements. The Western partners' equity share of the joint ventures was usually higher than 50 per cent. Forty per cent of the sample had first entered their chosen market via exports, and then moved more and more operations, such as sales and services or manufacturing, to the host country.

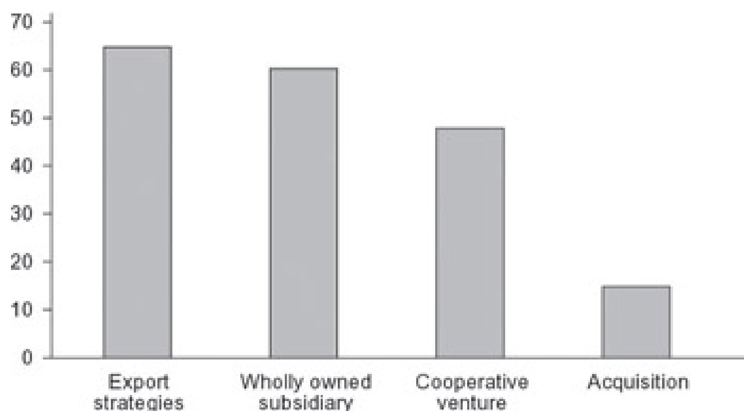

Figure 8.5: CEE market entry forms (per cent)

In our survey we paid special attention to the advantages of cooperative market entry and why it was preferred to other forms. When companies had decided against this form it was mainly because of a belief that the venture could only work if it was managed independently, and that there was a danger they would lose their exclusive know-how to competitors. Others said that it was too early to consider a cooperative venture as the market was not yet ready for it, that they had had a bad experience of such ventures in the past or that they had not been able to find a suitable partner.

As shown in Figure 8.6, the host-country partner's knowledge about market factors such as customers and competitors was the most important reason for cooperation (95 per cent), followed by speedier market entry (81 per cent), preventing attractive host-country firms from cooperating with Western competitors (68 per cent), legislative restrictions (60 per cent), tariffs and other trade barriers (29 per cent), economies of scale (28 per cent) and the reduction of financial risks (21 per cent). For the Eastern partners the most important motive for cooperating was to gain access to capital, technological and managerial know-how, and

brand names (for further analysis see Sadowski, 2001).

Where problems arose with the cooperative ventures they were mainly due to communication misunderstandings, divergent management and business cultures with disparate goals and values, and financial considerations. However not every company experienced difficulties.

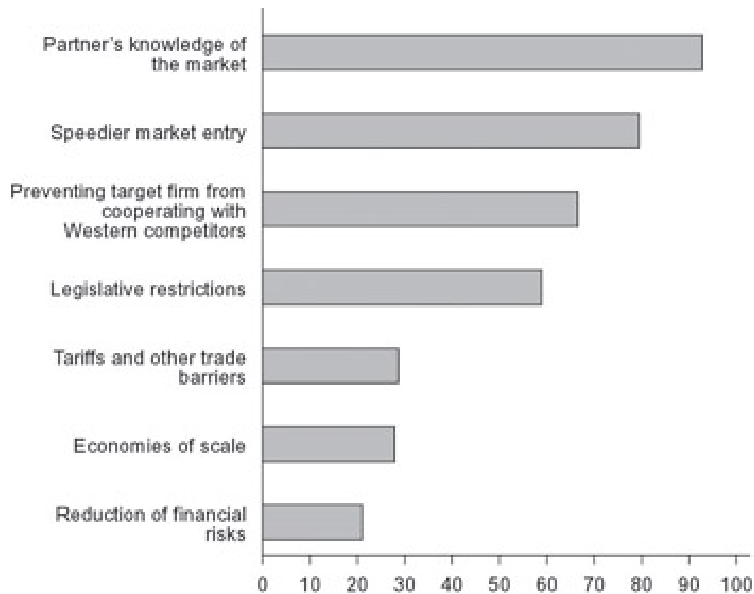

Figure 8.6: Motives for setting up a cooperative venture

In order to test the relationship between motives for market entry and form of market entry a cluster analysis was conducted to separate the sample enterprises into groups that were internally homogeneous and distinct from one another. The motive dimensions given in Section 8.4.1 served as cluster variables. With the help of the single linkage method all cases that differed strongly from the rest, and thus did not fit any of the possible clusters, were identified and excluded from further analysis. The subsequent grouping process using the Ward method revealed two major clusters. This can be rated as satisfactory according to the F-figures, which show the ratio between the variance of a cluster and the total variance of the sample and thus allow homogeneity per cluster to be checked (Backhaus *et al.,* 1996, p. 310).

The characterization of the clusters is derived from t-figures (Figure 8.7), which express standardized differences between the means per factor of each cluster and those of the sample. Positive t-figures indicate that a particular factor is of greater importance to a particular cluster than to the rest, and negative values mean the opposite (Backhaus *et al.,* 1996, p. 310 f.) As can be seen, the first cluster judged market attractiveness and competitiveness to be most important. Because 35 per cent of the firms in this cluster sold consumer goods and 26 per cent were service industries (Figure 8.8) they can be classified as sales oriented brand-name sellers. As shown in Figure 8.9, the most common form of market entry for this cluster was exporting (70 per cent). Since a number of firms decided to use more than one form of entry at the same time, overall 61 per cent of firms built a wholly owned subsidiary, 24 per cent engaged in joint ventures, 12 per cent acquired a host-country firm and the rest sat up licensing or franchising arrangements.

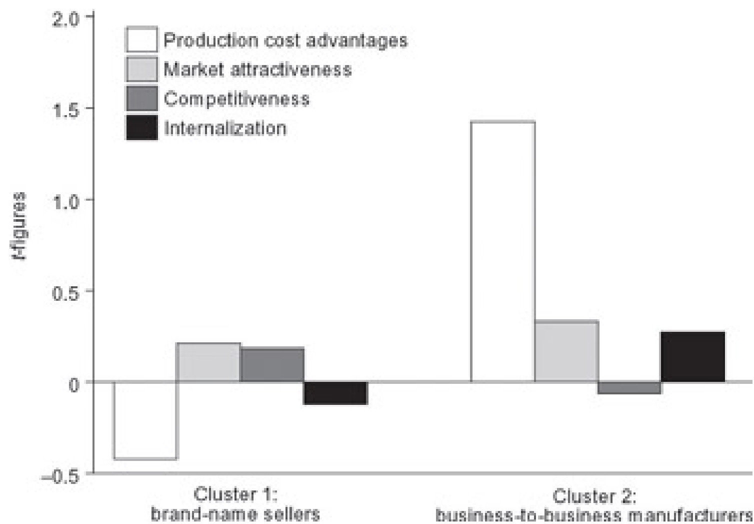

Figure 8.7: Characterization of clusters

For the second cluster production costs were the most important consideration, followed by market attractiveness and internalization advantages. This cluster was dominated by equipment manufacturers and mechanical engineering firms (45 per cent, Figure 8.8) and can therefore be labelled production- and supply-oriented business-to-business manufactures. This was mirrored in the firms' market entry choice (again, more than one form was used by a number of the firms): 73 per cent founded a wholly owned subsidiary, 55 per cent arranged a joint venture, 55 per cent exported their products, 36 per cent acquired a host-country enterprise, and 27 per cent used licensing strategies (Figure 8.9).

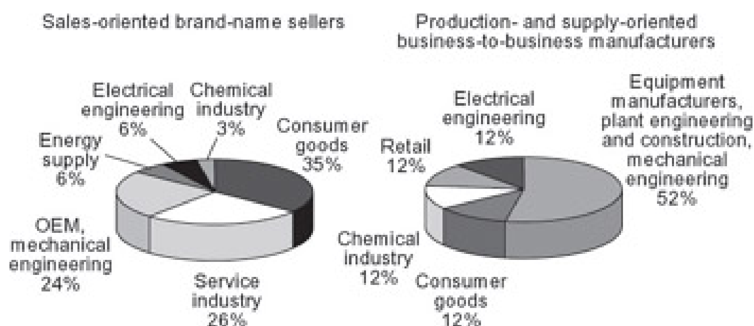

Figure 8.8: Industry composition by cluster

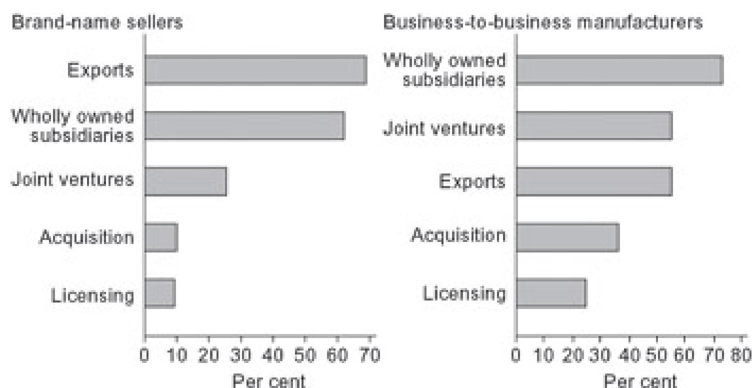

Figure 8.9: Market entry forms per cluster

The above findings confirm Dunning's propositions (Table 8.3). The brand-name sellers wanted to capitalize on their competitive advantages in attractive CEE markets (ownership advantages). Internalization advantages were of secondary importance and locational

advantages – in the form of production cost advantages – were of little concern. Hence export strategies dominated. Wholly owned subsidiaries (direct investment) came second because proximity to the customer (market proximity) was of great importance to business-to-consumer brand-name sellers (see also the Beiersdorf example in Chapter 7). Business-to-business manufacturers obviously put production cost advantages first and market attractiveness second. This led to an advantage configuration that – although different from the cluster one advantage configuration – also favoured direct investment FDI (wholly owned subsidiaries or joint ventures).

8.4.3 Influence of politics on the entry decision

Between 1995 and 2000 the volume of foreign direct investment in Poland increased sixfold. However between August 2000 and August 2001 mergers and acquisitions in CEE as a whole fell by 38 per cent to US$22 billion. With 355 contracts (worth US$4.8 billion) concluded in 2001, Poland is still considered the most attractive investment country in the region. This figure, however, represents a reduction of 65 per cent compared with the previous year. The biggest investors in CEE are from France and Germany. French companies largely buy into financial institutions, whereas German companies are mainly interested in the telecommunication industry. For example German Telekom paid US$6.6 billion for eight acquisitions between August 1999 and August 2000. Investment from Russia is still high, primarily in petrochemical sector. American investors – though still in third position – reduced their CEE engagement by 80 per cent during the period (FAZ, 2001a, p. 16).

However EU enlargement and recovery of the world economy could stimulate an investment upswing. Furthermore the present Polish government has pledged to ease the acquisition of property (agricultural land and woodland) by foreigners. Whereas the former premier favoured a changeover period of 18 years, this traditionally delicate issue will be reduced to a period of 12 years (with some further exceptions; see Flueckiger, 2001, p. 13; FAZ, 2002, p. 6).[5]

Interestingly, with the dismantling of trade barriers between the EU and Poland since its application for EU membership there has been a change in Western companies' motive for entry: whereas during the 1990s investors were attracted to Poland's low labour costs (which of course is still true today as the average income is just US$375 per month), nowadays it is the huge internal market of almost 40 million people that is attracting new investors (Knight and Webb, 1997).

With open markets Western companies often favour exporting as a market entry mode, rather than direct investment. The value of German exports to CEE rose to US$90 billion in the first three quarters of 2001, of which Poland received the second largest share (US$18.53 billion). At the same time (thanks to the comparatively high educational level) there was a shift from investment in labour-intensive industries (such as textiles and clothing) to high-tech industries. The investments by Philips and Alcatel are but two examples of the latter (Sadowski, 2001, p. 720). The market entry strategy of another company, the Beiersdorf group, whose case study stands at the centre of this book, is examined in the following subsection.

8.4.4 Beiersdorf's market entry strategy for Poland

As discussed in Chapter 7 the Beiersdorf group, the producer of Nivea and other leading branded goods, entered the Polish market by acquiring an interest in Pollena-Lechia SA (now Beiersdorf-Lechia) in Poznan in 1997,[6] and by 1998 it held the majority of shares.

The founding of wholly owned subsidiaries is the *market entry form* that is considered as most appropriate by Beiersdorf. While some managers of the subsidiaries are expatriates from Hamburg headquarters, Beiersdorf primarily employs local people. This helps Beiersdorf

being accepted by the Polish public as a local company ('insider') and it facilitates an adequate addressing of consumer and retail target groups. Employees are integrated into international project teams, which ensures a consistently standardized brand appearance, whereas some marketing parameters such as, for example local advertising can still be differentiated.

In terms of *regional strategy,* Poland is regarded as the key country to CEE markets in general. The country's strategic importance for Beiersdorf is reflected in the company's total investment of C=88 million in Poland. A new production plant was built in October 2001 and integrated into the paneuropean Beiersdorf network. Its commissioning builds another milestone in the strategic decision to reacquire the Nivea trademark rights, which in many countries had fallen into foreign hands as a consequence of World War II. The Nivea trademark rights in Poland used to be at Pollena-Lechia; 'Nivea Krem' was an already established leading trademark (Beiersdorf, 2002).

With regard to its *timing strategy*, the Beiersdorf group consequently introduces its different product lines when entering a new country market, with Nivea multipurpose cream and lotion being the first products to be brought to market. More specific cosmetics, like for example the 'Visage' product line (facial cosmetics), are launched on second place, then other product ranges follow. Currently, Beiersdorf is introducing Nivea hair care products to CEE markets.

Referring to the *market stimulating strategy*, Beiersdorf pays more attention to the quality of sales than to its quantity, in order to reach a top market position for each of its brands in every country. Yet, Nivea has reached the number one position with its skin care products in every CEE market. 'Nivea Visage' facial cosmetics, which were introduced later to the market, account six times for the number one position and three times for number two in CEE (Beiersdorf, 2002; Woelfer, 2001).

The positive start of Beiersdorf in Poland was fostered by high publicity and sympathy scores in CEE, that were due to the fact that the Nivea brand name had already been well-known in Poland thanks to the local supplier Pollena-Lechia and to license agreements in former Czechoslovakia and Hungary. Moreover, Nivea had been available in hard-currency shops during the communist regime in all CEE countries.

The formation of the Nivea brand name results from a stepwise strategic process, which is well adapted to environmental conditions of the market and to the consumers' wishes and demands. The positive future prospects for Nivea in CEE are highlighted by generally increasing per capita expenses for Nivea products. For example, Nivea per capita expenses in Russia have risen from C=0,45 in 2000 to C=0,90 in 2001. Poland already reaches C=3, in comparison to C=16 in Switzerland (Beiersdorf 2002; Woelfer 2001).

[5]Hungary and the Czech Republic have already agreed to a changeover period of seven years.

[6]According to Beiersdorf (2002), 'This means that the company from Hamburg is once again on ground that forms part of its history. In 1929 the foundation stone was laid here for a factory which was then opened in 1931. After 1945 the entire complex passed into state ownership.'

8.5 Conclusion

Companies planning to set up business in Poland must conduct a comprehensive analysis of the competitive environment in and the specific characteristics of the Polish market, and pay special attention to timing, location, market segmentation and form of market entry if they are to gain competitive advantage and create value. As shown in this chapter, any comprehensive analysis of international market entry strategies requires an integrated approach that considers all strategic parameters. Dunning's eclectic paradigm serves as a useful tool for this as it considers the relationship between competitive advantages and strategic decision making. The results of our empirical research confirm the basic elements of this paradigm. The motives for and forms of market entry into Poland can be related to Dunning's OLI configurations. Although in practice companies often use various forms of entry over time, some general patterns can be identified. It also is of utmost importance to consider the fact that the dynamics of the Polish market are constantly changing, especially in view of Poland's likely accession to the EU in the near future.

Notes

1. The applicants include Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Malta, Cyprus and Turkey. Most applicants are expected to complete their contractual negotiations by the end of 2002. Turkey, however, will not be able to start membership negotiations until certain reforms have been implemented (Auswärtiges Amt, 2001).

2. The non-CEE candidates Malta and Cyprus are in a much better position and are the only applicants to meet all the requirements of a functioning market economy (FAZ, 2001b, p. 15).

3. Comparative advantages can easily be obtained by any company. However in order to gain competitive advantage firms must achieve uniqueness through an advantageous combination of activities. (This argument is consistent with Michael Porter's view of successful strategies; see Porter, 1996.)

4. Hymer's (1976) monopoly theory, for example, provides an appropriate basis for analyzing ownership advantages. Partial theories on the problem of location can be found in international trade theory (for example Ricardo, 1911; Ohlin, 1931; Heckscher, 1966) and location theory (as outlined in Tesch, 1980). Internalization advantages can be analyzed on the basis of transaction cost economics. See Müschen (1998) and Müschen and Meyer (1999) for further explanations.

5. Hungary and the Czech Republic have already agreed to a changeover period of seven years.

6. According to Beiersdorf (2002), 'This means that the company from Hamburg is once again on ground that forms part of its history. In 1929 the foundation stone was laid here for a factory which was then opened in 1931. After 1945 the entire complex passed into state ownership.'

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Chapter 9: Marketing Strategies of Western Consumer Goods Firms in Central and Eastern Europe

Arnold Schuh and Hartmut Holzmüller

Abstract

The rapid and often drastic changes in national business environments in the course of the transition from centrally planned to free market economies pose specific challenges to Western consumer goods firms in Central and Eastern Europe. Once lured by the huge market potential they are faced with a poorly developed marketing infrastructure, price-conscious and not very brand-loyal consumers, and intense competition. When designing their marketing strategies they have to find a balance between likely returns on investment and the risks involved. Building up a local presence in a stepwise manner, transferring marketing strategies from the West in a sensitive way and developing regional management structures seem to be effective approaches for Western firms in this region.

9.1 Introduction

Most studies dealing with the massive changes in the economies and societies of the reforming countries of Central and Eastern Europe (CEE) in the years since the fall of the Iron Curtain focus on macroeconomic aspects, namely institutional reforms, their economic effects and the overall progress of the transition from a centrally planned to a market economy. Little attention has been paid to the consumer revolution that grasped the region, particularly in the more economically advanced countries of Central Europe. The economic opening of the region was followed by an influx of Western multinational corporations (MNCs), which flooded the markets with their international brands and products and introduced Western marketing methods. Developments that unfolded in Western Europe over a period of 30 to 40 years happened in CEE in just a few years. Consumer choice, in the Western sense, had not existed before: no real brands had been available, buyers had not been able to make informed choices about products or judge prices and quality, and the mere availability of a product had often been the main buying incentive in times of scarcity in the communist era. The media had been controlled by the state and contained no advertisements.

Today these markets have become – or at least on the surface – more similar to West European markets. The increased product offering, the strong presence of Western brands in supermarkets and shopping centres, mostly owned and operated by well-known foreign retailers, and Western-style advertising is noticeable when one travels through metropolitan areas of Central Europe. However from the consumer's perspective the differences from the West are still striking. Although average household incomes have risen, purchasing power is lower than the West European average. This limits the disposable income of households and leads to very price-conscious shopping. Brand loyalty is relatively low and value-for-money is the most important criterion for consumers in CEE (Shama, 1992; Schuh and Damova, 2001). This raises the pressure on Western marketers to find ways of offering their quality products to lower-income mass markets without tarnishing the brand image and selling at a loss. The desire to attract the relatively small group of consumers who can afford Western brands is heating up competition between international firms (Dahm, 1996) and CEE markets are now among the most competitive in the world. For instance 11 firms are offering 14 brands in the Polish detergent market at 30 per cent less than the West European price and marketing is far more active than in comparable West European markets. In technology-driven product markets (for example detergents, cosmetics and body care products) the competition is mainly international, but local producers are major actors in the food and beverages sector, where local tastes and a strong affection for traditional (and cheaper) local brands are challenging the marketing efforts of Western firms.

Against this background we shall now analyze the market entry and marketing strategies of Western consumer goods firms in CEE and investigate the business logic guiding these moves. Based on published studies and empirical evidence we shall focus on three issues:

- What are the right modes of entry and operation for Western firms?
- Can marketing strategies be transferred from Western markets or should highly localized strategies be adopted?
- How should Western firms organize their marketing activities in CEE?

9.2 Motives for market entry

The liberalization of the political and economic systems in Central and Eastern Europe opened a huge new market for foreign firms. In particular the enormous growth potential of the region prompted a rush into these markets in the early 1990s. The CEEC-10 alone – consisting of the more economically advanced countries of Central Europe (Slovenia, Hungary, Poland, Czech Republic, Slovak Republic), the three Baltic states and Romania and Bulgaria – constitute a consumer market of about 105 million people. When the countries of former Yugoslavia, Ukraine and Russia are added the number rises to 325 million people, close to the 370 million in the EU-15. GDP growth rates are expected to rise above the EU average in the course of the catching up process.

The prospect of building a market almost from scratch fuelled the expansion to the east. However the average consumption of typical consumer products such as toiletries, beverages, confectionary, detergents and household cleaners is still well below Western levels and a considerable proportion of people still have no insurance cover or cheque accounts. Therefore it is no surprise that entry into these markets was and still is market driven (Engelhard and Eckert, 1993; EBRD, 1994; Wes and Lankes, 2001).

In the case of European and global MNCs that are major players in oligopolistic industries, competitive considerations are important drivers too. ‘First mover advantage’ is seen as vital to success in CEE (Quelch *et al.*, 1991; Schuh and Damova, 2001) as first entrants can outmanoeuver their competitors by occupying ‘first in the market’ status in consumers’ minds, blocking access to marketing channels or buying leading local firms to secure local production facilities, established brands and the existing customer base. More recently a quicker and less cautious entry pattern has been exhibited by Western companies in the countries of Eastern Europe (for example Ukraine) and South-Eastern Europe (Bulgaria, Croatia, Bosnia-Herzegovina). The major players in the region are now fighting for dominance and are trying to complement their existing Central European operations. Having a presence in these new markets is regarded as a strategic necessity and this seems to outweigh the rather low attractiveness of certain country markets. Production-oriented considerations also play a part as the lower local production costs allow Western firms to service price-sensitive mass markets that could not be covered by exporting.

9.3 Market entry strategies

Market entry into the CEE countries more or less conforms to the modes laid down in internationalization theory, which is based on the experiences of European and US firms in Western Europe and other parts of the world in the 1970s. The dominant tendency is to increase resource commitments gradually over time (Engelhard and Eckert, 1993; Schuh *et al.*, 1994; Shama, 1995). Three major entry modes have been popular among Western firms: exporting, forming a joint venture with a local partner, and acquiring a local firm in the course of the privatization process.

International companies start with less risky entry modes such as exporting. Exporting to retailers or wholesalers presents the lowest financial risk and provides companies with valuable feedback on the acceptance of their products and the effectiveness of their sales tactics in the market in question. When sales rise and the local business outlook is favourable, companies may invest more in the market and open a representative office or a sales office. Representative offices allow companies to gain more information on the market, to educate customers and middlemen, and to secure better control over their marketing efforts. If the business develops according to plan the office may be transformed into a marketing and sales subsidiary, and parts of the production process (for example assembly or component production) may be shifted to the CEE.

The example of Philips Consumer Electronics depicted in Figure 9.1 can be regarded as a typical entry sequence in the mid 1990s. It also highlights the correspondence between level of commitment and the perceived economic development and political stability of the entered countries.

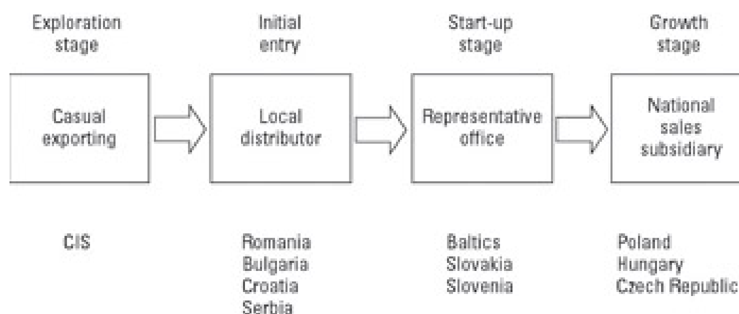

Figure 9.1: The entry of Philips Electronics into the CEE countries

Besides exporting, joint ventures between Western and CEE partners have been very popular (Shama, 1995). There are several reasons for the attractiveness of joint ventures. At the beginning of the 1990s, in some countries (for example Russia) foreigners were not allowed to be the sole owner of a domestic company. Even where full ownership was permitted joint ventures were viewed as an effective mode of operation in non-transparent business environments such as economies in transition where a strong local partner's knowledge of the market and business customs, integration into the local business network and relationships with government officials were valuable assets for the foreign investor. Moreover it was often politically impossible or unwise to sell an established national flagship company to a foreign investor. Although the people in CEE were aware of the economic stimulus generated by foreign direct investment they were emotionally averse to the sale of their country's 'crown jewels'. A joint venture where a major stake remained with local owners, mostly state agencies, gave the impression that local representatives still had a say in the company. However a look back tells us that most of the joint ventures were only temporary in nature. Local partners acted mostly as caretakers, knowing full well that in order to survive they depended on the capital, management know-how, technology and business network of the

investor. Success stories such as the acquisition of the majority share of the Czech car manufacturer Skoda by Volkswagen, and of the Slovak white goods producer Tatramat by Whirlpool Europe, show that major restructuring efforts and the subsequent turnaround happened only after the foreign investor obtained a qualified majority or full ownership of the firm.

When the privatization of state-owned companies began in the mid 1990s, the sale of large national companies offered a unique opportunity for established foreign companies to expand their market position and for new entrants to become major players in the market. While internationalization theory presupposes a trend from exporting to local production, the pattern in CEE was not uniform and differed by country and industry. Local production by foreign firms was more common in the consumer goods industry, where mass markets were served and therefore geographic coverage was important (for example in the case of retail outlets, breweries and petrol stations), and of course in financial and other services and telecommunications. The cultural rootedness of products such as chocolate, dairy products and beer in terms of taste and regional identity made local producers attractive takeover candidates for foreign companies, and major players such as Nestlé, Unilever, Kraft Foods and Danone seized the opportunity offered by the privatization process to establish a presence in the region.

Nowadays entering CEE markets has become more costly and difficult, new entrants are faced with stiff competition from well-entrenched international competitors and well-known local brands have already been bought up, although new local companies are mushrooming. Advertising prices have soared, making media campaigns more expensive. However, as retailing in CEE has been Westernized in the last few years (with the arrival of Metro, Carrefour, Tesco, Rewe/Billa, Spar and so on), entry via a retail partner has been another market entry option. The idea here is to capitalize on good business relations with Western retailers in the home market by following them into the CEE region. Exporting through a middleman suits producers of consumer goods aimed at upper market segments (for example spirits, confectionary, cosmetics) whose growth is highly dependent on overall economic development and where sales volumes are still very small. For smaller MNCs that cannot afford huge up-front investments the incremental approach offers a good balance between returns and risks.

9.4 Marketing strategies

A major consideration when entering a foreign market is the degree to which a marketing strategy used successfully in the core market should be adapted to the business environment and market conditions in the target market (Hooley, 1993). The main elements of this strategic marketing decision are the choice of target segment, the positioning of the product *vis-à-vis* local consumers and the selection of the marketing programme. By varying these factors it is possible to develop marketing strategies that are tailored to particular local markets. As there are huge gaps in purchasing power and overall market development between CEE and the West, at first sight a differentiation strategy seems most appropriate. The average GDP per capita, in purchasing power standards, ranges from 23 per cent of the EU-15 average in Bulgaria, 29 per cent in Romania, 48 per cent in Hungary to 60 per cent in the Czech Republic and 68 per cent in Slovenia (Eurostat, 1998). However efficiency considerations and the tendency towards more homogeneous global brand strategies are limiting the scope for local customization.

Parallel to the political and economic liberalization of the CEE countries there has been a strengthening of the market globalization perspective and global business logic (Schuh, 2000; Kozminski and Yip, 2000). World markets and consumer behaviour are viewed as increasingly converging, which is enabling internationally operating firms to adopt a more standardized marketing strategy worldwide, including CEE. Most of the marketing strategies of Western MNCs belong to one of three types:

- Transfer of Western strategy.
- Multitier product and brand strategy.
- Regional strategy.

Transferring the strategy used in Western markets is typical at the entry stage as it is not sensible to enter a market with an adapted product and a highly localized marketing programme (Arnold and Quelch, 1998). Adaptations are made only if they are not too costly. This is especially important in high-risk environments such as transition economies as firms, especially small and medium-sized ones, do not wish to invest heavily in product adaptations when the return is unclear, and the need for economies of scale prohibits costly variations in products and packaging. Core elements of the marketing mix – the product itself, packaging and advertising – are increasingly centrally determined and cannot be changed by the local management, although labelling, package design, package size and the name of the product sometimes have to be changed to meet local legal requirements (if not yet incorporated into the global or regional brand concept) and instructions have to be translated into the local language. Package sizes are often smaller in CEE because most households cannot afford to buy large quantities without reducing their spending on other necessary products. For instance Pampers disposable nappies can be bought singly in Bulgaria and shampoo and instant coffee are available in small sachets.

While exporting reduces the risk involved it also limits the scope for customization. However the Western origin of products is of appeal to consumers in CEE (Johnson and Loveman, 1995) who are familiar with Western brands from trips to the West or from media coverage, and are willing to pay a higher price for them, or at least as long as the price–quality ratio in relation to locally produced goods is considered fair. In combination with exporting, transfer of the Western strategy works well when product markets are small or just beginning to emerge, when local usages are not markedly different from in the West and when the product's superiority (in terms of quality, performance or image) is obvious to local target groups. Then the only obstacle to local expansion of the business is the high price.

Prices in CEE markets tend to be in line with those in the West and are not usually adjusted to the lower local purchasing power levels. The additional costs of exporting (transportation, taxes, import duties and so on) and the threat of re-export to the West by Europe-wide wholesalers or retail chains restrict the room for downward price adjustments. Even MNCs which manufacture global brands at lower cost in CEE have to follow the global pricing policy and are not allowed to offer these brands at reduced prices which are more in line with local purchasing power levels.

In their pricing decisions local managers often have to comply with 'European price corridors' that limit the maximum reduction from the highest price in Europe to 6–8 per cent. This does not reflect the differences in purchasing power between Western and CEE countries, and thus hampers or slows the expansion of the international brand business. To compensate for this, Western MNCs often switch to a so-called multitier brand and product strategy, in which well-known local brands are marketed alongside the international brands (Batra, 1997; Schuh, 2000). Typically such brands are acquired by an MNC through the purchase of a local firm. While the international brands cater to the luxury end of the market, the revamped local brands are aimed at the low- to medium-price segments (Table 9.1). The value-for-money local (and often regionalized) brands – are an extremely effective vehicle for opening up price-sensitive mass markets.

The 'portfolio' concept used by the German firm Henkel is a good example of a multitier brand strategy. Henkel divides the detergent market into three price tiers:

- Premium: brands such as Persil are promoted as offering top quality performance and are priced comparably to the West European levels.
- Medium: acquired local brands (Palmex, Tomi) are aimed at traditional, brand-loyal customers and are priced about 20 per cent lower than their counterparts in the premium range.
- Economy: new brands such as Rex are aimed at highly price-sensitive consumers and are priced about 40 per cent lower than the premium brands.

The incorporation of Western quality and modern image into reasonably priced products that meet local demands is very appealing to local consumers. From the perspective of Western MNCs, the parallel coverage of all market segments gives them some protection against fluctuations in demand, which can be dramatic in transitional economies as economic slumps usually lead to extreme cut-backs in household spending. Under budgetary pressure households will switch to the MNC's cheaper products and therefore will not be lost as customers. A diversified brand portfolio can also help to secure economies of scope in local production and logistics, to strengthen bargaining power *vis-à-vis* suppliers and retailers, and to fund the introduction of international brands to the local market. However, in strongly culture-bound product categories such as beer the major demand is still for local brands and international brands are less popular in most CEE countries.

Table 9.1: Brand portfolios of selected firms following a multitier strategy in Central and Eastern Europe

	Product category	**International brands**	**Examples of regional or local brands in CEE**
Henkel (Germany)	Detergent	Persil	Orion (Poland) Palmex (Czech Republic, Slovakia) Tomi (Hungary) Rex (throughout CEE)
Procter & Gamle (USA)	Detergent	Ariel	Tix (Czech Republic, Slovakia) Bonux (throughout CEE)
Kraft Foods (USA)	Chocolate	Milka Suchard	3Bit (Czech Republic, Poland, Hungary) Poiana (Romania) Svoge (Bulgarian)
Nestlé	Chocolate	KitKat	Orion (Czech Republic, Slovakia)
(Switzerland)	Sweets	Nestlé Polo	Boci (Hungary) Sfinx (Czech Republic, Slovakia)
Interbrew (Belgium)	Beer	Stella Artois, Beck's	Klinskoye (Rumania) Borsoni Sör (Hungary) AstikA (Bulgaria) Ozujsko Pivo (Croatia) Niksico Pivo (Yugoslavia) Chernigivski Pivo (Ukraina)
BBAG (Austria)	Beer	Zipfer Kaiser Gösser	Silva (Romania) Soproni aszok (Hungary) Starobrno (Czech Republic), Van Pur (Poland)

When considering whether to keep the existing brands or to introduce new ones managers are faced with cost issues. The sales volume of a local brand is often too small to generate sufficient profits to cover the cost of upgrading and relaunching the brand, especially, when it is aimed at the lower end of the market. Regionalization is often seen as a solution to this problem. The centralized production of products for a group of country markets allows firms to realize economies of scope and scale, as well as the opportunity to cater to regional preferences and tastes in product design or formula. Kraft Foods' 3Bit chocolate bars and detergents such as Procter and Gamble's Bonux and Henkel's Rex are now produced for several CEE markets after a successful start as local brands. The basic product technology is made available by the parent company and then adapted to regional needs. In order to improve efficiency the production sites are specialized by product line and are integrated into the regional or global production network of the multinational group. Regional free trade arrangements such as the Central European Free Trade Area (CEFTA) facilitate the development of such regional production networks. The planned eastward expansion of the European Union has also accelerated the use of CEE production sites as export platforms for Western European markets.

The current marketing practices of Western MNCs in the region provide a good picture of how localization is handled under the conditions of globalization. Marketing decisions in local markets are strongly guided by efficiency motives. Strategic considerations such as cost reduction by procuring and producing locally and saving costs and strengthening the impact of the brand by leveraging existing Western product and brand concepts often outweigh more market-related aspects such as adapting the products to local consumer tastes and preferences. This logic can be often found in small or strategically unimportant markets of the region.

Team LiB

9.5 Implementing marketing programme in CEE

Designing a business and marketing strategy for CEE operations is not only about choosing the right structure (in terms of formal definition of responsibilities and lines of reporting), but also about managing the decision-making and implementation process. This includes decisions about the composition of local management boards (locals versus expatriates) and the degree of autonomy headquarters should grant to local managers.

Different Western firms organize their CEE marketing efforts in different ways. Some choose to run the operations from headquarters or the home office. This is typical for the early stage of market entry when products are sold through local distributors or a company-owned sales office. In large firms the international division or the European group is made responsible for the operations, which ensures that the CEE strategy is integrated into the overall international or European strategy and pooled know-how is available during the preparations for market entry. One problem with this approach is that large international divisions tend not to pay sufficient attention to small CEE markets and therefore MNCs can easily forfeit opportunities to competitors who recognize the strategic importance of the region.

Another option is to assign a regional management mandate to an established subsidiary located close to the region. For example, companies like Henkel, Philips Electronics and Beiersdorf made use of the business relationships of their Austrian subsidiaries with firms and trade organizations in the neighbouring countries of CEE that existed already before 1989. Thus, the knowledge about the business in the region and the contacts of the Austrian management provided a pioneering advantage for these Western companies after the fall of the Iron Curtain. The advantage of this approach lies in the faster response to rapidly new sales opportunities in CEE (often the Austrian management initiated the entry into those markets) and form a coherent strategy for the region. Such shifts of responsibility from the international division to the regional management centre frequently run parallel to a changeover from opportunistic to strategic behaviour in the region, with the regional management centre taking charge of the development and implementation of a regional strategy. This makes sense when there is a certain degree of homogeneity among the countries of the region in terms of culture and economic and market development, and when a common regional strategy can be expected to produce synergies and economies of scale. Typical tasks include the coordination of production and logistics; making key decisions about the brand portfolio (the mix of global, regional and local brands), product introductions, the development of regional brands and advertising campaigns; the setting up of operations; the selection and training of local managers; and the provision of on-the-spot support to local teams' marketing activities.

When planning to enter a CEE country it is common practice to set up a team to select a target country, make the preparations for entry and find suitable local partners (distributors, dealers, suppliers). Local partners are important in countries where the market structures and institutions are not yet fully developed and numerous local peculiarities exist as they can act as interpreters of local business customs and facilitate access to the relevant authorities, established businesses and customer bases.

When it is decided to invest directly in a subsidiary or acquire a local firm, in the initial stages the presence of expatriates is required to take care of the transfer and implantation of the corporate culture, management style and management processes (planning, budgeting, reporting, remuneration, information dissemination, quality standards, the selection and training of staff and so on) and to maintain control over the local operations. In the case of the acquisition of a former state-owned company, the management team has to initiate and quickly implement a change and integration programme, with particular attention being paid to the timely integration of the local unit into the corporate group. The management's task is to instil a market and profit orientation, improve overall productivity, trim down the product

portfolio, revitalize sales and develop brand management. Cooperation between subsidiaries is also very common in this start-up phase. Nestlé uses a 'patronage model', whereby a West European subsidiary provides operational assistance to a CEE sister company. For instance, Nestlé Austria has supported and advised the Hungarian subsidiary in areas such as market research and packaging design, as well as providing managerial assistance for a short period. This is an efficient and flexible way of distributing know-how and resources within a corporate group.

When the expatriate managers have completed their tasks they are gradually replaced by local managers (Lawrence and Vlachoutsicos, 1993). Just after the fall of the Iron Curtain there was a shortage of local managerial talent, and this was the main reason for the considerable transfer of Western managers to CEE operations. Since then, however, the provision of Western management training has boomed in the region, and colleges, universities and management training institutions are producing an abundant supply of junior managers and are updating and improving the skills of more senior managers (*Economist*, 5 January 2002, p. 27). An added bonus for MNCs is that these young managers are less expensive than non-locals, with their generous 'expatriate packages'. While the transfer of Western managers to CEE is declining there has been a growth of managerial exchange within the region. It is difficult to find managers in the West for assignments exceeding a few weeks in East European countries such as Belarus, the Ukraine or other ex-Soviet republics in Central Asia. Harsh living conditions and a poor command of the local language are barriers for the transfer. However, it is more likely to come across a candidate with close cultural ties to the Ukraine or Belarus among the managers of the Polish subsidiary or to find someone among the local management in the Hungarian subsidiary for an assignment in Romania. This intraregional managers' exchange also fosters a stronger regional identity among MNC subsidiaries.

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Chapter 10: The Development of the Retail Sector in Poland since 1990

Tomasz Domanvski

10.1 Methodology

The author bases his conclusions on empirical research carried out under the European ACE program (1996–8) using in-depth interviews completed by direct observations of Polish and international retail enterprises. A broad range of information regarding the strategies of the retail enterprises operating in Poland has also been used.

The first section of the chapter identifies several different strategies of Polish retail enterprises to adapt to the changing conditions in the industry during the transformation process. These strategies range from the independent development of small-scale retail outlets after privatization to franchising concepts and integration into a large international retail network. The second section of the chapter describes the approaches undertaken by foreign-owned retail chains to adapt entering the Polish market during this period.

10.2 Facing fragmentation: Polish retail enterprises formulate new strategies

A detailed observation of the evolution of Polish retail enterprises after 1990 indicates a radical move away from state-controlled integrated structures toward individual solutions. This model of development of Polish trade stemmed from a rapid decline of the state-owned and co-operative trade enterprises, which were replaced with an atomized structure based on a large number of small independent private retail businesses. The number of these independent businesses reached nearly 410,000, equivalent to an increase of nearly 60 per cent between 1991 and 1998 (*Statistical Yearbook of Poland*, 1999: 432). It is also worth highlighting that small and medium-sized trade enterprises (SMEs, up to 9 employees) accounted for over one-third of all Polish SMEs. In 1998, 95 per cent of the sales turnover in Poland was generated by the private sector (*Statistical Yearbook of Poland*, 1999: 432; *Statistical Yearbook of Poland*, 1993: 392).

10.2.1 Privatization in the Polish retail sector and its consequences

The decision for a radical privatization and de-concentration by the Polish state and co-operative trade taken in 1990 had several important aspects. First of all, it meant the clear rejection of the option of reforming the state-controlled centrally planned retail system as a whole. This was based on the assumption that large state and co-operative retail enterprises could not be reformed and that they would be unable to adjust swiftly to the new market environment. Secondly, the idea of selling off the national and regional retail systems to strategic investors was also rejected. Instead, Poland opted for a model of individual privatization and de-concentration of retail industry. Independent entrepreneurs, predominantly former shop or warehouse managers, were the main target group of this privatization process. They had relevant market knowledge, experience in the Polish retail sector, and a functioning network of contacts with wholesalers. This privatization model was supported by the rapid creation of adequate conditions for private business development in the retail industry which turned out to be a crucial element in the transformation of the entire retail industry in Poland. With the choice of this model of privatization and de-centralization, the large-scale retail conglomerates which had been established under the planned economy system temporarily disappeared from the market. This had significant consequences for the future model of development of foreign retail chains in Poland.

10.2.2 Independent entrepreneurship

The early model of transformation in the Polish retail sector was predicated on the assumption that independent small business would be the most successful. This assumption became the basis for building a new type of retail enterprise (Domanski, 1992: 57–66).

This model had a direct link with the tradition of free trade, which was interrupted in Poland after 1948 and, subsequently, was cultivated only on the edge of the centrally planned economy. At the same time, it must be stated that the private sector, although in a rudimentary form, did function in Poland throughout the period of the so-called 'socialist economy', unlike other states of Central and Eastern Europe (Domanski, 1996: 96–8).

The Polish model of transformation rejected public ownership in commerce. The idea of having commerce gradually reformed and adjusted to the new conditions was given up in favour of a rapid and irreversible privatization. However, the intensive development of independent and private trade also strengthened the feeling of reluctance towards various forms of integration of businesses. The need for independent entrepreneurship excluded the

notion of integration for the majority of Polish small businesses.

This approach emphasized the need for internal development of small retail businesses. However, after 1990 in Poland, this model required time and capital resources as well as a certain readiness of the entrepreneurs to implement such a strategy. The author has come to an explicit conclusion: only a limited number of small entrepreneurs met the conditions necessary for achieving a dynamic development of their enterprises. It seems that in the case of trade, these barriers are often more serious than in the services and production sectors. In particular, this refers to the stage when a small-scale business seeks to compete with a retail enterprise operating in a medium or large-scale network. At the same time, the new category of Polish independent entrepreneurs were very sceptical about their mergers with foreign or domestic partners. Initially, this approach resulted from the lack of foreign competition on the Polish market (1990–4) as far as the retail sector was concerned. Owners of small retail firms set themselves short-term objectives, and they continue to do so. They refrained from considering a long-term development strategy for their firm and often underestimated the consequences resulting from the entry of large foreign retailers onto the Polish market. The Polish model of transformation revealed that small retail businesses were not good at long-term planning (from three to five years) and setting up integrated strategies of development. They were often unaware of the size of the challenges posed to their sector (at least through 1998–9).

This explains their reluctance to use a model of growth based on the concentration of businesses and an integrated system of management. Additionally, the lack of Polish managers who were specialized in managing integrated retail chains formed another barrier for a broader use of this model of growth.

10.2.3 Integration as a defence strategy

The development of 'bottom-up' forms of horizontal and vertical integration among Polish retail firms has been precipitated by the strategies exploited by large international retail networks (particularly after 1997) (Domanski, 2001: 1–41).

This was a characteristically defensive response to the strong position of international networks and potential threats resulting from their further growth. A delay in this process was caused by underestimating both the speed and the size of those challenges. It resulted once again from a very local strategy of the majority of Polish retail enterprises and from their short horizon for setting objectives. A tactical way of thinking with a maximum horizon of one year was predominant and typical for small retail businesses.

The development of the defensive strategies accelerated slightly with a weakening role of wholesalers and the fact that this group of firms had to look for a new strategic position in the market channel. Wholesalers, wholesale and retail firms, and associations of retailers with the greatest foresight initiated integrative links and were ahead of those who persisted in the older patterns of economic behaviour.

The activities undertaken by wholesalers or wholesale–retail firms trying to secure for themselves the function of the integrator of the market channel were highly efficient, as they had the dominant position in relation to a specific group of retailers on local and regional markets.

These attempts to adjust were often hindered by a shortage of capital at the disposal of Polish entrepreneurs, and their lack of readiness for friendly and strategic co-operation within a larger organized structure. Apart from the conflict of goals and interests, there was simply no precedent in Polish business culture. Processes of horizontal integration of retailers based on the principle of voluntary networks occurred even later owing to significant differences in the goals of the parties and the lack of skill in developing common objectives. A researcher of the integration processes of various groups of Polish retailers may conclude that one of the

main obstacles for their development was a lack of positive examples in the area of harmonious co-operation. These forms of integration were thus introduced with far greater efforts than those inspired by the international franchisers (see below).

After a two–three-year incubation period, many Polish entrepreneurs saw the strengths of co-operation, but again conflicting interests of directly competitive wholesalers and retailers were a key problem. It seems that only the choice of non-competitive entities with similar parameters guaranteed a coherent strategy. The most efficient stages of the integration concerned the organization of the process of supply, negotiations with suppliers, joint marketing activity and establishing a unified image of the network. In 2002, one may already talk about positive effects of this integration. Associations of retailers (varying in size from 200 to 1000 entrepreneurs) currently operate all over Poland.

10.2.4 Prepackaged retail chains

This strategy was adopted by only a few Polish enterprises. In this model of integration, an integrator established a larger structure within two to three years, which could then be sold profitably to a foreign investor: the integrator sowed ‘a seed’ of the retail chain, which was refined by a foreign strategic investor. This strategy assumes that only a Polish company knows the actual market conditions and can carry out rapid integration processes and establish a new type of retail chain in a short period of time. In an excessively fragmented market, a foreign investor obtained access to a larger network by purchasing a firm prepared in this way. At the same time, this model could also prove ineffective: the acquired chain might, in fact, be a set of poorly managed and wrongly selected retail units. The strong diversity of the units in such a network could pose a problem to its management, and the number of units within the network did not always reflect the quality of the system of management.

The Polish company Elektromis is a good example of the effective use of this ‘pre-packaged integration’ strategy. It established two forms of integrated chains ‘for sale’ to two foreign investors. In 1995, it sold Eurocash, a network of cash and carry wholesale warehouses, to the Portuguese group Jeronimo Martins, and in 1998 a network of 363 discount stores Biedronka (‘Ladybird’) to the same investor. Elektromis continues to develop its ‘convenience-stores’ chain, with plans for expansion to include 1800 franchisers. One may speculate that at the time of completing the process of integrating these shops, their network will also be offered for sale to a foreign investor. Observation of the strategies used by Elektromis indicates its growing professionalism in developing increasingly improved concepts of networks for sale.

10.2.5 Resistance by small retainers

This type of strategy is characteristic for Polish retail enterprises. This group mainly includes independent merchants, who do not want to adjust to the changes occurring on the market. These small firms, which are often ‘bazaar-like’, have a negative attitude toward foreign retail chains and want to block the process of their development. At the same time, they are not ready in terms of capital, management skills or organization to initiate any positive actions which would enhance their own competitive position. This group of entrepreneurs clearly wishes to ignore the changes occurring in the market. Similarly to France and other EU Member States, this group has a powerful lobby that promotes a negative attitude to modern forms of large-scale, integrated retailing.

This refusal to adjust to the changing retail environment and growing competition found support from local authorities that provided them with preferential conditions (for example, preferential rules of purchasing and leasing land, premises, and preferential rules of access to credit) that enable them to run small retail businesses in a manner that might otherwise prove non-competitive. This category of merchants does not present any positive vision of

development of their own firms, and since they are not ready to bear investment expenses, they adopt a strategy of survival, rather than adjustment or innovation, in the market.

10.2.6 Franchising strategies (2000–5 and later)

A lack of faith in the potential independent development of their own firms makes some Polish entrepreneurs get involved in the international franchise networks seeking to expand in the country. These independent retailers have a good knowledge of the local market and its strengths and weaknesses. Their decision to join a foreign franchise chain is due to a proper assessment of their own potential. This group of entrepreneurs also has the necessary resources for efficiently running their own businesses. In addition, these firms are often more open to partnership and transfer of modern managerial skills. It seems that with the use of a strict pre-selective procedure, it will be this group that will create a real symbiosis of Polish enterprises and foreign networks. These entrepreneurs are very realistic when assessing problems for running an independent business in the strongly competitive market.

It seems that this model will develop very rapidly between 2002 and 2005, owing to an invasion of foreign franchise networks (Intermarché, Spar, Leader-Price) and to a stronger pragmatism of Polish entrepreneurs. The involvement of Polish entrepreneurs in establishing Intermarché, an international network of supermarkets since 1996, is a positive example of this strategy (*Zycie Handlowe, 2001*: 9).

This formula of franchising provided Polish entrepreneurs with a safe model of development whereby they could combine the elements of the independent business activity with the strengths of an integrated network. In addition to the transfer of know-how, the new quality of these links is also determined by the agreements of Polish entrepreneurs participating in the management of the integrated network. According to the international rules of the Intermarché group, each member of the network contributes one-third of their time to perform managerial functions for the network, which is in addition to the time spent on their own business. This formula is very important for Polish entrepreneurs, as it teaches them positive ways of combining their individual business interests with the interests of the network as a whole.

10.3 From scepticism to accelerated innovation: strategies of the international retail networks

This part of the chapter aims to demonstrate how foreign retailers have changed their approach over time in dealing with the Polish market. Initially, international retail chain operated on the false premise that if Poland's economic development lagged thirty years behind Western Europe, then Polish consumers' sophistication must also be thirty years behind the times. This was, most certainly, not the case. Strong competition forced international retail chains to develop far more innovative initiatives for the Polish market than they had expected in the initial stages of internationalization in the newly emerging markets (see Table 10.1).

Table 10.1: Largest European networks in Poland, 2000

Network	Firm	Net turnover (million C=*)	Number of shops	Productivity (C=/m^2)	Profit before tax (per cent of turnover)
Makro	Metro	1632	19	–	2.6
Real	Metro	744	24	4182	–6.9
Géant	Casino	586	12	4448	–2.0
Hit	Dohle	439	13	5124	0.1
Carrefour	Carrefour	369	8	4638	–2.6
Auchan	Auchan	311	8	4936	–1.1
Tesco	Tesco	281	10	3659	–9.9
Leclerc	E.Leclerc	273	8	6301	–1.2
Hypernova	Ahold	122	9	3436	–7.1
Jumbo	Jeronimo				
	Martins	107	5	–	–2.6

Note: *Estimated data

Source: Commerzbank Securities and Handel (9/2001, p. 8).

10.3.1 Delayed entry on the Polish market

The strategy of large foreign retailers toward the Polish market soon after 1990 may be described as sceptical and anticipatory. They underestimated the market potential and believed that the process of transformation from a centrally controlled to a free market economy would be only temporary, and therefore reversible.

Large European retail chains on average need three–five years to make the decision on entering a new market, thereby inhibiting their ability to respond quickly to the new opportunities in Central Europe after 1989. This market had not been included in their earlier plans of expansion, that targeted mainly South America and Asia. The retail chains which noticed the potential of the Polish market first were the retailers with strong international

orientation (such as Makro Cash and Carry, a Dutch network), and the chains for which Poland could become the starting point of their future internationalization (Dohle Handel, a German network, and Billa, an Austrian chain of supermarkets). Therefore, they belonged to diametrically opposite categories, with highly different experience in internationalization.

10.3.2 Exporting an outdated retail concept

The widespread assumption about Poland's backwardness in the development of retail infrastructure led some of the international retail chains to favour a strategy of exporting to Poland a format of stores that was developed in the European Union in the 1960s and 1970s and characterized by extensive floor spaces. The simple mechanistic transferral of this strategy was based on the expectation that the gap of thirty years in the development of the Polish retail infrastructure automatically justified exporting a rather primitive and outdated version of retail premises. This type of thinking was, however, a misconception of the actual situation on the Polish market and its future development.

The introduction of a retail outlet with extensive floor space, in the version already in the final phase of its life-cycle among EU states, created a cognitive dissonance among urbane Polish consumers. Those shoppers were very familiar with more modern types of retail outlets in EU states and unimpressed with the 'downscale' retail format established in Poland. In contrast to certain imported products that found favour among Polish consumers, only the most modern format (i.e. with the potential to remain competitive in the market for at least the next 10–15 years) would become a suitable subject of transfer.

The concept of large-surface retail in the outdated version proved to be short-sighted. The French retailer Leclerc, for instance, used this approach when it opened the first hypermarket in the centre of Warsaw. The very simple and economical outlay of the hypermarket failed to please Polish consumers, who expected that a foreign retailer would provide them with a new format, a symbol of the larger economic transition going on throughout the country and synonymous with the promise of a better future. This mistaken promotion of the 'poor formula of hypermarket' seems to have resulted from an inappropriate assessment of market expectations carried out by advisors coming from the circles of emigrants who had left Poland in the early 1980s and remembered the country where people had significant problems with meeting elementary needs and for whom low prices of goods were a key variable when making their buying choices.

It was not accidental that this type of mistake was made by those foreign retailers that in their strategy placed special emphasis on the policy of low prices and a shop format where any investments to improve the quality of the retail space were limited. The concept of the anachronistic hypermarket was confronted by the innovative one, which targeted the quality of customer service and provided the basis for future competition. These critical remarks apply only to the first stage of the inflow of foreign retail chains to the Polish market. The formula of exporting the outdated format of hypermarket to Poland had to be replaced quickly with a more innovative formula.

10.3.3 The forerunners: early foreign entrants to the Polish market

A second group of foreign retailers adopted a different approach to the Polish market: they were open to innovation and to the characteristics of the local environment. They emphasized their role as a leader of change and their commitment to new strategies, and thereby quickly secured a leading position on the market. Their managers were able to anticipate market changes and adjust to them accordingly. These retailers showed more flexibility in adjusting the standard formula of hypermarkets to the needs of the local market.

This group included both retailers with a strong international orientation, which typically used

global strategies, such as the Dutch Makro Cash and Carry or the Swedish Ikea and retailers which perceived the Polish market as the starting point for internationalization, such as Dohle Holding, a German chain.

The case of Dohle Holding is an interesting example of a strategy adjusted to the conditions of a foreign cultural environment. The source of success of this company was based on its early entry into the Polish market and its strategy of purchasing top locations in major cities for planned expansion of its HIT hypermarkets. Paradoxically, its lack of earlier experience in internationalization resulted in a wider openness in exploring the Polish market. Dohle management put special emphasis on the co-operation with local suppliers and a strong representation of Polish products in its product line.

A very positive attitude to Polish managers, whose energy and effectiveness differed from popular German stereotypes, also accounted for the success of the firm's strategy. The example of Dohle Holding, which in 2002 managed in Poland a network of 13 hypermarkets with a total turnover of C=439 million (*Handel*, 2001: 20), accounting for nearly 19 per cent of the total turnover of this firm, confirms the thesis that medium-sized retail groups with no experience in internationalization may be highly successful in a turbulent environment such as CEE markets during the transition process because they show more flexibility in response to the specific conditions of these local markets.

In the case of the German Real (Metro) hypermarkets, one should highlight its vision of the fast development of the chain, which was founded on the model developed on the German market in the 1980s and based on observations of transformations occurring in the trade sector in East Germany.

The dynamics of the development of the network shows that an early market entry provides a clear competitive advantage. This holds also for the Dutch chain Makro Cash and Carry (now the Metro Group). It seems that this type of strategy may be adopted mainly by a network with a clear international orientation, and a strong organizational and capital background supportive of international development. Making good use of the opportunities created by the market and a limited number of threats generated by the competitive environment were characteristic of the strategy adopted at this stage of the development in the Polish retail industry.

10.3.4 The second wave of foreign investment (1997–2000)

A third group of international retail chains that had failed to recognize the strategic importance of the Polish market in the early stages and subsequently had delayed their entry, tried to catch up with their competitors after 1997. The pace of growth by these relative latecomers resulted from a range of strategic challenges in chain management during such an intensive expansion. Even the firms with very strong international orientation suffered from their inability to manage the process of radical changes required over time. Managers of foreign retail chains also showed a weakness in operating in conditions of uncertainty and competitive pressure. In extreme cases, this weakness gave rise to an inability of some international managers in managing business under the conditions of a strong competitive pressure, a broad range of changes and decisions which had to be made quickly and in an unknown environment. A difficulty in obtaining qualified managers and a frequent rotation of high- and medium-level managerial staff were a result of these challenges. Managers were lured away by competitors; this considerably destabilized managing the retail chain and building a cohesive strategy. The most severe problems occurred at the stage of staff recruitment, staff training and transmission of management standards in the new environment. This revealed the huge difficulties that foreign managers had with operating under the new conditions and in making effective communication with their Polish employees. These problems concerned mainly the style of communication and management methods.

A strong increase in competition in the Polish retail sector was a direct consequence of the

mass influx of foreign entrants in a very short period of time. It also created increased pressure among the retail chains to innovate and experiment in order to increase their market share, thereby refining their store formulae. The case of Poland shows that the management of change applied on the emerging markets leads to implementing and testing a range of innovations relating to store formula and forms of customer service.

The vigorous development of the large retailers also demonstrates their ability to use the opportunities provided by the Polish legislation, and their parallel fears that these regulations might be amended in such a way as to make them more restrictive to the large retail chains. Difficulties in managing the development of the chains in conditions of strong competition result mainly from the increased pace of the development, the time pressure regarding the decision-making process, a lack of experienced international managers able to act in uncertainty, a lack of continuity in the process of development, contradictory decisions on changes in the adopted model of development issued by the headquarters of the international retail chains, difficulties in external and internal communication and a lack of 'best practice' in the new environment.

10.3.5 Competing for the future

The development of international retailers on the Polish market will significantly depend on their skill in competing for the future. The 'store of the future' in Poland will need to combine classic elements with new services and an attractive shopping atmosphere for customers. The concept of multifunctional shopping centres already implemented in Western European countries will need to be adjusted to the local conditions in CEE countries.

Foreign investors that create an image for new-generation shopping centres and add to the process of revitalizing of city centres and provide them with a range of complementary functions are likely to gain competitive advantage. The effective competition of the future will strongly depend on convenient locations and attractive buildings for new premises, and on establishing links with businesses that build and administer these premises. The competitive advantage will be obtained by those networks that are more skilful in managing networks of multiple partners performing complementary functions and creating new added values. Harmonious co-operation with local authorities and the government will have particular importance.

Competing for the future also assumes a certain openness of the network managers to change and to adjusting the standard shopping formula to the conditions of the regulatory environment. Polish legislation is rather liberal in this respect. In practice, this means that some retailers are able to open their stores for 24 hour a day, seven days a week (Tesco). Continuous extension of product lines on offer, new premises located in city centres and the establishment of larger sites (such as new-generation two-storey hypermarkets) require change management skills and an ability to take advantage of opportunities provided by the liberal retail legislation.

10.3.6 Partnerships between international and Polish retail companies

In the process of their strategy development, large international retail chains will need to put more emphasis on partnership with local businesses. Experiences gained on the highly competitive Polish market may in turn also have positive effects on the development of the retail business on Western markets. The challenges of the emerging markets are an excellent lesson for Western managers, who have become accustomed to schematic work processes and routine behaviour in a stable environment where one may quite easily predict competitors' behaviour. The interaction with Polish entrepreneurs will often call for their active participation and a reassessment of the network's business models. This development has

been observable mainly in franchise agreements (used by such retail chains as: Intermarché, Spar and Leader-Price), and in close co-operative relationships with local suppliers of products sold under private labels.

Table 10.2: Presence of biggest European retailers, by country

Position	Country	Number of retailers
1	Poland	16
2	Spain	12
3	Czech Republic	11
4	France	9
5	Belgium	8
6	Italy	8
7	Austria	7
8	Hungary	7
9	The Netherlands	7
10	UK	5
11	Portugal	5
12	Greece	4
13	Germany	4

Source: 'Zestawienie Top 50' (2002), in *Handel*, 1/2002, p.16.

10.4 Conclusions

The evolution in Polish retail reveals a combination of two contrasting trends. On the one hand, there is a dynamic development of large-surface units mainly resulting from foreign investments made by the largest European networks with strong presence in Poland (Table 10.2).

Owing to this process, the Polish market is one of the most competitive in Europe, and it forces specific companies to use more innovative strategies of development.

On the other hand, despite the strong foreign competition, one may also observe a very clear presence of SMEs on the market, who tend to operate as independent businesses or associations and companies which are undergoing a gradual integration process. In 2001, there were 117 200 grocery stores in Poland: 136 operated as hypermarkets, 1900 as supermarkets and discount shops, 30 200 as grocery shops (large and medium), and 85 000 as small grocery shops. Paradoxically, the number of small grocery shops is *not* declining but remains at a relatively stable level.

The share of modern forms of distribution (hypermarkets, supermarkets, discount stores) amounted to 29 per cent of the food sales in 2002. Nearly 71 per cent of the turnover (*Handel*, 3/2002: 16–17) continue to be sold in traditional grocery stores of various sizes (including kiosks and petrol stations) owing to traditional customer habits. It can be expected that traditional distribution channels will keep a rather strong position in Poland but competitive pressure will lead to more integration and consolidation in the long run. The Polish retail sector is bound to undergo many radical adjustments affecting both large international retailers and small and medium size retailers which search for new ways of operating within professionally managed and integrated chains. The expected integration will particularly force SMEs to adopt management practices and technologies (IT and logistic systems, modern merchandizing and selling techniques) in order to keep pace with international competition. Polish SMEs seem to be increasingly aware of the challenges ahead.

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Team LiB

Chapter 11: The Leadership Behaviour of Managers in Austria, the Czech Republic and Poland: An Intercultural Comparison Based on the Vroom–Yetton Model of Leadership and Decision Making

Gerhard Reber and Werner Auer-Rizzi

Abstract

This chapter uses the Vroom–Yetton situational leadership model to compare the leadership behaviour of managers in Austria, the Czech Republic and Poland. The model applies a methodology that is 'close to action', in contrast to the collection of empirical data based on questionnaires that use basic values as determinants of intercultural differences ('far from action'). The results show that leadership behaviour in the Czech Republic and Poland remains autocratic despite dramatic changes in the societal and political environments of the two countries.

11.1 Cross-cultural studies: value concept versus action orientation

Empirical studies of cross-cultural differences in leadership behaviour are rare (House *et al.*, 1997) and the classical studies conducted by Geert Hofstede (1980, 2001; Hofstede and Bond, 1988) are still drawn on today. Hofstede's data was collected between 1967 and 1973 by IBM subsidiaries in 64 countries. He subsequently added 10 other regional groupings that have since been split into 23 nation states.

Hofstede's theoretical concept focused on 'basic values', which is viewed as the 'deepest' level of a culture. According to Hofstede (1993, p. 127), these values are embedded in the individual by the country in which he or she is born and socialized. In comparison with cross-national differences, the cultural dimensions of a profession or an organization are seen as 'superficial' at the level of symbols, heroes and rituals.

Hofstede identified five dimensions of national culture: power distance, individualism versus collectivism, masculinity versus femininity, uncertainty avoidance, and short-term versus long-term orientation. In addition to anchoring leadership behaviour in the culture of the nation, Hofstede was convinced that this behaviour has a high resistance to change. With regard to methodology, Hofstede employed traditional quantitative empirical research and factor analysis.

Hofstede's work went unchallenged until 1994, when Robert House initiated the global Leadership and Organizational Behavior Effectiveness Research Program (GLOBE). The project was conducted by 150 researchers from 60 countries (see House *et al.*, 1997, 1999) and followed in Hofstede's footsteps. His basic value orientation and methodology were retained, but during the research the quality of Hofstede's dimensions and their quantitative operationalization were criticized and improved. This led to the identification of seven cultural dimensions: uncertainty avoidance, power distance, collectivism I, collectivism II, gender egalitarianism, assertiveness, future orientation, performance orientation, and humane orientation. The latter is defined as the degree to which a group encourages and rewards individuals for being fair, altruistic, generous, caring and kind to each other. The initiators of the GLOBE project did not draft a complete theory of culture and accepted the eclectic and rather unsystematic theoretical limits of Hofstede's work. As far as leadership theories are concerned, the concept of charismatic leadership and the attribution theory of leadership come closest to the GLOBE project, in which 'implicit leadership' is one of the topics of research and 'Leadership is defined . . . as the ability of an individual to influence, motivate and enable others to contribute toward the effectiveness and success of the organization of which they are members' (House *et al.*, 1997, p. 220).

Just before the GLOBE project started Trompenaars (1993) surveyed more than 10 000 managers in nearly 50 countries, with particular emphasis on Europe and eight ex-communist states, including Czechoslovakia. Trompenaars' questionnaire included items that addressed seven hypothesized dimensions of cultural valuing. Thus he shared Hofstede's value orientation; but in contrast to the GLOBE project he deliberately avoided replicating Hofstede's dimensions. This was done to challenge the quality of the dominating classification and to check the replicability of the results of these older dimensions (Smith *et al.*, 1996).

The seven dimensions that Trompenaars borrowed from earlier theories by sociologists and anthropologists were reduced to two in subsequent studies, since it appeared that some of these were strongly correlated with one another:

> The first of the two dimensions can be thought of as representing 'hierarchy' versus 'equality'. . . . Nations whose managers score high on hierarchy are those in which

> power differences are accepted, paternalism is expected, job appointments are likely to be on the basis of ascribed qualities, and preferential treatment is given to one's immediate associates. Nations whose managers score high on equality are those in which work is evaluated and appointments are made on the basis of objective criteria which are applied equally to all persons. The second dimension distinguishes 'involvement' from 'autonomy'. . . . Nations whose managers score high on involvement are those in which one's identity is defined in terms of one's long-term commitment to the organization. Nations whose managers score high on autonomy are those where job involvement is seen as dependent upon a calculus of one's current rewards, career prospects and alternative opportunities. (Smith, 1997, p. 377)

Comparing their results with those from Hofstede's earlier study, Smith *et al*. (1996) found that the scores on both of their dimensions were to some extent associated with Hofstede's scores for 'power distance' and 'individualism versus collectivism'. As far as country differences were concerned, they found a striking feature: the former communist countries of the Central European cluster were all characterized by combinations of 'hierarchy' and 'autonomy', in contrast to the West European nations, which were characterized by a combination of 'equality' and 'involvement' (ibid., p. 247).

Two conclusions emerge from this comparison of Hofstede's and Smith *et al*.'s data bases. First, the links between Hofstede's dimensions and the two dimensions extracted by Smith *et al*. provide some evidence of continuity in approaches to management in various countries of the world. The two studies used very different samples of respondents and different instruments, and were completed at different times, so the fact that their results showed some agreement is a persuasive indication that the global variations found by Hofstede were still there, even if they had decreased in magnitude. The second conclusion came directly from the inclusion of former Soviet bloc nations in Trompenaars' samples. The data from these countries were collected in the late 1980s. The scores obtained confirmed what many would have expected, namely that the major variation in approaches to management within Europe lay between East and West:

> The footprint of history which appears to leave the sharpest imprint at present is not that of the Roman Empire, but that of the Soviet Empire. These data do not of course establish that conclusion unequivocally. There may have been major divergences in approaches to management between Eastern and Western Europe long before the end of the Second World War. (Smith, 1997, pp. 377–8)

Thus the major value-oriented studies, despite some missing data and their neglect of Central European countries, seem to have produced some coherent results. However, their relevance may be limited by their common reliance on the value concept, as values may be illusions and not predictors of behaviour. Values can be seen as 'far from action' concepts with a relative distance from 'close to action' concepts such as intended behaviour, commitment and volition (Szabo *et al.,* 2001). A 'close to action' approach involves the investigation of actual leadership behaviour across cultures and includes basic values as well as situational factors. While value-oriented and action-oriented research can produce matching outcomes, as Jago *et al.* (1995) demonstrated in the case of Czechoslovakia and Poland using the action-oriented Vroom–Yetton model, the results can also diverge. For example the identification of diversity among the countries of the former Soviet bloc in Smith and Peterson's (1995) action-oriented 'event management' study contradicted the value-oriented results of Trompenaars' (1993) data, which led Smith (1997) to make his statement about the sharp imprint of the Soviet Empire.

11.2 The Vroom–Yetton model

The Vroom–Yetton (1973) model comprises three elements that are interconnected in the logic of contingency theory: there is (1) no leadership strategy (style) that is successful in all situations, (2) therefore the situations have to be diagnosed and (3) rules have to be found in respect of which strategy best matches which situation. The Vroom–Yetton model has been tested in a number of studies and is perhaps the best empirically supported of all situational leadership theories. In this section we provide a brief description of the three elements of the model in order to aid understanding of the results of our study.

11.2.1 Leadership strategies

According to the Vroom–Yetton model a leader can choose from five levels of participation when making a decision: AI, AII, CI, CII, GII, where A stands for autocratic, C for consultative and G for group, I stands for concentration on one person (AI = leader alone, CI = one-to-one consultation with all subordinates who could be affected by the decision), and II stands for the inclusion of two or more persons at the same time. These strategies range from an autocratic decision (AI) to a total group decision (GII). AI represents 0 per cent and GII 100 per cent participation. The assignment of different participation scores to strategies between the extremes of the scale is based on empirical studies in which managers rated distance on a scale of 1 to 10. AII denotes 10 per cent, CI 50 per cent and CII 80 per cent participation.

11.2.3 Situational attributes

The leadership decision situation is characterized by seven attributes, which correspond to seven diagnostic questions: (1) Does the problem possess a quality requirement? (2) Does the leader have sufficient information to make a high-quality decision? (3) Is the problem structured? (4) Is acceptance of a decision by subordinates important for effective implementation? (5) Will an autocratic decision made by the leader be accepted by subordinates? (6) Do subordinates share the organizational goals to be attained by solving this problem? (7) Is there likely to be conflict among subordinates over preferred solutions? These questions rely on the assumption that leadership effectiveness is based on the mastering of two main variables: $LE = f(Q \times A)$, where Q stands for quality and A for acceptance. Quality refers to a leader's professional competence – with an emphasis on knowledge – to meet the technical and task-oriented requirements of an organizational goal. Acceptance refers to the subordinate's commitment to executing the organizational goals. A commitment of this kind is endangered when subordinates are in conflict with the leader's aspirations or the company's goals, or when there is insufficient consensus among themselves about how to tackle the task at hand. The leader needs 'social competence' to diagnose these commitment problems.

11.2.3 Decision rules

The model provides seven decision rules (the leader information rule, goal congruence rule, unstructured problem rule, acceptance rule, conflict rule, fairness rule and acceptance priority rule), each one of which excludes certain decision strategies in specific situations. The leader information rule, for example, makes strategy AI (autocratic decision making) unfeasible in a situation where the quality of the decision is important (diagnostic question A = 'yes') and the leader does not have enough information or expertise to solve the problem alone (diagnostic question B = no). The result of applying all seven rules to a decision situation is a set of strategies (feasible set) for that situation. When the feasible set contains more than one strategy, two additional criteria are applied to produce just one strategy: time and subordinate development. According to Model A the most time-saving (least participative) strategy is

always selected from the feasible set. Model B replaces the goal of time efficiency with a goal of subordinate development and selects the strategy that will allow the greatest involvement of subordinates in decision making and will provide more opportunities to develop their own managerial, technical and team skills.

11.3 Cross-cultural comparison of Austrian, Czech and Polish Managers

11.3.1 Methodology and data collection

The methodology and data collection were dominated by a clear action orientation. No questionnaire was used and all the data were collected by administering a 'problem set' in the form of 30 decision-making situations. The 30 situations were selected and rewritten from descriptions of real decisions provided by hundreds of real managers and were validated with the assistance of trained managers (Vroom *et al*., 1976). If eight out of 10 of those trained managers detected the same problem, the same case, sufficient validation was assumed. This test was first applied in English (Jago and Vroom, 1978) and was later repeated in a German version (Böhnisch, 1991). For the Czech and Polish studies a translation of the 30 situations by native speakers was used. The semantic 'corrections' were not tested systematically. However in discussions with the Czech managers during their training programme, one of the authors in charge of the feedback session got the impression that the translation has a high degree of validity because the managers found the same problem attributes for each case. The reliability of the Polish version of the problem set was tested for half the cases (15). Based on a sample of 121 Polish managers this test produced adequate results (Maczynski *et al*., 1997).

The problem set was administered to managers who, at the time of data collection, were unfamiliar with the Vroom–Yetton model. In addition to the 30 decision-making situations they were presented with five strategies and asked to select one for each situation. An average time of two hours was needed to study the situations and make their decisions.

The results of the decision-making process mirrored intentions. The validation studies conducted by Jago and Vroom (1978) for the US and replicated by Böhnisch *et al*. (1988) for Austria concluded that the intentions given in response to the problem set were equivalent to the actual behaviour of the managers concerned.

The Czech and Austrian data were collected prior to the holding of leadership training programmes. In such programmes, the respondents did not work through the problem set to do a 'favour' to the researchers – but were mainly concerned to improve their own leadership behaviour. All of the participants received feedback, in which their first reactions to the problem set were compared with a description of the model. Training was provided to help the participants to use the diagnostic questions and decision rules for leadership decisions in their own organizational environment.

The Polish data stemmed from two prior studies. The data were collected in 1988 from 146 managers (Maczynski *et al.,* 1994) and in 1993–94 from 253 managers (Jago *et al*., 1996). In this case the data collection was not completed within the framework of a training programme. The results received some underpinning by the study by Szabo *et al*. (1997), who used the value-oriented framework of the GLOBE project for 278 Polish and 169 Austrian middle managers.

The data collection began in 1984 in Austria and in 1991, in the Czech Republic, the most recent data being collected in Prague in spring 2002. The total numbers were standardized, based on a matching process. Matching was performed on organizational and demographic variables (provided by the respondents) that are known to affect leadership style: gender, hierarchical level, managerial function, age, organization type, number of subordinates, and tenure with the company.

11.3.2 Results

11.3.2.1 Participation

The most straightforward problem-set statistics are the frequency with which managers choose each of the five strategies. Table 11.1 shows the means for Austria, the Czech Republic and Poland. The comparison confirms the finding that Austrian managers are least inclined to employ autocratic strategies (AI and AII) and most frequently use group processes (CII and GII) for decision making. Polish and Czech managers do not differ significantly from each other in the use of autocratic strategies and consultative group processes (CII); managers in the Czech Republic are only different from their counterparts in Poland in that they use the GII strategy less frequently. As far as the CI strategy is concerned no differences can be found, and the use of this strategy in all three countries has the second lowest frequency. CI is the only strategy in which managers in all three countries showed no significant difference.

Table 11.1: Participation

	A (146)	CZ (146)	PL (146)	F-value	A vs CZ	Avs PL	CZ vs PL
Use of strategies (per cent)							
AI (autocratic)	17.50	25.80	25.70	24.69**	**	**	–
AII (autocratic)	14.90	19.60	18.10	10.65**	**	**	–
CI (Consultative)	15.40	17.00	17.00	7.72	–	–	–
CII (Consultative)	30.90	23.30	22.40	27.8**	**	**	–
GII (group decision)	21.20	14.30	16.80	18.24**	**	**	**
Mean level of participation	5.52	4.34	4.50	48.67**	**	**	–
Standard deviation	3.57	3.69	3.75	5.96**	**	**	–
*p < 0.05. **p < 0.01							

Based on the participation score of the five leadership and their corresponding participation score strategies a mean level of participation (MLP) can be computed. In our study it is not computed at the individual level (which reveals a personality factor), but rather as an average at the national level. The standard deviation (SD) around the average is also computed at the national level. The SD indicates flexibility: the higher the score – the maximum on the participation scale being between AI (0) and GII (10) – the higher the variance of strategies.

The MLP scores and standard deviations are shown at the bottom of Table 11.1. As can be seen, the Czech Republic and Poland are united in having significantly lower MLP. It is interesting to note that the standard deviation for these countries is higher than for Austria. This confirms the assumption (based on the GLOBE data) that Polish and Czech managers possess a high degree of flexibility as a whole, which can be interpreted – as already mentioned – as a sign of readiness for the process of change.

Table 11.2: Agreement with the Vroom–Yetton model

	A (146)	CZ (146)	PL (146)	F-value	A vs CZ	Avs PL	CZ vs PL
Percentage conforming to:							
Feasible set	73.6	65.7	64.1	68.08**	**	**	–
Model A choice	37.9	36.0	32.2	12.50**	–	**	**
Model B choice	30.8	20.3	21.3	51.84**	**	**	–
Rule violations (per cent)							
Rule 1 (Leader info.)	8.6	13.0	17.4	22.55**	**	**	**
Rule 2 (goal congruence)	12.0	9.4	11.7	2.16	–	–	–
Rule 3 (unstructured)	33.9	48.4	50.8	24.36**	**	**	–
Rule 4 (acceptance)	15.1	28.9	32.1	49.17**	**	**	**
Rule 5 (conflict)	31.5	51.5	56.4	54.62**	**	**	**
Rule 6 (fairness)	23.9	56.9	48.3	18.47**	**	**	**
Rule 7 (accept priority)	58.4	73.3	75.7	23.01**	**	**	–
Quality rules (1–3)	15.0	18.7	21.8	28.84**	**	**	**
Acceptance rules (4–7)	28.9	45.4	42.7	77.80**	**	**	–
*p < 0.05.							
**p < 0.01							

11.3.2.2 Agreement with normative model

Table 11.2 shows the mean frequencies with which the Austrian, Czech and Polish responses fell within the feasible set across the 30 decision-making situations. Austrian managers outperform their counterparts in Poland and the Czech Republic, with a very high F-value. Austrian and Czech managers show the same degree of conformity to Model A (time efficiency) but there is a substantial difference between them in the case of Model B (subordinate development), where the scores of Polish and Czech managers lie close together.

Each time a respondent's choice lies outside the feasible set, that choice has violated one or more of the seven decision rules underlying the normative model. The rates of rule violation are reported in Table 11.2. These data isolate the sources of disagreement between managers and model behaviour. For six of the seven rules the Austrian respondents show a lower rate of violation than the Czech and Polish respondents; the Czech and Polish managers are congruent in five of the seven rules. Rule 2 – which excludes the GII strategy in situations where quality is at stake and the subordinates do not share the organization's goals – has one of the lowest frequencies of violations and is the only strategy for which there is no significant difference between the three countries.

As previously stated, rules 1 to 3 are designed to protect decision quality whereas rules 4 to 7 are designed to protect decision acceptance. The rates of quality rule violations (appropriately adjusted for the frequency of rule applicability) and acceptance rule violations are also included in Table 11.2.

The first conclusion to be drawn from the aggregation of the rule violations is that regardless of culture, departures from the model's prescriptions are more likely to be violations of acceptance rules than of quality rules. This is consistent with the finding in all studies completed within the framework of the Vroom–Yetton model (Vroom and Yetton, 1973; Vroom and Jago, 1988; Reber, *et al*., 1993; Maczynski *et al*., 1994; Reber *et al*., 2000) and seems to have specific significance for the education of future managers. The deficits are significantly higher in the area of social skills than in professional skills. The latter refer to a narrow task orientation regarding the technical quality of a decision (for example: solving accounting problems, doing market research, scheduling the production process, etc.). Social skills have to do with social interaction, especially conflict resolutions.

Nonetheless there are significant differences among the three countries. Poland displays the highest rate of quality rule violations. Austria displays significantly lower rates of acceptance violation, for which Poland and the Czech Republic do not show significant differences.

11.3.2.3 Situational attributes – main effects

Based on the seven diagnostic questions, the main effects are reported in Table 11.3. The main effects show behavioural differences that take place when an attribute is present versus absent and show the sensitivity to that particular attribute. A positive main effect indicates a tendency to be more participatory when the attribute is present (that is, when the answer to the diagnostic question is yes; a negative main effect indicates the reverse. The results present a relatively complicated picture. With regard to the quality requirement, Austrian and Czech managers are more participatory when the problem at hand includes a quality component and is, from the organization's perspective, not trivial, and they display greater autocracy in the case of organizationally trivial issues. Polish managers, however, display the opposite tendency. That is, they are more participatory in the case of trivial issues and more autocratic on substantial issues.

Table 11.3: Situational attributes – main effects

	A (146)	CZ (146)	PL (146)	F-value	A vs CZ	Avs PL	CZ vs PL
Situational main effects:							
Only requirement	0.49	0.86	–0.39	19.70**	–	**	**
Leader information	–0.32	–0.73	–1.10	11.89**	**	**	**
Problem structure	–2.00	–1.57	–0.86	14.08**	**	**	**
Acceptance requirement	0.79	0.85	0.32	7.09**	–	**	**
Prior prob. acceptance	–2.80	–2.33	–1.98	9.30**	**	**	–
Goal congruence	0.55	0.73	0.47	1.43	–	–	–
Subordinate conflict	0.16	–0.11	–0.40	7.31**	–	**	–
*p < 0.05.							
**p < 0.01							

In all three countries leaders become more participatory in situations where they do not have sufficient technical and/or professional information. This tendency is strongest among Polish managers (–1.10), followed by Czechs (–0.73) and Austrians (–0.32). If the situation is unstructured, there is a tendency for autocratic behaviour to decrease in all three countries with significant differences between the three countries in the magnitude of the decrease: Austria (–2.0), followed by Czech (–1.56) and Poland (–0.86). In situations where acceptance of subordinates is important, Czech (0.85) and Austrian managers (0.79) significantly tend to favour participative strategies to a higher degree than their Polish colleagues (0.32). In situations where leaders and subordinates are in conflict, Austrian managers (–2.80) become significantly more participatory than managers in the Czech Republic (–2.33) and Poland (–1.98). If the conflict is between subordinates, managers from Poland (–0.40) and the Czech Republic (–0.11) become more autocratic, whereas Austrian managers (+0.16) become slightly more participatory.

Team LiB

11.4 Discussion

This study substantiates four conjectures and empirical findings of the earlier studies mentioned above:

- Austrian managers exhibit a very high degree of participatory leadership behaviour.
- Polish and Czech managers diverge from their Austrian counterpart in respect of their preference for autocratic leadership styles and divergence from the prescriptions of the Vroom–Yetton models, and in terms of most of the 'main effects'.
- Czech and Polish managers are relatively similar in respect of most of the measured dimensions in the Vroom–Yetton framework.
- National culture is a dominant factor in the formation and execution of leadership styles.

How can we explain the results for Poland and the Czech Republic, which at the national level successfully reorganized their centrally planned economies into a privatized market system open to international competition? Did the more drastic changes remain at the national level and fail to penetrate the organizational and individual levels? The latter seems to be the reality, in spite of the fact that individual managers show a high degree of flexibility, with high scores in their standard deviation. Does it look as though a 'configurational' view is the best way to explain lack of change within a change process? A closer look at the three main levels may bring us closer to understanding this paradoxical situation of stasis amid the flux of change. The majority of the Czech citizens (individual level) expected that their individual freedom had to be honoured by the state; this is not (yet) expected in the framework of private companies (organizational level). Perhaps in such a historic situation a change at the organization level can materialise only from 'above' by democratic legislation as was done in Austria and Germany through different forms of codetermination of capital and labour after the Second World War. In this way citizens would not only have a 'voice' (Hirschman, 1970) according to the national constitution in state affairs but also within the national economy and private enterprises. In such a development a democratic pattern would reign on all three levels: the national, the organizational and the individual level would be united within one participative configuration ('Gestalt'). The existing values need appropriate situational conditions in order to be transformed into actions.

The situation in Austria after World War II may provide an example. It can be argued that during the war, culturally and individually preferred leadership styles did not score highly on the AI to GII scale. The state was in the hands of one party and the economy was state-controlled to divide the most available goods among the majority, leaving little for private consumption. When the war was over and democracy was restored, the social/economic partnership model was created and political and economic power was shared by the social democrats and conservatives. This occurred under the leadership of the prewar political elite, who saw no future in the extremes of either capitalism or communism. To deal with decision making and conflict resolution a system was constructed in which all stakeholders had a voice, and consensus (GII) was the preferred strategy for decision making and actions (Szabo *et al.,* 2002). The idea of partnership governed not only the highest political and economic levels but also the daily experiences of managers at the organizational level. Laws requiring codetermination – as in West Germany – forced them, their subordinates and union representatives to negotiate and establish norms of cooperation and participation, which required new forms of leadership behaviour. This system eventually took a toll on development, with 'over-consensualism' delaying Austriás adaptation to the rapid changes in Europe and elsewhere in the world. The erosion of the coalition power structure became manifest in the elections for the present parliament, with evidence of value changes in the population and the expression of individualism by younger generations with no experience of

war, poverty and the need for solidarity.

In the Czech Republic the organizational level could be the bottleneck in any change in managers' leadership behaviour. It seems crucial that the results of the 'de-governmental' process with its key elements of privatization and the governance structure in the new private companies were insufficient. Of all the economic plans launched since 1989, voucher privatization (Kost, 1994; Fogel, 1994) must rank among the most ambitious. In contrast to other ex-communist countries, the majority of state property has been formally transferred to private hands. However the process has not been transparent and enterprise 'owners' are often not real owners but managerial cliques whose power is owed to connections cultivated during the old regime. Voucher privatization has caused a paradox: share ownership has been transferred to investment funds, which are private in legal terms but are actually controlled or owned by banks in which the state has a large or even a majority stake. The state banks are owned by the National Property Fund (NPF). Hence the banks own the investment funds, which in turn own the majority of companies. Companies indebted to the banks are artificially kept alive because otherwise the banks will be forced to admit that many of their loans are unrecoverable.

In a situation like this the market system does not bare its teeth at inefficient companies and managers in protected industries can maintain their old ways of acting and thinking. These managers are characterized by a lack of entrepreneurial spirit and a strong aversion to responsibility, leading to a delay in the necessary restructuring measures. Managers remain order-takers, conservative, risk averse, operations focused, 'inside' people with a strong reliance on personal contacts. Proficiency in foreign languages other than Russian is relatively low. Older managers in particular are technically oriented with a propensity to stick rigidly to plans. To a degree they are flexible, but their flexibility is aimed in the wrong direction. A typical feature of central planning was the shortage of raw materials, manufactured inputs, energy, workers, investment capital and so on. This called for an ability to improvise and be flexible on the input side of business activities. However the market system's emphasis is on the output side, with a consumer and market orientation.

Market reform alone cannot change the governance structure of companies. The Czech government's reforms were not based on Germany and Austriás experience with codetermination; rather its economic ideals were closer to the Anglo-Saxon models, particularly that of the United States. Perhaps consensus-seeking was seen as too close to collectivism. It seems that concepts such as freedom, individualism and competition are now more appealing to victims of the command system than to politicians, who were hurt by the failure of their first democratic system. The maintenance of the old hierarchical governance structure by the numerous directly and indirectly state-owned companies has not encouraged managers to change their habits. In leadership seminars managers repeatedly state that they would like to include their subordinates in the decision-making process but the latter expect them to make their decisions alone. That way, if their decisions are wrong the subordinates will not have to share the blame. Perhaps a communication problem exists (who tells whom first, what is expected in reality) or the leader forgets his or her responsibility to act as model and be the front runner when it comes to admitting that he or she does not have all of the necessary information and therefore needs the help, advice and commitment of subordinates to get the job done effectively.

Not all companies are part of a supposedly privatized but actually state-owned conglomerate. Real private companies do exist but they struggle with financial problems in a system that makes it nearly impossible for small new businesses to obtain loans, which normally have to be repaid within four years. However opportunities are offered by international alliances. For example Volkswagen and Skoda have formed a very successful partnership (Kunz, 1995; Groenwald and Leblanc, 1996; Dorow and von Kibed, 1997) using the so-called tandem system, in which for a transition period of several years a manager from Germany and a manager from the Czech Republic shared the same job and decisions had to be authorized by both managers. This procedure can be seen as a bilateral consensus seeking program

within one company; namely a structure with some elements of the partnership system (as we can see on the national level in Austria and on a company level in Germany). The Skoda/VW company is successful not only in the Czech Republic but also internationally, despite competition from manufacturers in countries such as Germany, Spain and Mexico.

In contrast to the development in large market-driven companies, two other sources of change seem to be effective. First of all, the charismatic leaders as owners act as entrepreneurs, take responsibility for their enterprise under difficult conditions and find acceptance in the form of identification by the sub-leaders in their organizations. The second source may come from a new breed of young managers who are professionally oriented, educated (some hold an MBA) and able to speak languages such as English, German and French. These young managers are not only entrepreneurial but also flexible and open-minded. As a typical Czech trait they also possess a special talent for improvisation and survival. They rely on market signals and are risk takers with strategic vision. These characteristics are optimistic conjectures; we hope that they may become reality and be reported in scientific investigations in the future.

A similar situation has been found in Poland by a number of action-oriented researchers employing the Vroom–Yetton model. According to Maczynski *et al.* (1994, p. 313):

> The combination of a centralized directive, an enormous bureaucracy, and passive subordinates produced managers who behaved in the same way they themselves were being treated – that is, in a highly autocratic fashion. . . . The current situation in Poland is vastly different from the situation that prevailed at the time our data was collected. Control is no longer exerted so exclusively from the top. There is no longer such a strong emphasis on coercion as a means for achieving managerial control. Employees now have much more power and a concomitant expectation that their views will be solicited and considered. Simply stated, managers can no longer function effectively by applying the traditional mechanisms of unilateral control and command. Today's Poland demands more participative management practices consistent with a 'human resources' conception of what participation means. Of course, evidence of how Poland's enterprises and their managers respond to the enormous changes associated with decentralized control must await future research.

These statements perhaps reflected some optimism and hope for short-term change. The evidence emerged in a follow-up study in which the style of Polish managers in 1988 was compared with the style of managers in 1993 and 1994. The results of this study were summarized as follows:

> The results suggest that, although political change may be swift, cultural change is very slow. And this includes changes in the 'leadership culture' that may exist in organizations. A radical political transformation between 1988 and 1994 produced few differences in managerial styles. If the political changes can be labeled a discontinuous leap, the management change must be labeled incremental. . . . The few differences that did emerge in the current study are of interest. Privatization has significantly reduced the use of the most autocratic behavioral alternative and has increased the use of subordinate consultation. This may represent the first step in a gradual change toward more participative practices. Government managers, however, remain highly autocratic; this sector may be the slowest to manifest a behavioral change despite its dramatic political transformation' (Jago *et al*., 1996, p. 314).

Szabo *et al*. (1997) also found some momentum and resilience towards established behaviours combined with the tendency towards incremental new orientations. The GLOBE project's results confirm this:

> Concerning autocratic behavior, the GLOBE results support the assumptions that the prototypical Polish manager is expected to be more autocratic than the Austrian counterpart. . . . Individual items results show that Polish subordinates tend not to question their superior (means > 4.5 at the 'as is' and the 'should be' level) and are expected to go along with their decisions (mean > 4.0 at the 'should be' level). . . . It looks as if there is a trend in Polish management's power basis to shift from formal authority toward expert and information power. . . . Based upon the GLOBE research results, it follows that whatever the (new) power base might be, once a person is accepted as a leader, subordinates still seem to expect an autocratic leadership style. . . . The large standard deviation shows that Polish managers can be characterized by cognitive concepts which would basically allow them to behave in a flexible way. It seems, however, that the conditions that actually make use of this flexibility are not yet in place. In particular, subordinates seem to expect leaders to continue to behave autocratically. (Szabo *et al.,* 1997, pp. 286, 288, 289)

Smith's (1997, p. 382) event management study also found that 'Poles emphasized reliance on their superior'. With regard to the organizational practices of effective Polish firms, Obloj and Thomas (1996, p. 475) report the existence of a 'cultural gap between the top management and the rest of the employees. Top management is clearly in charge, controls the information flows and makes the decisions. They do not engage with employees in mission building exercises; teams are a rarity, consultants are used sparsely and for particular purposes.' Adding to Reber and Jago's (1997) conclusion and to our discussion above, Maczynski (2002) suggests that cultural changes may succeed if changes in institutional structures have been initiated and are accompanied by adequate training programmes: 'In order to effectively introduce changes into Polish culture, not only do autocratic structures need to be transformed into more participative structures, but Polish leaders and managers need to be effectively trained in participative modes of behavior as well' (ibid., p. 213).

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Team LiB

Chapter 12: Remuneration Management in Polish Companies

Thomas Otte

Abstract

This chapter identifies geographical location, ownership structure and industry type as the most important factors in wage differentiation in the Polish labour market. When determining the base pay of their employees, Polish companies mainly use methods of job evaluation that have been developed specifically for the Polish situation, but methods designed and promoted by international human resource consultancy firms are gaining popularity, especially among corporations with a foreign capital share. Major methodological problems are the inappropriate modification of standardized methods and insufficient updating of the existing systems. With regard to performance appraisal and variable pay, the main findings are that Polish corporations are increasingly adopting a more systematic approach to this area of remuneration management, and that performance-related elements are already accounting for a substantial part of the total pay package in some parts of the job market.

12.1 General wage levels

In Poland, wages increased dramatically in nominal terms during the 1990s; however prices also very sharply, so on balance there was only a comparatively modest increase in real wages of abo per cent between 1992 and 2000 (Table 12.1).

In general there has been a slow but steady differentiation between the wages paid for different t job. The most common tendency is to link pay with the qualifications required for a job. While the wage differentiation between men and women and between industries has remained more or less constant, salaries and wages have risen faster in public companies than in privately owned ones (Wolynka, 2001).

Table 12.1: Indices of nominal wages and salaries, price of consumer goods and services, real wages and salaries, 1994–2000

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**1992**	**1**
	(previous year = 100)							**(=100)**	**(=**
Average monthly gross nominal wages and salaries	134.5	131.6	126.5	121.9	115.7	112.5	111.1	532.1	2
Prices of consumer goods and services	132.3	128.0	119.9	115.1	112.0	107.4	110.0	418.2	1
Average monthly gross real wages and salaries	101.7	102.8	105.5	105.9	103.3	104.7	101.0	127.2	1
Source: Central Statistical Office (2001a), p. 165.									

Geographical location is a very important factor in wage differentiation. Within the same industry, average wage for a certain job category often varies considerably from region to region. The high wages are paid in the Warsaw region (Table 12.2), where the average pay for certain positions c nearly 100 per cent above that in some other regions, mainly due to the fact that most large dom and foreign corporations have their headquarters in the Warsaw region (FAZ-Institut, 1997, p. 25

second position is held by the region of Silesia.

In 2000 the average Polish wage amounted to 1894 zloty. In sectors such as mining, electricity, g
water and finance the pay was considerably above the national average, whereas in areas such
health, social work and fishing it was considerably below the average (Table 12.3).

Ownership is another important factor in variations in pay (Table 12.4). In 2000 state-owned com
paid an average salary of 2239 zloty. While local government bodies only paid 1778 zloty, this wa
slightly above the average in the private sector, where the lowest salaries were paid by private P
companies and the highest by foreign-owned ones.

Despite many years of substantial pay increases, the pay gap between Poland and, for instance,
members of the European Union is still large. This difference is put into even greater relief by the
that Poland shares a border with Germany, which is part of the so-called 'high-pay zone'. Polish r
managers or specialists still only earn 25–30 per cent of the salaries of their counterparts in Wes
Europe (Watson Wyatt, 1999, p. 1), and the pay awarded to manual workers in Poland, as in the
CEE region, is only a fraction of that in the EU, especially when productivity differences are taker
consideration. However the gap has narrowed at the top of the pay structure, and general manag
senior managers' salaries are now reaching the levels in EU countries where pay levels are lowe
as Portugal (approximately 50 per cent of the neighbouring high-paying EU countries). When the
levels are adjusted for purchasing power the gap reduces further (ibid., p. 2).

Table 12.2: Average monthly gross wages and salaries, by region, 2000 (zloty)

Region	Total	Industry	Manufacturing	Trade and repair	Transport and storage	Financial intermedi
Poland	1894	1942	1757	1590	2144	3258
Dolnoslaskie	1811	1997	1660	1405	2031	2612
Kujawsko-pomorskie	1669	1693	1649	1306	1916	2514
Lubelskie	1679	1695	1558	1272	1938	2580
Lubuskie	1670	1623	1566	1294	1904	2306
Lodzkie	1669	1664	1457	1355	1975	2640
Malopolskie	1744	1824	1750	1416	1935	3126
Warsaw	2470	2291	2219	2289	2876	4735
Opolskie	1732	1813	1730	1342	1902	2622
Podkarpackie	1639	1694	1648	1230	1830	2538
Podlaskie	1676	1629	1560	1335	1958	2554
Pomorskie	1826	1862	1820	1451	2155	2698
Silesia	1954	2304	1775	1439	1965	2887
Swietokrzyskie	1718	1856	1732	1287	1880	2414
Warminsko-mazurskie	1671	1703	1660	1275	1946	2299
Wielkopolskie	1772	1767	1679	1507	2007	2797
Zachodno-pomorskie	1741	1808	1722	1342	2107	2540

Source: Central Statistical Office (2001b), p. 114f.

Table 12.3: Average monthly gross wages and salaries, by sector, 2000

Sector	Zloty
National average	1894
Public Service	1932
Agriculture	1712
Fishing	1355
Mining	3210
Manufacturing	1756
Electricity, gas and water supply	2563
Construction	1706
Trade and repairs	1560
Hotels and restaurants	1301
Transport, storage and communications	2144
Financial intermediation	3258
Real estate	2133
Public administration	2432
Education	1835
Health and social work	1480
Other community, social and personal service activities	1892

Source: Central Statistical Office (2001a), p. 163.

Table 12.4: Average monthly gross wages and salaries, by ownership category, 2000

Ownership category	Zloty
National average	1894
Public Service	2066
State	2239
Local government	1778
Private sector	1760
Private domestic	1520
Cooperatives	1554
Foreign	2729

Source: Central Statistical Office (2001a), p. 164.

Detailed and reliable information on managers' and specialists' pay in Poland is not easy to obtai

quickest (and the most expensive) way to ascertain the relevant pay levels in different job marke
obtain data from one of the major human resource consultancies. The salary surveys published f
to time in certain journals and newspapers also give some indication of the current pay levels in s
parts of the Polish job market. For example, one study carried out in 2001 reported that a sales d
in an IT company earned between PLN 8100 and 23 000, PLN 14 600 being the average salary f
position (Wolynka, 2001). According to the same survey, a software engineer earned PLN 3500
average, with PLN 2200 and PLN 4850 as the lowest and highest values, respectively. In genera
managers receive much higher salaries than specialists, and specialists are paid considerably m
employees in posts requiring little or no specific education and experience. Thus, a financial dire
large company earns about PLN 11 600, a department head in human resources somewhat more
PLN 5600 and a specialist in purchasing a little over PLN 3500, whereas accounting clerks and
secretaries earn only around PLN 2500. A survey carried out in 1997 revealed that the influence
corporation's location on the level of executive and specialist remuneration is particularly strong
F.A.Z.-Institut, 1997: 25). Thus, for most managing and specialist positions salaries in the Warsa
reach easily 200 per cent of what is paid in the less central regions of the country. In other major
managers and specialists still earn about 50 per cent more than their colleagues in smaller cities
rural areas.

12.2 Job evaluation

Although performance-related factors have become an increasingly important part of the remuneration structure, for most employees the base salary still accounts for the largest proportion of their pay. Thus determining the base salary for each job within the organization is one of the most important tasks in remuneration management. This involves assessment of the value of a job with regard to its specific contribution to the overall success of the corporation.

There are four basic job evaluation methods: ranking, classification, the point method and the factor comparison method (Kanungo and Mendonca, 1992, p. 247). Ranking and classification are referred to as non-analytical methods (each job is evaluated as a whole and is classified as most demanding, less demanding or least demanding), whereas the point method and the factor comparison method are seen as analytical methods (each job is evaluated independently of other jobs using a specific set of remunerable factors) (Hopfenbeck, 1989, p. 305).

In Poland a number of individual job evaluation methods are used, but most fall into the point method category. In Rostkowski's survey on job and performance evaluation, 70 per cent of firms indicated that they were using such a method (Rostkowski, 2001, p. 12). Also known as the point rating or point factor method, the point method evaluates jobs by reference to an evaluation system that assigns point values to a set of remunerable factors (Kanungo and Mendonca, 1992, p. 254). A job is evaluated for each factor and the overall value of the job is determined by adding up the points assigned to each remunerable factor.

According to Oleksyn, designer of the Polish AWP job evaluation method, the point methods used by Polish corporations can be divided into three different categories (Oleksyn, 2001, p. 3):

1. Universal methods designed by individuals (scientists, consultants) for use directly in a wide range of firms.
2. Universal methods adapted to the specific needs of individual corporations.
3. Methods developed by employees or external consultants for use in a particular firm.

However type 3 methods are often in fact type 2, because a type 1 method has been chosen to form the basis of the evaluation system. The existence of a real need to develop a completely new method is actually quite unlikely and it is mostly done for psychological reasons (on the part of the firm) or in commercial interests (on the part of the consultant). Furthermore these 'tailor made' methods have certain shortcomings (ibid., p. 4):

- Insufficient theoretical knowledge of and practical experience in job evaluation on the part of the people involved in developing the system.
- Inappropriate selection of renumerable factors (due to group or individual interests).
- Insufficient consideration of the situation on the external labour market.
- Insufficient pretesting of a new method before its implementation.

All in all, point methods dominate job evaluation in Poland. Two have been developed specifically for the Polish context: UMEWAP and AWP, from which different versions have evolved. Other point methods have been developed for use in Polish firms under foreign ownership, including those designed and promoted by two international human resource consultancy firms: Hay and Mercer (ibid., p. 3).

The most frequently used method is UMEWAP, which was developed in the 1980s by the Polish Ministry of Social and Labour Affairs. According to Rostkowski (2001, p. 12) 48 per cent of companies use this method. It was even more dominant in the past, but this was due to the fact that for a time it was practically the only method known to Polish managers (Oleksyn, 1995a, p. 21).

The remunerable factors in UMEWAP are based on the CIOS model (developed by the Comité International de l'Organisation Scientifique), which also forms the basis of many Western job evaluation systems, for example the system developed by Bloch in Germany. UMEWAP has been updated two times. The original version, UMEWAP-85, was followed in 1987 and 1995 by UMEWAP-87 and UMEWAP-95 respectively. The latter adapted the system to the new demands of the market economy, but UMEWAP-87 still seems to be the most frequently used version.

Job evaluation with UMEWAP considers four groups of remunerable factors: complexity, responsibility, demands (physical and mental) and working conditions (Jacukowicz, 1988, p. 21; Kopertynska, 1996, p. 63). For each compensatable factor, there is a certain maximum number of points that can be credited. In the work complexity category, for example, this value is 75 for 'education', 55 for 'experience', 25 for 'skillfulness', 45 for 'mental ability' and 25 for 'co-operation', whereas in the demands category the values are 45, 25, 25, 20 and 20 for the compensatable factors 'physical demands', 'demands on nerves and senses', 'mental demands', 'monotony' and 'psychological demands due to a low prestige of the job', respectively.

Many companies have adapted UMEWAP eliminating one or more dimensions to their specific organizational requirements, if these are of no relevance to the jobs being evaluated (Kopertynska, 1995, p. 24) and adding new dimensions, such as 'responsibility for coordination'. Modifications may also be made to the scales used for evaluation and the maximum number of points awarded to each remunerable factor (for example the maximum number of points for 'education requirements' may be reduced by 10 while that for 'responsibility for the work process' may be increased by 15).

One of the main problems with modifying the UMEWAP method at the firm level is that the adaptations are usually carried out by employees with insufficient experience in job evaluation. Whereas the original method is relatively well structured and easy to understand, the results of modified evaluation systems are not always understood by employees whose jobs are being evaluated. In one case the job of one secretary was given a 40 per cent higher rating than that of another, although their job descriptions were basically identical. The reason for this was that the higher educational level of the first employee had been taken into consideration, even though this contradicted the very idea of job evaluation (it was the job, not the person holding the job, that should have been evaluated). Another frequent occurrence is double consideration of the experience: besides the general experience-related renumerable factor in the job evaluation system a certain amount is paid on top of the base salary to reflect the professional experience of individual employees. Hence modifications that are made to the UMEWAP method without due care and knowledge can lead to lack of transparency and consistently, leading to dissatisfaction on the part of employees and the possibility of conflict between them and the management. When it is not clear whether pay differences are due to performance or are the result of good relations with management, individual negotiations or other such factors, employees' acceptance and support of the remuneration system may be put at risk. In practice it is not so much the nominal level of pay that determines employees' satisfaction and motivation, but the issue of justified differences in pay.

A further problem area is the updating of job evaluations. In many companies the method was introduced before 1989 but the jobs have not been re-evaluated since then, even though they have undergone considerable change (Rostkowski, 2001, p. 6). In other companies jobs have been re-evaluated but the task has been carried out halfheartedly, again leading to

inconsistency, lack of transparency and potential pay-related conflict between workers and management (Sekula, 1995, p. 27). Managers frequently have considerable difficulty trying to explain and justify the final results of the job evaluation process.

In general, then, the use of UMEWAP has not proven to be unproblematic in the Polish context, even though the method is regarded as relatively easy to manage when compared with other methods (Oleksyn, 1995a, p. 21).

The problems encountered with UMEWAP were one of the main reasons for developing the simpler AWP method of job evaluation (ankietowe wartosciowanie pracy, or questionnaire-based job evaluation), which requires no specific knowledge of job evaluation. Besides the original method there are two modified versions: AWP-2 and AWP-2 bis. A questionnaire is completed for each job being evaluated (a separate job description is not required, Oleksyn, 1995b, p. 11). For each question the evaluator selects one of the several options presented in the questionnaire, for example ‘For the job, the following education is required: (a) Primary education, (b) Vocational level, (c) . . .’). For each answer a fixed number of points is allotted so that the job value can be determined on the basis of the options chosen by the evaluator. The AWP-2 bis method is based on 15 analytical criteria from the CIOS system (Oleksyn, 2001, p. 6):

- Level of education required
- Experience required
- Independence and innovativeness
- Foreign language abilities required
- Computer-related abilities, computer-based work
- Cooperation within the organization
- Skilfulness
- Responsibility for work results and subordinates
- Responsibility for machinery/means of production
- Responsibility for the safety of others
- Responsibility for external contacts
- Intellectual demands
- Attentiveness and perceptiveness
- Physical demands
- Unusual working hours

In general the AWP method seems to have proven its worth in practice, which can mainly be attributed to the fact that it is simply structured and easy to apply (Oleksyn, 1995b, p. 15). In comparison with UMEWAP, however, it is used by a relatively small number of companies (among the companies examined by Rostkowski only 6 per cent used AWP while 48 per cent used UMEWAP – see Rostkowski, 2001, p. 12).

Besides the methods of job evaluation developed specifically for the Polish context, some Polish companies use analytical methods tailored to their own specific needs. Twelve per cent of the companies studied by Rostkowski were using such methods. It is difficult to evaluate the quality of these methods, but they have certain limitations compared with the

universal methods. The main problem is that they generally consider a very limited number of remunerable factors, and sometimes the value of a job is defined only by the amount of training and experience required to carry out the tasks in question. Another common shortcoming is the overvaluation of certain factors, for example physical demands may already be reflected in the base salary, but then a second allowance is added for extraordinary demands related to the job.

The final group of analytical job evaluation methods used in Poland are those promoted by international human resource consultancies. Of the companies examined by Rostkowski, 4 per cent used such methods. At the moment the Mercer and Hay methods seem to be the most popular. The Hay method is used by several hundred mainly international companies, and the Mercer method is rapidly catching up. The basic approach of these methods is similar to that of the other point methods but they concentrate more on international market orientation and compare jobs inside the organization with those in comparable firms. On this basis the firm decides how to position itself *vis-à-vis* its competitors in the job market, that is, whether to be among the top-paying 5 per cent, 10 per cent or 25 per cent of employers for a given position.

Thirty per cent of the companies examined by Rostkowski used non-analytical job classification methods (Rostkowski, 2001, p. 12) in which jobs are placed in pre-established classes. Each class reflects such factors as education, responsibility, degree of difficulty and extent of public contact. The classes are arranged in an ascending order, from the most simple to the most complex in terms of the factors that make them up. During evaluation the description of each job is reviewed and the job is placed into the class that best matches the job description. Thus a job’s value is determined by its position in the predetermined series of classes (Rostkowski, 2001, p. 21; Hopfenbeck, 1989, p. 307f.; Kanungo and Mendonca, 1992, p. 248f.)

According to Oleksyn (2001, p. 2), job evaluation is dominated by non-analytical methods in smaller Polish corporations, whereas larger firms tend to make more use of analytical methods.

12.3 Performance appraisal and performance-related pay

The base salary, as determined in the process of job evaluation, does not account for all of Polis employees' remuneration and performance-related or variable pay accounts for a growing percer Performance-related pay refers to that part of the salary which is not paid automatically for carryi the regular tasks linked to a job but for the individual performance of the employee holding that p

When the Polish economy was centrally planned there were already a few elements of performar related pay, but in the mid-1980s government restrictions on the extent of this were abolished an were free to develop their own systems. However few made use of this freedom and either abanc performance-related pay altogether or retained their existing system. The old method essentially consisted in paying a fixed amount on top of the base salary at the end of a certain period, and n payment reflected a negative assessment of the work of the employee concerned (Jacukowicz, 1 97).

According to Jacukowicz (1996, p. 30), three different versions of performance-related pay are cu used by Polish corporations:

- Model A: an allowance is paid for above-average performance. Expected average performa reflected in the base salary arrived at as the result of job evaluation (this version is typically by companies with an analytical system of job evaluation).
- Model B: a performance-related bonus is paid for work results that are of crucial importance overall success of the corporation, for example high product quality or the optimum use of ra materials.
- Model C: a performance-related allowance is a regular part of the salary and can only be withdrawn under certain conditions. In the event of extraordinary performance it may be incr In one Polish bank this allowance is withdrawn under three conditions: distrain of the employ salary, intentionally damaging behaviour towards the company and formal admonition of the employee by the management.

Until the early 1990s few companies regarded performance-related pay as an incentive for their employees to do a better job, but in recent years there has been increasing awareness of and readiness to use the instrument and to introduce state-of-the-art systems of employee and perfor appraisal. More than a quarter of the companies examined by Rostkowski had adopted this pract between 1998 and 2000, and a further 8 per cent had introduced their system between 1995 and Prior to that time only 3 per cent had introduced such a system (Rostkowski, 2001, p. 15). Of the cent of companies that still lacked a systematic performance appraisal system, 36 per cent plann introduce one in the near future.

According to the data collected by Rostkowski, performance appraisal is dominated by two metho rating scales (81 per cent of companies with performance appraisal) and the essay method (35 p cent). Methods such as ranking and 360-degree feedback do not yet play an important role (3 pe each), but they are becoming better known and there seems to be a degree of willingness among companies planning to introduce performance appraisal in the near future to use these instrumer per cent for ranking and 7 per cent for 360-degree feedback – see ibid., p. 18).

With rating scales the relevant criteria and their relative weight have to be chosen. Also required specific scales with different levels, such as 'poor', 'average' and 'excellent'. The criteria often inc traits such as cooperation, communication ability, initiative, punctuality and technical or work skill appraiser rates the employee's performance on each scale and, taking consideration of the relati weights, a total performance value is obtained (Ridder, 1999, p. 391). Most companies use betwe five and 20 criteria and four to seven performance levels (Rostkowski, 2001, p. 22). Smaller corporations only consider four or five traits (such as product quality, material consumption and cleanliness of the workplace) (Czajka and Krawczynski, 1992, p. 55).

With the essay method the appraiser prepares a written statement about the employee being appraised, usually concentrating on specific strengths and weaknesses in respect of job perform The statement may be written and edited by the appraiser alone or composed in collaboration wi appraisee (Ridder, 1999, p. 388). More structured versions of the method include questions such 'Describe in your own words the progress made with regard to work quantity, work quality, work- knowledge and skills, development opportunities, own strengths and weaknesses' (Rostkowski, p. 21).

A unique feature of 360-degree feedback is the number and diversity of appraisers, including inte and external customers, superiors, colleagues and subordinates – that is, everybody who is in re contact with the appraisee and is able to give an appraisal of his or her performance (Ridder, 19 390; Rostkowski, 2001, p. 21f).

There is relatively little information on the proportion of employees in Poland whose pay is signifi performance-related, but according to an estimate by Watson Wyatt (1999, p. 2), about 80 per c general managers, 70 per cent of middle managers and 50 per cent of professional staff in CEE countries are currently eligible for annual bonuses. Both short-term and long-term incentives are increasingly being used and the bonuses that are paid out (as a percentage of annual base salar similar to those in Western Europe (Table 12.5). In fact for some Western companies the propor bonus pay is higher in their Polish subsidiaries than in their home country. The bonus paid to an employee for a given period generally depends on two factors: individual performance and the performance of the company. In the case of companies situated in Poland, it is estimated that bo account for about 15 per cent of total remuneration for upper management levels and 10 per cen lower management levels (FAZ-Institut, 1997, p. 25).

Table 12.5: Proportion of bonus pay in the salaries of general managers in selected Europ countries (per cent)

	Hungary	Czech Republic	Portugal	Poland	United Kingdom	Austria	Germ
Bonus pay/base salary	29.0	16.3	21.3	37	23.3	30.4	22.3
Bonus pay/total salary	22.5	14.0	17.6	27.0	18.9	23.3	18.3

Source: Adapted from Watson Wyatt (1999), p. 1.

Long-term incentives such as stock options are also being offered by a growing number of comp in the CEE region, especially in the rapidly growing high-tech and telecommunications sectors (W Wyatt, 1999, p. 3). Lying behind this is the competition for experienced and talented executives a fact that stock options can help to create an 'ownership mentality'. This latter point is particularly important for companies in emerging markets where until the 1990s employees worked for state- enterprises. Furthermore stock options are a good way of building leverage into the pay package Watson Wyatt study carried out among 25 high-tech and telecommunications multinationals ope in CEE found that these companies were fairly democratic in their provision of long-term incentiv the companies surveyed, 63 per cent offered stock options to *all* employees, and the restriction o and other long-term incentives to executives at higher levels of the organization rarely occurred i region. The minimum period in which employees can exercise their stock options is critical in ter tying their interests to the success of the company.

12.4 Conclusion

In Poland, companies have to take account of considerable variations in the job market when deciding on their employees' wages. With regard to geographical location, pay levels are much higher in the Warsaw region than in other major cities and the rest of the country, especially in the cases of managers and specialists. There are also pay differences between industries and according to form of ownership, with public companies paying higher salaries than private ones and foreign corporations paying more than domestic ones.

When determining the base salary of their employees most companies use analytical methods of job evaluation that have been developed in Poland for the Polish situation, with UMEWAP heading the list. However methods promoted by international human resource consultancies are growing in popularity, especially in the private sector. This could contribute to the modernization of this area and might also indicate a growing market orientation on the part of Polish companies.

With regard to performance appraisal and performance-related pay, Polish companies are increasingly developing their own appraisal techniques, although the heritage of the socialist era continues, especially in the public sector. It will be interesting to see whether sophisticated methods such as 360-degree feedback will enjoy more widespread use in the future. Performance-related pay accounts for a significant proportion of the remuneration of Polish managers. In terms of the percentage of employees concerned and its relative weight in the total compensation package, it is already more important than in some Western countries with long-established market economies.

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Chapter 13: Change of Organizational Identity in Polish Enterprises[1]

Krzysztof Konecki

Abstract

This chapter is based on an empirical study of 186 Polish enterprises (mainly in the metal and textile industries) in 1998–99. The study focused on changes in organizational identity – that is, the set of characteristics that distinguish a given firm from others in its organizational environment. The chapter considers factors that affect organizational identity, such as privatization, the economic situation and leadership. It shows the context of organizational identity and factors posing a threat for the present identity of Polish industrial companies.

[1]This chapter is based on a study entitled 'Organizational Identity of Polish Enterprises. Consequences of Privatization', supported by the Research Support Scheme of the Open Society Support Foundation, grant no. 1143/1998.

13.1 Introduction

The transformation of the ownership system and business environment in Poland has made it necessary for enterprises to reform their entire structure, that is, their strategy and mission, production programmes, organizational culture, human resource management, forward planning, ways of thinking about business and the firm, means of external and internal communication, and so on. These changes and their extent can be investigated with the help of economic, organizational, marketing or psychological methods, as well as from a sociological viewpoint. The concept of organizational identity and its change can be used to pinpoint changes in Polish industrial companies and the factors that have determined these changes. It allows for identification of those factors which managers and owner/managers can influence and those they cannot.

13.2 Organizational identity

Sociologists, psychologists and researchers on organization and management started to investigate organizational identity at the start of the 1990s. Their inspiration was the rapid acceleration of changes in the strategies, structures and operations of organizations in the West. Likewise the magnitude of the changes experienced by postcommunist economies has inspired studies in disciplines as diverse as economics, management science, political science, sociology and psychology. The study described below and the conclusions ensuing from it represent a continuation of this trend.

Postcommunist economies have always had a problem with their identity, and the same problem is faced by enterprises and formal organizations operating in these economies. However the need for these organizations to adapt their identity to the new market conditions and the opening of the economy to Western competition, and the problems ensuing from this, have received the attention of only a few researchers (Kostera, 1996; Obloj, 1998). The application of knowledge derived from social psychology, anthropology and sociology can create a new perspective on the transformation process in postcommunist economies that will allow us to investigate whether organizational phenomena of a psychosocial character are dependent on economic variables (profit, demand and so on). It will also allow us to examine the dynamics between different organizational variables, one of which is organizational identity.

Organizational identityencompasses not only the organization's basic values and other elements of its culture but also its production methods and programmes (Stuart and Whetten, 1985; Duton and Dukerich, 1991). For the organization's members, its identity becomes manifest in a cognitive scheme and their perceptions of the distinguishing characteristics of the organization, including its status in comparison with other organizations.[2] Consequently external events that put into question the distinguishing characteristics of an organization can threaten the perception of organizational identity held by the members of the organization (Duton and Dukerich, 1991; Elsbach and Kramer, 1996).[2]

A crisis or turning point in the enterprise's history can induce major changes in the enterprise's internal and external relations. Such changes have both an objective dimension (changes in the management system or organizational structure) and a subjective one (the perception of these changes by management and employees) (Konecki and Fraczak-Konecka, 1998). It appears that turning points similar to those in individuals' lives can spark identity changes in organizations. They can be triggered by an economic crisis, privatization, an ecological disaster caused by the enterprise, criticism by the public and the mass media, tough competition, merger, the emergence of a strong leader and so on. Changes in identity can also take place in a planned and regulated manner, such as when organizational experts and consultants, assisted by the top management, restructure the enterprise methodically and by means of appropriate procedures (Ozynski, 1998).

Duton *et al*. (1994) suggest that a distinction should be made between two perceptions of organizational identity or two types of image of the organization:

- The perceived identity is based on organizational characteristics, which are considered by its members to be important, distinguishing and stable.
- The construed external image is based on organizational characteristics considered to be important, distinguishing and stable from an external viewpoint, that is from the perspectives of the organization's state-holders or the general public. This outsider's image of the organization reflects back onto the organization's members' perceptions. Similar to the individual 'I', the organizational self also depends on outsiders' perceptions. Using Cooley's term, this identity type could be called the organization's

'looking-glass self'.

The concept of construed external identity should be distinguished clearly from the concept of corporate identity, which is created for the purpose of a uniform perception of the organization's identity by its environment. In order to achieve an external standardized picture of the organization stress is laid on:

- Visual information about the organization, including its architecture, product design, packaging and so on.
- The style, principles and culture of the firm's activities and the values existing within the organization (Wojcik, 1997, pp. 87–8).

Corporate identity does of course influence organizational identity, because that which is presented outside the organization (public relations) also influences the way in which employees perceive their firm.3[3]

[2]Qualitative studies are particularly useful in identifying these characteristics. A case study of a Japanese company showed that the company's uniqueness as a feature of its identity commonly experienced by employees is based on three factors: (1) general feeling of uniqueness (a common cultural assumption developed, for example, during the employees' training; (2) organization of work (activities at the shop-floor level were not overly controlled by managers, which permitted a degree of autonomy, aided communication and promoted the development of good relations between employees); and (3) forms of address (non-hierarchical forms of address and language, which helped to create a good organizational climate). On the other hand the organizational structure (autonomous subsidiaries) and promotion system was not commonly felt to be an element of organizational identity. Rank and file employees, unlike managers, did not perceive that these characteristics were specific to the company and argued that in this respect their company was no different from other Japanese firms. However, the absence of trade unions in the company and their inability to exert an influence on wage levels, were perceived as part of the company's unique identity (Konecki, 1994, p. 145–59).

[3]According to organization sociologists, organizational identity can be maintained through the practice of 'self-referential closure'. The marketing or public relations department, through its marketing research, image analysis and advertising, creates a 'mirror' in which the organization can look at itself to assess, confirm and recognize itself as a culturally distinct entity that is simultaneously interested in needs of the market (Christensen, 1995, pp. 666–7). 'Numerical statements compiled by the organization and graphs concerning market trends, competitive position, sales forecasts, accessibility of raw materials, and so on, are, in fact, projections of interests and concerns of the organization itself. They reflect the way in which the organization understands itself. It is by means of this process of referring to themselves that the organization's members can intervene in their own functioning and, thus, participate in building and preserving their own identity' (Morgan, 1997, pp. 281). Thereby, the marketing function helps the organization to protect and confirm its identity of a customer and market oriented organization. Marketing also relies on proactive activities (for example products innovations and relaunches), which try to anticipate future customers' needs. Thus, the organization could get ahead of the market dynamics, thereby preventing that an unexpected change in customers' needs could bring about a crisis for its identity.

13.3 Research objectives and hypotheses

The main goals of the study presented below were as follows:

- To identify the main distinguishing characteristics of Polish enterprises in the textile and metal sectors.
- To find out what Polish directors thought foreign customers and competitors considered to be the distinctive characteristics of their enterprises.
- To find out what Polish directors thought Polish customers and competitors considered to be the distinctive characteristics of their enterprises.

An attempt was made to advance several hypotheses on the organizational identity and its determinants in the Polish context. They are exploratory in nature and could be used as a basis for further empirical testing.

- Hypothesis 1: Polish enterprises have a dual organizational identity: one constructed for Polish customers and the other for foreign customers.

The second hypothesis addresses the way in which Polish enterprises have responded to threats to their identity, particularly after 1990. These threats include privatization, acquisition by foreign or Polish firms, restructuring, stiff competition by foreign firms, criticism by ecological movements, and accusations by the mass media, the public and other stakeholders.

- Hypothesis 2: there is a trend among Polish enterprises to cling on to their old identity when faced with a threat.

Contrary to this hypothesis, it is generally thought that identity changes when it is threatened by any of the factors listed above (Duton and Dukerich, 1991; Elsbach and Kramer, 1996; Famielec *et al*. 1999; Aniszewska, 1999). Does a change in identity always take place when a threat emerges? Has this occurred in the metal and textile industries?

The next two hypotheses (3 and 4) will be tested to see whether structural variables (privatization, restructuring) influence changes in organizational identity or whether organizational leadership is the more important variable.

- Hypothesis 3: privatization is linked to a tendency to change the organizational identity.

It is commonly believed that the privatization of state-owned enterprises is a strong driving force in economic and organizational changes (Balcerowicz, 1992). Privatization, for instance, affects organizational culture, although its positive impact is not at all obvious (Konecki and Fraczak-Konecka, 1998).

- Hypothesis 4: strong leadership is linked to a tendency to change the organizational identity when there is a threat to the existing identity.

Research shows that strong organizational leadership can change the organizational culture to one that is better adjusted to the competitive environment (Konecki and Fraczak-Konecka, 1998). Theorists of organizational identity also claim that strong leaders are agents of change in respect of organizational identity, and adapt the organization's decision-making processes to the nature of the new identity (Strategor, 1999, pp. 522–5, 527–42, 571).

The fifth and the sixth hypotheses aim at preliminary verification of the impact of strength and type of organizational identity (utilitarian identity versus normative identity) on the formulation of a new organizational strategy.

Highly significant relationships sometimes exist between several structural variables. For example the structure should match the strategy (Strategor, 1999, pp. 287–95); the structure is dependent on the environmental culture (Konecki, 1994, pp. 25–35); the complexity of the structure depends on the firm's size and its technology and the structure is dependent on the complexity and uncertainty of the external environment (Strategor, 1999, pp. 287–95). We shall try to verify the following hypotheses in order to identify the relationship between structure, strategy and organizational identity.

- Hypothesis 5: the stronger the organizational identity the smaller the chance of formulating a new organizational strategy.
- Hypothesis 6: type of organizational identity (utilitarian versus normative) determines the likelihood of a firm formulating a new organizational strategy.

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13.4 Research methods and description of sample

The main research methods were a mailed questionnaire and structured interviews with board members and specialists in firms throughout Poland. The main sectors studied were the textile and metal industries (including the engineering industry), which had been severely affected by the economic crisis in Poland. An attempt was made to obtain a balance between private firms, state-owned firms and firms with foreign investors (about 30 per cent each). Over 50 per cent of the firms had existed in 1990 and were chosen in order to establish how their identity had changed over a period of ten years. Thus it was a targeted sample. The questionnaires were mailed and interviews conducted between December 1998 and March 1999. The data obtained from 186 of the targeted firms were then processed statistically.

The majority of respondents occupied the highest organizational positions (directors/presidents 57.0 per cent, management board members 12.4 per cent), which ensured that their knowledge of and information on their enterprises were reliable. The remaining respondents were managers or specialists. Most respondents were male (73.3 per cent). Their length of service in the sample firms (including in managerial posts) averaged 12 years and their average age was 44 years.

Of the completed questionnaires, 46.2 per cent were from the textile industry, 44.1 per cent from the metal industry and 9.7 per cent from other industrial sectors. In 1998 the enterprises on average employed 256 persons compared with 422 in 1990.

The final sample included 18.3 per cent of firms with foreign capital and 76.3 per cent with full Polish ownership. The firms were also divided into two categories: state-owned enterprises (35 firms, or 18.8 per cent) and private firms (151, or 81.2 per cent). This categorization enable us to examine the impact of ownership form on other variables.

The age of the firms averaged 28 years (private firms 23 years, state-owned firms 50 years). However the average duration of their present legal form amounted to only 10 years (seven years for private firms and 25 years for public enterprises), which reflected the considerable structural–legal transformations that had occurred recently. Firms had not only changed their legal form but also tried to adapt themselves to changes in their environment by changing their production programmes. However these changes were not significant and about half of the firms had not changed their product range. More changes had occurred in the metal industry than in the textile industry, and in state-owned enterprises than in private firms. State-owned enterprises had experienced a stronger need for change than private firms, which had already adapted themselves to the new market situation.

Over 50 per cent of the enterprises assessed their general financial situation as good or very good. However 36.6 per cent were coping with stagnation and a deteriorating market situation. The financial situation of enterprises with foreign capital investment was similar to that of enterprises with only Polish capital but, the situation in the metal industry was better than in the textile industry, with 63.4 per cent of firms in the metal industry being in a good or very good position. The financial situation in private firms was better than in state-owned firms, with almost 61.6 per cent of private firms assessing it as good or very good, compared with 42.9 per cent of state-owned enterprises.

The main competitors of the sample firms in both sectors were domestic enterprises whose product range had not changed since the socialist times, and domestic producers who had recently entered the market. The firms also experienced significant competition from foreign enterprises: 20.9 per cent in the textile industry and 14.6 per cent in the metal industry. Firms with foreign investors felt a stronger competitive pressure than did domestic enterprises.

On average the sample firms exported 18.4 per cent of their output, but some exported as

much as 90 per cent and for one firm it was 100 per cent.

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13.5 Research findings

We shall now consider how organizational identity was defined and constructed in the sample firms, and the differences in this respect between state-owned and privately owned ventures. The main identity characteristics perceived by members of the firms were as follows:

- ‘Perfection’ and ‘high-quality products’ were more frequently cited in private enterprises than in state-owned ones.
- ‘The enterprise’s trademark’ and ‘the enterprise’s position in the market’ were more frequently cited in state-owned enterprises than in private ones.
- ‘Highly qualified personnel’ was more frequently cited in private enterprises than in state-owned ones.
- ‘Job security’ was more important in state-owned enterprises than in private ones.

Thus quality and qualified personnel were at the centre of private firms’ identity, while the enterprises’ trademarks and job security were ranked highly in state-owned firms.

We shall now address hypothesis 1: Polish enterprises possess a dual identity: one constructed for Polish customers and the other for foreign ones ‘construed external identity’. The most important identity characteristics for all firms in relation to foreign customers and competitors were perfection and high-quality products, followed by low product price and reliability. All four characteristics were more important in private firms than in state-owned ones.

Construed external identity in relation to Polish customers was almost identical to that for foreign customers, with perfection and high-quality products ranking top, low product price second and the firm’s trademark and its position in the market third. Hence hypothesis 1 is disproved: Polish enterprises do not have a dual external identity in relation to Polish and foreign customers. This may be due to the fact that to some extent the firms had adapted to operating under global conditions. The internal image of Polish enterprises was positive and the characteristics most frequently cited – perfection and high-quality products indicate that Polish enterprises are heading into the right direction and adopting international operating standards.

The second research goal was to determine the way in which the sample firms responded to threats to their identity (the general feeling that their identity was being undermined). As stated earlier it is commonly believed that such threats emanate from the following: privatization, acquisition by other firms, including foreign ones (Famielec *et al.*, 1999, pp. 126–31), restructuring, strong international competition (Aniszewska, 1999), criticism of firms by ecological organizations, and criticism of firms by the press and others. The hypothesis tested here is: there is a trend among Polish firms to cling on to their old identity when faced with a threat.

Our results show that organizational identity had changed in 51.7 per cent of the firms since 1990. The data also shows that most enterprises (70.4 per cent) had not experienced a threat to their identity. What threats had been felt had been stronger in state-owned enterprises than in private firms. The more that privatization had caused changes in identity, the more it had been perceived as a threat (correlation coefficient 0.16, $p < 0.05$ – see Appendix 13.1). However privatization was also seen as offering a chance to change the firm’s identity, although this was not always fully realized (0.18, $p < 0.09$). Identity changes tended to take place in younger firms, with the correlation between firm age and identity change between 1990 and 1998 reaching 0.25 ($p < 0.01$). The main elements of threat were stiff competition from foreign firms and the necessity of restructuring the firm.

Hence we can verify the hypothesis: there is a general tendency among Polish firms to maintain their existing identity. External pressures do not always arouse anxiety or prompt reflection on possible changes to organizational identity, so there is no direct correlation between a general feeling of threat and identity change (Aniszewska, 1999), rather this change is produced by other factors. In general, threat to identity correlates positively with changes to the organizational structure and strategy, indicating that threats cause changes to be made to the firm's operations but not to its identity. Crises, an adverse economic situation, privatization or continuing public ownership may pose a threat to the identity of firms, but they do not necessarily cause an immediate change to the existing identity. However younger firms have inherited a smaller burden from the past (for example the pre-1990 organizational culture and structure) and are therefore more likely to change their organizational identity (Appendix 13.1).

We shall now test the third hypothesis: privatization is linked to a tendency to change organizational identity. The data on structural variables show variations between state-owned and private enterprises. Identity characteristics such as job security, the firm's trademark and its position in the market were cited more frequently in state-owned enterprises than in private ones. Conversely characteristics such as perfection, high-quality products and qualified personnel were cited more frequently in private firms than in state-owned ones. Many of the top managers of the sample firms claimed that their employees were generally proud of these identity characteristics (60.5 per cent), although 51.7 per cent of the respondents said that certain characteristics had changed. Fewer changes had occurred in state-owned enterprises than in private and privatized ones.

The results show that privatization had little effect on identity: 22.0 per cent said that privatization had had no effect on identity; 8.6 per cent admitted that changes had occurred but only in certain characteristics, and only 6.5 per cent stated that privatization had changed the firm's identity entirely). These data indicate that in the view of top management, privatization alone was not sufficient to cause a change in organizational identity. It should be noted, however, that there were major differences between the definitions of organizational identity presented by private and state-owned enterprises, as well as differences between the satisfaction they derived from their identity. It appears that identity had tended to change less in private firms as the need for such change had not been as great as in the state-owned enterprises. Likewise the degree to which privatization had threatened the existing identity was less in private firms (–0.13, $p < 0.09$). A correlation also exists between privatization and identity change between 1990 and 1998 (0.18, $p < 0.09$). With regard to hypothesis 3, therefore, it can be said that structural variables such as ownership form produced highly differentiated results. Although privatization was objectively connected to identity change the respondents did not perceived it as an important cause of change. We turn now to hypothesis 4: strong leadership is linked to a tendency to change the organizational identity when there is threat to the existing identity. According to 60.2 per cent of the respondents, strong leadership had had a significant effect on identity change, although the influence of strong leaders had been greater in private firms than in state-owned ones (0.17, $p < 0.05$) as managers of the latter were constrained by numerous social and organizational factors. The overall results were as follows:

- Strong leadership influence: 34.9 per cent.
- Rather strong influence: 25.3 per cent.
- Hard to say: 12.9 per cent.
- Rather weak influence: 4.3 per cent.
- Very weak influence: 2.7 per cent.

These results will be easier to understand when the variable 'strength of organizational

identity' has been considered.

13.5.1 Strength of organizational identity

'Strength of organizational identity' concerns familiarity with the firm's history and the pride that is derived from its mission and position in the market, as well as employees' identification with their firm. This concept was examined with the help of the following questions. (The indices used were a modified version of those in Gioia and Thomas, 1996, pp. 396–7.)

- Does top management feel strongly about tradition and know the history of the firm?
- Do managers feel proud of the firm's goals and mission?
- Does top management feel that the firm holds a significant position in its sector?
- Does top management possess an explicitly defined set of goals to be achieved by the firm?
- Are there managers in the firm who know its history and tradition well?
- Does the firm have employees who identify strongly with it?

The answers to the above questions were measured according to a five-point scale. The most positive answers pointed to a strong identity, and all the results correlated quite strongly with one another. Almost all correlations were above 0.50 and the significance level was also very high: 0.001. The average strength of organizational identity amounted to 4.2 on the five-point scale (4.02 in state-owned enterprises and 4.25 in private firms).

We shall now look at the correlation of the variable 'strength of organizational identity' with other relevant variables. The stronger the organizational identity the more changes in identity were due to strong leadership (0.27, $p < 0.01$). Identity is created by top managers and only they are able to change it.

Strong identity also implies better and more open communication with the external environment and the firm's personnel, which is confirmed by the correlation between identity strength and the number of promotional instruments implemented (0.16, $p < 0.05$). This finding corresponds with the results obtained by Gioia and Thomas (1996, pp. 396–7), who found that strong organizational identity influences the interpretation of organizational problems in respect of strategy as well as policy. Firms with a strong organizational identity are more proactive and more inclined to effect changes. Furthermore our data show that the stronger the influence exerted by leaders on changes, the larger the variations in identity between 1990 and 1998 (0.32, $p < 0.01$). Thus we can partially confirm our fourth hypothesis and state that strong leadership is linked to changes in identity, but only when the existing identity is strong. Threats to identity do not play any role in this relationship.

As implied above, the stronger the organizational identity the more promotional instruments are used (0.16, $p < 0.05$). Firms with a strong organizational identity are more inclined to be open to the external environment and to use such instruments as brochures, media interviews, press releases, press conferences, sponsorship, and so on. These instruments help to create an image and make the firm better known to the public and other stakeholders, which in turn tends to make employees proud of their firm (0.22, $p < 0.01$).

The sample firms frequently used the following kinds of promotional instrument: participation in trade fairs (21.8 per cent), brochures (20.9 per cent) and press releases (15.2 per cent). The least regularly used instruments performed a public relations function: open-door days (1.4 per cent) and press conferences (1.4 per cent). Internal instruments such as in-house news bulletins and broadcasts (0.7 per cent) were used extremely rarely. Polish firms are obviously less interested in internal communication with their employees than they are in

external communication instruments, which tend to be more closely related to marketing than to public relations and creating an image. This assertion is supported by the fact that 80.1 per cent of the sample firms did not have a public relations department or a press spokesperson. Of the firms that did have PR departments, 11.4 per cent were state-owned and 19.2 per cent were private. Moreover 80.6 per cent of firms did not use PR agencies. Of those which did, 16.7 per cent were private and 9.7 per cent were state-owned. More firms with foreign capital investment used PR agencies (23.5 per cent) than did firms without (12.7 per cent).

In summary, foreign capital investment and private ownership produce a slightly stronger tendency to use PR agencies, but in general public relations is a minor consideration among Polish firms. With regard to marketing promotions, there are no major variations between the use of promotional instruments by state-owned and private firms.

13.5.2 Identity type

Two types of organizational identity can be distinguished: a utilitarian type (U) and a normative type (N). The utilitarian type is oriented towards the market, competition and profit. The normative type is focused on organizational symbols and culture, and on hierarchical rules and procedures. These concepts were investigated by means of the following questions:

- Should, according to top management, your firm compete aggressively with other firms? (U)
- Are symbols, formal meetings and ceremonies important for the functioning of your firm? (N)
- Are salaries usually fixed by the management board for particular departments according to the annual performance of those departments? (U)
- Are financial profits the only measure of success for your firm? (U)
- Is concentration on explicitly formulated executive procedures a mission of your firm? (N)
- Is there a common conviction in your firm that attention should be paid to marketing, advertising and public relations? (U)
- Do cuts or increases in salaries depend on the performance of particular departments or sections? (U)
- Is cost effectiveness the main criterion for changes in the firm’s activities and administration? (U)
- Are economic effects the most important criteria determining the fulfilment or otherwise of the firm’s mission? (U)
- Are strict procedures, formal rules and subordination to a hierarchy important elements in the success of your firm? (N)

The answers to the above questions were measured on a five-point scale (using indices adapted from Gioia and Thomas, 1996, pp. 396–7). Correlations between the results of the above questions were also examined.

The average value of the utilitarian identity was 3.41 (state-owned enterprises 3.25, private firms 3.45) on the five-point scale, and that of the normative identity was 2.82 (state-owned enterprises 2.76, private firms 2.83). Thus it can be stated that the sample firms possessed a rather utilitarian identity (market-oriented), but the strength of this identity was not great, particularly in state-owned enterprises.

We shall now look at the correlation between the utilitarian identity and other variables

(Appendix 13.1). The stronger the utilitarian identity, the more promotional instruments were used (0.22, $p < 0.01$). Enterprises oriented primarily towards the market, profit and cost effectiveness were more open, communicated more fully with their stakeholders and wished to convey their image to the maximum number of customers. The opposite was true of firms with a normative identity – the higher the value of the normative identity indicator, the fewer promotional instruments were used (–0.31, $p < 0.001$). These firms were less open towards the external environment and did not necessarily wish to communicate with it.

It appears that it is easier to be utilitarian when the financial situation is favourable – the better the financial situation of the sample firms, the more utilitarian their organizational identity (0.16, $p < 0.05$) and the larger the budget for promotion and PR (0.13, $p < 0.09$).

Our results also show that the longer the length of service of top management (the average was 12 years), the more utilitarian the firm's identity (0.17, $p < 0.05$). This is a very interesting finding because managers with long years of service in planned-economy organizations are often stereotyped as being resistant to change and innovation, and as lacking a market orientation. In fact the reverse is often true and experienced managers can be flexible, open to change, have a strong marketing and profit orientation, and see the value of advertising and public relations. Moreover they know their firms better and can respond better to the demands made by the market. They also have a better understanding of the constraints on action for their firms in given sectors. The positive correlation between length of service and utilitarian identity is confirmed by two further correlations. The longer the length of service, the more changes were made to the firm's organizational structure (0.24, $p < 0.05$) and the more likely it was that a new corporate growth strategy was introduced (0.17, $p < 0.05$). Frequent changes in top management mean that managers are not well acquainted with their firms and are slower to adapt to new market situations.

13.5.3 Formulating a new corporate strategy

This section addresses our fourth and fifth hypotheses. Hypothesis 5 – the stronger the organizational identity the smaller the chance of formulating a new organizational strategy – was not confirmed by the correlations (Appendix 13.1) and can therefore be rejected. However a change in organizational identity between 1990 and 1998 was correlated with new strategy formulation (0.17, $p < 0.09$), so there is some relationship between strategy and identity change.

With regard to hypothesis 6 – type of organizational identity (utilitarian versus normative) determines the likelihood of a firm formulating a new organizational strategy – strategies had been formulated by 49.8 per cent of the sample firms and the utilitarian type of identity was significantly correlated with this variable (0.19, $p < 0.05$).

Actions of a utilitarian nature can be observed in the strategies employed by the sample firms: market-oriented activities (38.8 per cent), restructuring and reorganization (30.0 per cent) and investment (14.9 per cent). Market-oriented activities featured more prominently in private firms (43.6 per cent) than in state-owned ones (38.8 per cent). The connection between market orientation, strategy change and utilitarian identity is confirmed by the positive correlation between 'chance of formulating a strategy' and 'number of promotional instruments used' (0.28, $p < 0.01$). The correlation between 'restructuring and reorganization' and 'chance of formulating a strategy' is also very strong (0.46, $p < 0.05$). Changes had taken place in 54.8 per cent of the firms, with restructuring as a strategic activity being more important in state-owned enterprises than in private firms. Investment was also an important element of strategy. Thus with regard to hypothesis H6 we can state that utilitarian identity is connected with the formulation of new strategies.

13.6 Conclusions

Our study has shown that the organizational identity of over 50 per cent of Polish firms in the me characteristics are as follows:

- Perfection and high-quality products are perceived as more important to organizational ident
- The firm's trademark and the firm's position in the market are valued more highly in state-ow
- Highly qualified personnel are more characteristic of private firms than state-owned ones.
- Job security is more important in state-owned enterprises than in private firms.

Those firms which operate in international markets do not have a dual external identity in relation this reflects their adaptation to operating under global conditions.

There is a general tendency among Polish firms to maintain their existing identity in the face of e pressure, change in ownership form (privatization) and economic downturns. Hence there is not a However threats to identity correlate positively with changes to the organizations structure and st

Our results show that ownership form has a large effect on the nature of organizational identity a more likely to result in identity change in private firms than in state-owned enterprises, and the st reformulation occur more frequently in state-owned enterprises, which are characterized by less having been forced by the market and legal regulations to carry out bigger changes.

Privatization is not an important cause of change to organizational identity, although it can prese

PR and promotional activities are rather weakly developed in Poland. However the stronger and better the firm's financial situation and the more frequent the formulation of new strategies. Firms better communication with their stakeholders. They are not afraid of the external business enviro

In summary, a strong utilitarian identity and strong leadership are the main factors in identity cha future studies should take more note of leadership strength, and strength and type of organizatio market competition. On the basis of the data presented in this chapter and the possibility of influe to change their organization's identity:

1. A broad spectrum of public relations and promotional instruments should be used to supp
2. The selection of top managers should be careful and thorough in order to ensure that they
3. The privatization of as yet unprivatized enterprises will offer the chance to change the org

Table Appendix 13.1: Correlation table

Variable	Utilitarianism	Normativeness	Promotional instruments	Pride in firm	P
Identity strength	0.00	–0.10	0.16*	0.22**	0
Utilitarianism		–0.23**	0.22**	0.11	–
Normativeness			–0.31***	–0.03	0
Promotional instruments				0.07	0
Pride in firm					0
Privatization					

Leadership					
Size 1990					
Size 1998					

	Structure	**Strategies**	**Firm’s age**	**Exports**	**L s**
Identity strength	–0.06	–0.03	0.02	0.04	0
Utilitarianism	0.13	0.19*	–0.08	0.00	0
Normativeness	–0.05	–0.05	0.00	0.00	–
Promotional instruments	0.21**	0.28**	0.27**	0.04	0
Pride in firm	–0.01	0.01	–0.07	0.12	–
Privatization	0.12	0.04	0.31***	0.13~	–
Leadership	0.04	0.21**	–0.02	0.05	0
Size 1990	0.26**	0.19**	0.46***	0.16*	0
Size 1998	0.24**	0.21*	0.40***	0.26**	0
Financial situation	–0.07	0.05	0.00	0.00	0
Structure		0.46*	0.30***	–0.05	0
Strategies			0.26**	0.00	0
Firm’s age				0.06	0
Exports					0
Management length of service					
Ownership form					
Identity variations					
Identity threat					
Foreign capital					

Notes: ~ p < .09; * p < .05; ** p < .01; *** p < 0.001.

Notes

1. This chapter is based on a study entitled ‘Organizational Identity of Polish Enterprises. Co Society Support Foundation, grant no. 1143/1998.
2. Qualitative studies are particularly useful in identifying these characteristics. A case study

commonly experienced by employees is based on three factors: (1) general feeling of unic training; (2) organization of work (activities at the shop-floor level were not overly controlle the development of good relations between employees); and (3) forms of address (non-hie climate). On the other hand the organizational structure (autonomous subsidiaries) and pr file employees, unlike managers, did not perceive that these characteristics were specific Japanese firms. However, the absence of trade unions in the company and their inability t (Konecki, 1994, p. 145–59).

3. According to organization sociologists, organizational identity can be maintained through t its marketing research, image analysis and advertising, creates a 'mirror' in which the orga that is simultaneously interested in needs of the market (Christensen, 1995, pp. 666–7). 'N competitive position, sales forecasts, accessibility of raw materials, and so on, are, in fact, the organization understands itself. It is by means of this process of referring to themselve in building and preserving their own identity' (Morgan, 1997, pp. 281). Thereby, the marke market oriented organization. Marketing also relies on proactive activities (for example pro organization could get ahead of the market dynamics, thereby preventing that an unexpec

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Chapter 14: Simple Rules and Simple Solutions: The Dominant Logic of High and Low Performers in Turbulent Environments

Krzysztof Oblój

Abstract

This chapter considers the impact of a dominant logic on a firm's performance with regard to the development of a set of Polish companies during the 1990s. One of the main findings is that high performers have simple rules that enable them to create and seize opportunities. Low performers follow more complex strategies and develop their dominant logic at a very early stage of the market's and the company's life cycle. Whereas leading firms manage to benefit from learning opportunities in difficult situations, peripheral firms display a rather passive attitude towards the challenges of the dynamic Polish business environment.

14.1 Introduction

Company strategies have been conceptualized as positions, configurations, core competences and sets of simple rules (Porter, 1980; Hamel and Prahalad, 1994; Porter, 1996; Miller, 1999; Eisenhardt and Martin, 2000). The dominant theme in all these approaches is that a pattern is embedded in organizational decisions and actions. This pattern is variously called a 'strategic frame' (Huff, 1982), a 'dominant theme' or 'configuration' (Miller, 1999), 'interconnected choices' (Siggielkow, 2000) or, most often, 'dominant logic' (Prahalad and Bettis, 1986). Many of these models are an extension of Cyert and March's (1963) argument that in their decision-making managers rely on a repertoire of schemas, frameworks and solutions. In cognitive terms this is effective because it prevents them from being overwhelmed by a flood of information and decision options. Once set in place, a dominant logic becomes a dominant force shaping an organization's actions.

To date only limited light has been shed on how dominant logic influences organizational performance. Does the evolution towards a coherent dominant logic enhance performance, as notions of fit and alignment suggest (Miles and Snow, 1978; Powell, 1992; Jennings and Seaman, 1994; Zajac *et al.*, 2000)? Or, as the literature on inertia suggests (Tushman *et al.*, 1986; Kelly and Amburgey, 1991), does a dominant logic eventually create rigidities that limit performance, resulting in the need for change? Or perhaps the influence of dominant logic depends on the specific set of external opportunities and threats that firms face in the industry (Cavaleri and Obloj, 1993)? In short, we do not fully understand how a dominant logic can create winners and losers in a dynamic marketplace.

This chapter addresses this question by examining the dominant logic of several firms that attained leading or peripheral positions in Poland during the decade 1989–99. In doing so it follows Bettis *et al.*'s (1978) suggestion and focuses on outliers rather than central tendencies.

14.2 Theoretical background

Numerous research streams deal with the question of how managers develop mental maps, knowledge structures and administrative routines that create a dominant logic over time (Mintzberg and Walters, 1982; Walsh, 1995; Miller, 1999; Baum and Dobbin, 2000). Four of these, grounded respectively in decision theory, evolutionary economics, neo-institutionalism and strategic management, are among the most influential.

March's (1994, 1996) theory of organizational action offers an answer in the form of a rule-following model that stipulates that organizations grow, learn and adapt by alternating between modes of exploration and exploitation. The process results in socially constructed rules that offer a reasonable adaptation to appropriate contexts (Levinthal and March, 1993). Rules also guide actions in a consistent and mutually understood way (Weick, 1995), and are therefore an important element of an organization's dominant logic.

Important findings have also been produced by parallel research in evolutionary economics and institutionalism. In evolutionary economics (Nelson and Winter, 1982) the term 'routines' is used to describe the guiding rules of organizational evolution when organizations are moving forward with limited knowledge of the context and options. In this situation routines limit cognitive strain and provide clear, if suboptimal, guidance for actions. Institutional theorists (DiMaggio and Powell, 1983) offer a typology of mechanisms that regulate organizational change and create dominant patterns of behaviour in organizations. The most important of these are coercive isomorphism, mimetic isomorphism and normative isomorphism, all of which lead to institutionalized behaviours that homogenize the way organizations behave and once put in place are difficult to change or remove (Powell, 2000).

In the field of strategic management Prahalad and Bettis have developed a framework of dominant logic defined as a 'mind set or a world or conceptualization of the business and administrative tools to accomplish goals and make decisions in that business' (Prahalad and Bettis, 1986, p. 491). The conceptual foundations of dominant logic consist of two main elements: operant conditioning and complex problem-solving behaviour. Operant conditioning serves to reinforce behaviours that have led to success. Thus strategic choices (Child, 1997) that have proved successful are remembered and reinforced. Complex problem-solving behaviour is a result of cognitive bias (heuristic decision making) and cognitive simplifications created by conventional wisdom (paradigms) and past experiences.

Prahalad and Bettis's (1986) definition of the concept as a 'mind set' offers, as Grant (1988) notes, only limited guidance to operationalizing the concept for research purposes. Instead Grant examines dominant logic as a set of specific corporate-level functions: resource allocation, the formulation of business strategies, and the establishment and monitoring performance targets. This approach, however, equates dominant logic with routines and is not consistent with the cognitive premises of the original theory.

In this chapter dominant logic is understood as a much more complex regulator than just routines, and therefore closely follows the dominant logic model originally conceptualized by Bettis and Prahalad (1995). In this conceptualization dominant logic is viewed as an information filter and knowledge structure that owes its evolution to experiences related to the characteristics of the core business, tasks that are critical to success, performance measures and values, and the evolution of norms over a substantial period of time. Thus they incorporate into the model both cognitive and operational dimensions, and this approach shapes our research model (Figure 14.1).

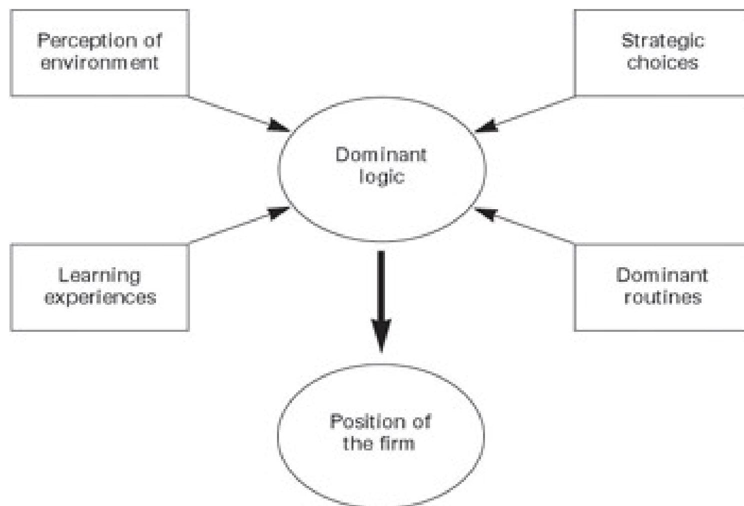

Figure 14.1: The research model

14.3 Research method

The aim of this study is to explain how the dominant logic of new ventures in Poland influenced their performance during the economic transformation of 1990 to 2000.

The cognitive, 'soft', dimension of dominant logic is shaped by two variables. The first of these, 'perception of environment and organization', comes from Prahalad and Bettis's (1986) concept of operant conditioning, research on sense making (Weick, 1995) and the development of organizational identities (Petraf and Shanley, 1997). This construct refers to managers' perception of how organizations function (deliberate planning versus emergent strategies) and of the effect of environmental forces (opportunities or threats). The second variable, 'learning from experiences', reflects both behavioural psychology (Levinthal and March, 1993; Von Krogh, 1996) and the seminal work of McCall *et al.* (1988). This variable is measured by the quantity, content and consequences of events that respondents consider critical to a company's life cycle.

The operational, 'hard' dimension of dominant logic is also shaped by two variables. First, depending on their results, strategic choices made by management (Bettis and Prahalad, 1995; Child, 1997) either reinforce or weaken the patterns of dominant logic over time (Prahalad and Bettis, 1986; Siggielkow, 2000). Second, dominant routines (Nelson and Winter, 1982; March, 1994; Grant, 1988) are important because they structure operations across the value chain and can determine final firm performance (Bettis, 2000).

Poland's transformation from a planned to a market economy, initiated in 1989, offers a unique opportunity to study the evolution of dominant logic in new ventures, comparable only to the study of emerging high-tech industries (Zyglidopoulos, 1999). The change to a market economy allowed entrepreneurs to start new ventures and create markets and industries that had previously barely existed.

In our study, in order to minimize the influence of different conditions from the start, it was necessary to concentrate on companies with a similar point of departure in 1989–90; that is, had been established at roughly the same time, were in the same industry and had similar opportunities and resources. Because the fate of firms can be decided by several factors we had to control for environmental changes and unexpected jolts (for example radical changes in statutory laws that favoured particular types of firm or the rapid entry of MNCs). Therefore we decided to focus on industries that met the following conditions: relative newness, low barriers to entry, initial lack of economies of scale, and limited strategic significance for multinational companies (MNCs).[1]

Relative newness means that the industry did not exist under the communist regime or was underdeveloped because of its lack of strategic importance to Poland's planned economy. Hence there was neither a market structure nor regulations to limit the entry of entrepreneurs. Low barriers to entry were a necessary precondition for new, undercapitalized entrepreneurs. An initial lack of economies of scale was considered important in levelling the chances of new entrepreneurs. Finally, if the market in question was of limited strategic interest to MNCs the new ventures would have ample time to develop their strategies and attain significant market shares.

After identifying industries or industry segments that met these conditions we chose five pairs of companies in the following industries: cosmetics,[2] public opinion and marketing research, consultancy, computers, and outdoor sports equipment.

In the computer industry we chose Optimus, a dominant computer producer established by an entrepreneur in 1989. In 1999 its turnover exceeded US$150 million. We paired Optimus with Baza, a former competitor of Optimus that had had a turnover of almost US$30 million in

1996 but was now on the verge of bankruptcy and had a turnover of less than US$3 million. In the cosmetics industry we identified Eris and Dax as outliers. Eris was a dominant firm in the industry and had a wide product range, the best brand name among Polish producers and a sophisticated distribution network. Dax was a much smaller niche firm. In the consulting business we studied WGK and Management Focus, which by international standards were quite small. WGK was five times larger than Management Focus and had a much more extensive record of sectoral studies, privatizations and large projects. The outdoor equipment industry was booming in Poland and had a clear leader: Alpinus, one of the most recognized brands in Poland. It produced equipment and clothing for climbers, cyclists, sailors and other outdoor sports enthusiasts. At the periphery of the industry was Janysport, a small producer of backpacks and climbing gear. The public opinion and marketing research industry also had a dominant leader: SMG/KRC. Established in 1990 by ten sociology students and scholars it had become a household name and had developed methods that had quickly become industry standards. We paired SMG/KRC with Demoskop, which had been established at the same time as SMG/KRC by two sociologists and was also well known. It had initially had first mover advantage, but due to a complex sequence of events it was now a much smaller company.

The author and his research colleagues conducted field interviews and surveys in 1999–2000. In total, over 50 structured interviews were conducted and the number of interviews at each firm ranged from four to nine. The interview protocol had four distinct parts. The first focused on the managers' perception of the business environment and their organization over time. They were asked about their perception of the environment in terms of opportunities, threats, problems to be solved and so on, how this had changed over time, how the firm cooperated with vendors and customers, and about the firm's relation with its competitors. Questions that focused on the formalization, centralization, and standardization of organizational operations were intended to reveal the dominant paradigms of organizational design.

Table 14.1: Pairs of analyzed firms and their turnover in 1999

	Leading firm	**Peripheral firm**
Cosmetics	Eris	DAX
	(US$20 million)	(US$5 million)
Public opinion and research	SMG/KRC	Demoskop
	(US$12 million)	(US$1.4 million)
Consulting	WGK	Management Focus
	(US$3 million)	(US$2.4 million)
Computers	Optimus	Baza
	(US$150 million)	(US$3 million)
Outdoor sports	Alpinus(US$22 million)	Janysport (US$250 000)

The second part of the interview protocol concentrated on decisions considered to be strategic. We were interested in how such decisions were made (incrementally or at a stroke), what they were, and how they were evaluated *ex post*. The third part consisted of a series of questions about routines in the organization – how they were developed, which dimensions of the organization's activities were first formalized as routines, which routines could be bypassed and under what circumstances, and what areas in the organization were not regulated by procedures and why. In the final part of the questionnaire managers were asked

to name two of the most significant events in the history of the company and how they had been handled.

[1]This set of conditions was agreed upon by a panel of eight entrepreneurs, managers and consultants as creating in the early 1990s the best conditions for the growth of new ventures and as not favouring any particular player at the starting point.

[2]A cosmetics industry did exist under the communist regime, but after 1989 many companies were so dependent on exports to the Soviet Union that they either went bankrupt or had such a poor reputation and limited product range that they could not set up significant barriers to entry.

Team LiB

14.4 Exemplary 'twins'

The Polish cosmetics industry was well developed under the communist regime. Several factories used the umbrella brand of Pollena and established a wide range of products for the domestic and export markets. It was also an industry that many entrepreneurs decided to enter in the 1980s (Eris, Soraya, Dax, Oceanic, Kolastyna, Comindex, Catzy, InterFragrances and others). These new entrants focused on niche markets.

Eris was established in 1983 by a pharmacist who wanted to develop new types of cosmetic. She was able to leave her job and establish a firm due to an unexpected inheritance. She started with one employee and a very limited product range. Production was undertaken in leased premises and without any professional equipment, but with the clear goal of making high-quality products at a reasonable price. Many of the ingredients were imported and production frequently halted because an ingredient or packaging had run out. State-owned shops were not interested in purchasing products from an unknown private producer, but in spite of all obstacles the firm slowly grew, employing four people in 1984 and producing 6000 units per month. Real opportunities were created by the transformation in 1989. The owners of the company decided to borrow money and to invest this and all their earnings in the development of the business. They built new production facilities, and because of a clause in Polish employment law that provided companies with tax relief if they supported the employment and rehabilitation of disabled individuals, the new factory was specially adapted to enable the employment of a number of disabled people. Swiss-made machinery was installed.

Despite a rapid increase in sales the company encountered serious cash-flow problems, and when bankruptcy became a distinct possibility the owners agreed to sell products to a powerful distributor at cost just to continue operations. This was a hard lesson in cash-flow management and the managers learnt it well, securing a collection of accounts receivable with each new project. In 1993 the product range was extended to include body lotions, skin tonic and cleansing milk, and employment increased. Monthly production rose significantly to one million units. In 1994 the firm established its own laboratory, which guaranteed a stable technological regime and consistently high quality. In the same year the firm decided to launch a product line for women aged 40 and above to compete with renowned Western brands. Industry experts viewed this move with disbelief because the products were expensive, bore heavy advertising costs and had a comparatively limited market. However the entire range proved very successful and the firm quickly followed with a similar line for women in their thirties.

In 1996 Eris changed its organizational structure and remodelled its distribution system in order to focus on supplying 19 large wholesalers. This proved disastrous as other companies refused to cooperate as minor partners. Sales went down, but the CEO of the firm persisted with the tactic. After almost a year of downturn, sales bounced back. In the meantime the firm opened Poland's first cosmetic institute, which offered comprehensive face and body treatment by a dermatologist and skin-care specialists. This move enhanced the company's reputation as an industry trendsetter and led to the establishment of a 'beauty farm' in the Polish mountains, where each client received a customized programme of treatment by a team of dermatologists, skin-care specialists, masseusses, rehabilitation specialists and dietitians.

The speed of the company's development and its positive financial results attracted numerous awards for its products, services and management style. At the time of the study Eris controlled 16 per cent of the market share, but its owners' attention continued to focus on company promotion and their most valuable asset – a well-known brand that was now also recognized outside Poland.

The history of Dax was very different, despite its similar beginnings. Two colleagues from the Medical Academy established the company in 1984. The first two years were difficult, but the firm slowly increased its sales and began to focus on exporting to communist countries where quality requirements were not high and good packaging could sell anything. This proved to be a profitable strategy and the firm grew rapidly. However in 1989 the communist markets collapsed and the company's sales slowed. The company already had high fixed costs but it nonetheless invested additional money in new machinery in order to increase output. But its problems persisted as it had difficulty collecting payments from the former communist markets and had problems with selling its low-quality products on the Polish market as the brand name was practically unknown and distribution channels were limited.

In 1991 a well-known international company entered the Polish market with a new, heavily advertised liposome cream. Dax decided to piggyback on this company's success and placed a similar but cheaper cream on the market. This proved successful and the firm decided to expand into other product ranges by similar means. A short time later the international company warned Dax against using its registered brand name, so Dax renamed the product and placed it on the market at a higher price. It did not sell well – partly because general sales of liposome cream were declining due to bad press – and the firm began to face severe cash-flow problems. In 1996/97 Dax reduced its employee and production levels. In 1998 it began to restructure in order to focus more on marketing and distribution. New sales representatives were appointed and a rational distribution system was slowly developed. Once again the company decided to copy a successful international brand, this time a shampoo. It then launched a body lotion, and later a facial mask. This strategy worked and the company expanded. Over the following years its product range grew and in 2002 Dax held a 4 per cent share of the body-care market in Poland.

14.5 The dominant logic of leading firms

Both leading and peripheral firms in the Polish market place have a coherent dominant logic, but the elements and dynamics of their logics differ, as even our brief comparison of firms in the cosmetic industry has shown. In a nutshell, winners follow simple rules and use them to maximize their opportunities. They are flexible and quick. The dominant logic of winners is developed in a similar way to Siggielkow's (2000) patch-to-patch mode of behaviour.

The most common feature of managers' paradigm is external orientation. They focus on environmental trends and events and perceive them as a set of opportunities to be exploited. They are oriented towards marketing their products and services by means of optional marketing strategies, experiments and innovations, and quick entries and exits in search of an opportunity to create a standard and/or brand. In our study the key role in this respect was played by the owners, who were natural, passionate and optimistic leaders.

In terms of routines, leading firms are pragmatic and opportunistic. They introduce new routines only when it is necessary and only when they think they will benefit from them. They do not respect formal structural arrangements. Rather they rely on trial and error to evolve into a flexible but centralized organization, where there is limited formalization and standardization and leaders can bend rules and procedures.

On average, leading firms also make more strategic choices than do peripheral firms. For example the managers of Eris decided to focus on quality, to use imported ingredients, to construct a new factory adapted to the needs of disabled workers, to risk entry into luxury segments, to reorganize their distribution channels and to diversify into related markets. Most of these choices were made rapidly, but with a reasonable degree of analysis and calculation.

Finally, leading firms readily acknowledge that they experience difficult situations, but they treat these as learning experiences. For the market research institute SMG/KRC it was the departure of the whole department of quantitative analysts, and the loss of a major client. The consultancy firm WGK lost some large and important contracts, as well as being confronted by accusations of professional misconduct and a long legal suit, and had to close its human resources practice. Eris went through several learning experiences, including an up-market move, problems with its distribution network and an expensive effort to diversify.

Traumatic and difficult experiences in leading firms inevitably trigger structural or procedural changes, and are used to remind managers of possible problems and pitfalls. The synthesis of paradigms, choices, experiences and routines create a dominant logic with simple rules of action that enable leading firms to operate in a confusing and turbulent environment. In our research we did not encounter the comprehensive set of methodological, boundary, priority, timing and exit rules proposed by Eishenhardt and Sull (2001) because in a turbulent environment no firm can have *a priori* knowledge of what will make sense and what will not. Therefore winning firms develop their rules piecemeal in response to difficult experiences and choices.

The two main rules of leading firms are 'be optimistic' and 'move fast'. The managers of winning firms perceive the business environment as offering a set of opportunities to be seized and exploited. A natural extension of this is the development of an organizational culture that emphasises action, risk taking, initiative and allowance for errors. All leading firms behave like inquisitive children and are always ready to experiment with something new, even though this means making more (and more costly) mistakes than peripheral firms. However leading firms eventually mature. The owners of all the firms we studied introduced routines for key processes, and most of them eventually hired professional managers. However none of them formalized and standardized their operations to the same degree as did peripheral firms.

The second strategic rule of leading firms – 'move fast' – means entering fast, growing fast or exiting fast. In our study we observed a clear passion to fight, to win and to be a leader. The founders established the boundaries of their firms' strategic domain and set priorities, but then allowed their managers to experiment. Leading firms sometimes institutionalized innovations and offered symbolic or financial rewards. Over time SMG/KRC entered all possible research markets (political, social and marketing) and offered all styles of service – customized, joint and so on. It introduced special awards for innovative thinking: Virtuti Researcheri (a special decoration modelled after the Polish military famous decoration Virtuti Militari), dinner with the president, a bonus of one month's pay and so on. Alpinus, the leading producer of equipment and clothing for outdoor sports, experimented with all possible product lines, most of which proved unsuccessful in terms of profitability. Optimus (the leading computer hardware and software producer) strived from the very beginning to attain a dominant position in the industry and used rapid product upgrades, alliances with Microsoft, Intel and Lockheed Martin, and frequent new offerings (computer consultancy services, integration services, B2B (business to business), portals, vortals) to maintain its first mover advantage. At the time of the research Optimus had developed into a group of 29 firms, headed by a core firm.

14.6 The dominant logic of peripheral firms

A surprising discovery of our research was that at the beginning the dominant logic of companies that later lost their chance in the market place had been very coherent and almost mature, and that its evolution had resembled Siggielkow's (2000) 'thin to thick' model. In terms of orientation the founders and managers had a balanced perception of the business environment as consisting of opportunities but also threats and problems to be solved. Eventually however, as their firms had lost ground to industry leaders, they had focused less on opportunities than on events and trends that might have a negative impact on the industry as a whole and on their firms in particular. They perceived competitors as ruthless or unfair, customers as fickle and the general business climate as bad.

In general, in terms of routines losers formalize their activities and introduce standard operational procedures much faster than do winners. Their structures are centralized and rigid compared with the structures of leading firms. Whereas leading firms formalize and standardize activities that are critical in terms of overall productivity or have to be standardized by law (for example accounting), peripheral firms do it because they have limited trust in their employees. They centralize decisions at the top management level as a response to what is perceived as an 'unfriendly' environment, and the organizational culture is shallow.

Few strategic decisions are taken by peripheral firms, and those which are taken are made very early in their life cycle. In spite of changes in the business environment the owners of peripheral firms stick to their original strategy, as predicted by organizational ecology theory (Hannan and Freeman, 1989). However as our research showed, in turbulent markets agility and experimentation pay off – sticking to the original strategy does not. For example in our study Janysport (the producer of high-quality backpacks and climbing equipment) failed to introduce new models and colours, and did not attempt to follow or set trends in the way that Alpinus did. Likewise the owner of Baza, which was established at the same time as its competitor Optimus, did not modify his original strategic decision to limit the product range to computers and peripheral products, despite the industry trend towards the integration of computers, software and services. In addition his initial decision to structure the firm as a federation of regional offices may have enabled Baza to grow rapidly at the beginning, but it eventually precluded synergy, cooperation and integrated effort, and by 1997 its regional offices were closing one after the other. Meanwhile Demoskop's continuing commitment to public and social research and 'scientific' methodology meant that it lost the opportunity to grow. In all of these cases, conscious strategic decisions were made with regard to markets, products and sources of competitive advantage, but the strategies were not successful in the long run because they were rigidly maintained rather than adapted to the changing environmental situation.

Finally, the most striking feature of the peripheral firms in our study was that they almost never learned from their experiences. One would have thought that after a decade of limited growth or decline the owners or managers would have been able to describe at least two difficult situations as learning experiences. Instead some had difficulty identifying even one problem (Management Focus and Baza) or blamed their problems on a conflict between the owners (Demoskop and Janysport) or on a crisis in the Russian market (Dax). Hence peripheral firms do not learn easily and if any learning does occur it merely reinforces the existing dominant logic in terms of perceiving of the environment as hostile, the correctness of earlier strategic choices and the limited value of routines.

14.7 Conclusions: inquisitive children and mature losers

This chapter has addressed the issue of dominant logic as a cognitive, strategic, operational and evolutionary concept to study how winners and losers built their strategies in the turbulent Polish markets between 1989 and 1999. By studying the constituent elements and consequences of the dominant logic of pairs of competing firms with almost the same chance of growing in the newly established markets we have identified two types of dominant logic that determine performance. High performers – firms that attain leading positions in the market – do not have coherent strategies and rigid plans. They follow simple rules that enable them to create and exploit opportunities, influence events, establish standards and brand names and attract publicity. Their dominant logic is developed in a piecemeal fashion in response to the outcome of strategic choices, and they learn from their experiences.

Low performers that attain only a peripheral position in the market develop their dominant logic at a very early stage of the firms' life and strengthen it over time. The result is a more coherent and consistent strategy than that of high performers, but it is also more limited and rigid. Peripheral companies do not pursue opportunities but concentrate on problem solving. They develop their strategies early and follow them rigidly. They are centralized and formalized, and eventually become slaves of their dominant logic, rationalizing failures and failing to learn from experience.

Both winners and peripheral firms have a dominant logic that has both cognitive and operational components, and most of the time they stick to their cognitive paradigm and managerial decisions. However the dominant logic of winners enables them to exploit opportunities and grow rapidly, while that of peripheral firms is governed by their early strategic choices (Child, 1997), which limits their options and renders them unable to change. Leading firms learn from their difficult or traumatic experiences (such as strictly ruling out further diversification after engaging in a disastrous diversification that at first looked like a sure winner), while peripheral companies simply dismiss them as 'bad memories'.

In a way, from their inception leading firms operated like inquisitive children, using simple rules to experiment in the market place. Conversely peripheral firms adhere to their early strategies and operate like mature and experienced companies from the start. This dominant logic strengthens over time, despite difficult experiences and the obvious limitations it places on growth. Limited environmental investigation leads to erroneous evaluation of the firm's position, lack of cultural change and inertia. Managers in peripheral companies learn to live with their limited options, and tend to blame their problems on the business environment or the unfair strategies of winners.

Notes

1. This set of conditions was agreed upon by a panel of eight entrepreneurs, managers and consultants as creating in the early 1990s the best conditions for the growth of new ventures and as not favouring any particular player at the starting point.

2. A cosmetics industry did exist under the communist regime, but after 1989 many companies were so dependent on exports to the Soviet Union that they either went bankrupt or had such a poor reputation and limited product range that they could not set up significant barriers to entry.

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Chapter 15: How Multinational Corporations Can Upgrade Foreign Subsidiaries: A Case Study from Central and Eastern Europe

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Abstract

While many companies operate across borders, some of them still hold the view that headquarters are the principal source of competitive advantage. These companies do not fully use the potential that foreign subsidiaries offer. In this chapter one means of upgrading foreign subsidiaries is presented: the setting up of a centre of competence. The role of a centre of competence is illustrated by the results of a case study conducted in Central and Eastern Europe. It is shown how a Slovakian subsidiary of a German multinational corporation was developed into a centre of competence. The chapter has two major objectives: to show that MNCs that establish centres of competence abroad have to undergo strategic, structural and cultural changes; and to demonstrate that not only subsidiaries in Western countries but also subsidiaries in transition economies can become centres of competence.

15.1 Internationalization strategies and headquarter–subsidiary relations in multinational corporations

Internationalization strategies are multifaceted and multinational corporations (MNCs) have to formulate strategies on a number of dimensions.[1] They have to decide which markets to serve. They have to choose appropriate modes of entry for every country and region. They have to determine at what time and in which sequence different markets should be entered. They have to choose between centralization and decentralization, between globalization and localization, and between standardization and differentiation. Finally, they have to coordinate and integrate their widely dispersed activities. (For these dimensions of internationalization strategies Kutschker and Schmid, 2002, pp. 787–1032.)

For many MNCs, foreign subsidiaries are playing an increasingly important role in their internationalization strategy, so the relationship between headquarters and subsidiaries has changed during the last 15–20 years. Some MNCs have become multicentre firms in which competences, capabilities or resources are dispersed (Forsgren, 1990; Forsgren *et al.* 1992). They have become aware of the fact that their subsidiaries' influence is growing, partly as a result of the latter's embeddedness in internal and external networks (Pahlberg, 1996). They also know that their subsidiaries have individual tasks to fulfil and might therefore take on different roles.[2] The result of all this is that headquarters are not as powerful as they were previously (see Birkinshaw and Hood, 1998; Holm and Pedersen, 2000).

Not all MNCs, however, have recognized that a shift in perspective is necessary, and do not take proper advantage of their foreign subsidiaries by making full use of their potential. Admittedly, taking advantage of a subsidiary requires the subsidiary to have something special to offer, both to headquarters and to its sister companies. But many subsidiaries have much more to offer than headquarters believes. In this chapter one way of exploiting subsidiaries' competences, capabilities and resources is presented: the establishment of a centre of competence, which is a way of upgrading foreign subsidiaries.

Section 15.2 provides a definition of centres of competence and describes their activities, while Section 15.3 presents the findings of a case study in Central and Eastern Europe. This case study will show that centres of competence can be just as successful in transition economies as in mature markets. As will be discussed in the conclusion (Section 15.4) managing centres of competence is a challenging and difficult task.

[1]In this chapter 'multinational' is used as a generic term for companies operating in more than one country. It should not be interpreted in Bartlett and Ghoshal's (1989) way, who differentiate between international, multinational, global and transnational firms. For a discussion of Bartlett and Ghoshal's work see Schmid (1996, pp. 27–33) or Kutschker and Schmid (2002, pp. 281–93).

[2]Bartlett and Ghoshal (1986, 1989) differentiate between 'implementers', 'contributors', 'strategic leaders' and 'black holes'. For a review of the various typologies see Schmid *et al.* (1998).

15.2 Foreign subsidiaries as centres of competence

15.2.1 General definition of 'centre of competence'

In line with earlier publications (Schmid *et al.* 1999; Schmid, 1999, 2000), in this chapter the term centre of competence is used to describe an MNC subsidiary that:

- Has specific competences or capabilities in one or several areas (functions, products or processes).
- Is responsible for the markets in several countries with regard to these areas.
- Is highly integrated into the MNC.

To be a centre of competence all three conditions must be fulfilled, as discussed in the following subsections.

15.2.2 Competences and capabilities

The most important decision an MNC must take is which type of centre of competence it wants to establish, that is, the types of responsibility the centre should have due to its specific resources, competences and capabilities. This comes close to what White and Poynter (1984) call 'value-added scope'. A centre of competence can be one of three types: functional, product-oriented or process-oriented.

Functional centres of competence are foreign subsidiaries in which one or several value-adding activities are developed into an area of competence. Examples are research, development, purchasing, production, sales, marketing, logistics and distribution. Superior competences or capabilities can relate to any function. Even subsidiaries that are involved in supporting or coordinating activities rather than primary value-adding activities can be centres of competence.[3]

Product-oriented centres of competence are subsidiaries responsible for all value-adding activities for a specific product or service, although in some cases the responsibility can extend to several products, a specific group or line of products or a certain area of business.

Process-oriented centres of competence are responsible for processes such as product development. Although cross-border business processes are difficult to handle, MNCs can establish centres of competence for processes.

15.2.3 Geographical responsibility

As stated in the definition above, for a subsidiary to be a centre of competence it must be able to apply its specific competences or capabilities in several countries' markets. Thus MNCs have to define the geographical responsibility of their centres of competence, or what White and Poynter (1984) call their 'market scope'. There are three basic options: worldwide responsibility, regional responsibility and country-portfolio responsibility. MNC subsidiaries with global responsibility can be described as having world mandates or global mandates. Likewise a subsidiary that is responsible for a specific region can be said to have a regional mandate. Some centres of competence have individually defined portfolios of country markets, and therefore have country-portfolio mandates.

Table 15.1: Basic types of centres of competence and different options for their geographical responsibility

Geographical responsibility	Functional centre of competence	Product-oriented centre of competence	Process-oriented centre of competence
World-wide	World functional	World product	World process
responsibility	mandate	mandate	mandate
Regional	Regional functional	Regional product	Regional process
responsibility	mandate	mandate	mandate
Country-	Functional mandate	Product mandate	Process mandate
portfolio	for specific	for specific	for specific
responsibility	countries	countries	countries

Table 15.1 summarizes the basic types of centres of competence and the options for their geographical responsibility. It demonstrates the wide range of possibilities open to MNCs that wish to establish such centres.

15.2.4 Integration into the organizational network

While centres of competence have a certain degree of independence they are also an integral part of the MNC. Thus a basic feature of such centres is that they function fairly autonomously while at the same time being a decisive part of the corporation as a whole. As we shall see, a centre of competence is given as much independence as possible in particular areas (certain functions, products or processes), but other parts of the corporation are entitled to make use of its competences and capabilities. The MNC can therefore be seen as an intraorganizational network, with complex flows between headquarters and its foreign subsidiaries.

To gain an idea of the degree of integration of the network an MNC might consider the consequences that would arise if the focal centre of competence no longer had access to the competences, capabilities and resources of the parent company and the rest of the network, and *vice versa*. The greater the consequences in both cases, the greater the integration of the centre of competence into the MNC. At the same time integration is a question of influence. A highly integrated subsidiary is influenced in various ways by the decisions, actions and behaviour of headquarters and other subsidiaries, and it also influences other parts of the corporation. For example a centre of competence might have a positive impact on the development of the competences, capabilities and resources of other units (Schmid *et al.* 2002; Kutschker *et al.* 2002).

15.2.5 The centres of competence and the literature on MNCs

The importance of competences, capabilities and resources for firms has frequently been stressed by scholars and practitioners alike. The resource-based view argues that competitive advantage is not only a question of intelligent positioning in the market, it is also about intelligent use of a firm's internal strengths, including competences, capabilities and resources (Wernerfelt, 1984; Prahalad and Hamel, 1990). These can give competitive advantage to firms if they fulfil the following criteria: they should be valuable, rare, imperfectly imitable and difficult to substitute (Barney, 1991). In addition many authors stress that they are not static; they have to be constantly adapted, changed and developed.

In MNCs competitive advantage is not necessarily the preserve of the parent company as different parts of the corporation, especially foreign subsidiaries, often have different resources. It is surprising that, for a long time, neither the literature on strategic management nor the literature on international management fully addressed the possibilities offered by these diverse resources. Admittedly authors such as Hymer and Kindleberger did stress that firms should spread their monopolistic advantages across borders (Hymer, 1976; Kindleberger, 1969), but most authors assumed that monopolistic advantages were primarily created by headquarters in the home country and subsequently transferred abroad.

Only later did Hedlund and Kogut (1993) argue that it might be helpful to view the MNC as a bundle of competences, capabilities and resources. According to these authors, important competitive advantages can be created by subsidiaries abroad. One source of competitive advantage is ‘metacapability’ – the ability to integrate widely dispersed activities and to exploit the various competences, capabilities and resources available.

From this perspective it can be argued that MNCs should strive to make the most of their foreign subsidiaries. Clearly this view differs from that which prevailed in the international management discipline for decades: that MNCs have monopolistic advantages that are primarily developed at home and then used to enter other markets. The major differences between the traditional view and the view that emerged at the end of the 1980s are shown in Table 15.2. Obviously some MNCs are still adhering to the traditional view, but those which change from the traditional model to the modern model require changes in strategy, structure and culture.

Table 15.2: Traditional and modern views of MNCs and their competitive advantage

	Traditional view of MNCs	**Modern view of MNCs**
The basic assumption	Missionary model	Network model
Dominant perspective of the MNC	Centre-periphery perspective	Multicentre perspective
The organizational character of the MNC	The MNC as a hierarchy (dominance of vertical relationships	The MNC as a heterarchy (vertical, horizontal and lateral relationships)
The influence of subsidiaries within the MCN	Mostly limited influence	Steadily growing influence
The roles of subsidiaries within the MNC	UNO-syndrome (assumption that all subsidiaries are equal or similar)	Differentiated set of subsidiary roles, one being the centre of competence role
Approach to coordination within the MNC	Primarily the task of headquarters, top-down	The task of both head-quarters and subsidiaries, top-down and bottom-up
Geographical origin of MNC competitive advantage	Only headquarters in home country	Headquarters in home country and subsidiaries in host countries
Basis of MNC competitive advantage	Intelligent positioning in all markets	Intelligent positioning in all markets and building upon diverse competences

Responsibility of the subsidiary within the MNC	Primarily own (country) market	Responsibility can go beyond the scope of its own (country) market
Leveraging of competences, capabilities, and resources within the MNC	Primarily by headquarters	Both by headquarters and by subsidiaries
Corporate culture of the MNC	Dominated by headquarters rather ethnocentric	Primarily geocentric, but with polycentric and regiocentric elements

While many MNCs are aware that subsidiaries are of crucial importance to their overall development,[4] not all have found a way to upgrade and empower their foreign subsidiaries. A good way of using the foreign subsidiaries' competences is to establish a portfolio of centres of competence within the MNC. There are clear benefits of having centers of competence. These centres of competence enable an MNC to use specialization advantages, to leverage different country-specific or organization-specific resources and to motivate subsidiary employees, for instance via extensive transfer of decision-making competences. It is helpful if subsidiaries which have superior competences and capabilities and which are responsible for other markets are officially labeled 'centres of competence'. The official label serves as an indicator for recognition. Recognition is not only motivating for the subsidiary in question; it also provides other MNC units with the necessary information about the subsidiary status. The label stresses the subsidiary's distinctive role within the MNC network.

[3]The distinction between primary and secondary activities is made by Porter (1986, pp. 15–60), but not all authors share Porter's view on how to differentiate between primary and secondary value-adding activities.

[4]It is surprising that subsidiaries have long been neglected in the literature. Research on subsidiaries has only become of interest in the last 15 years, and has only gained particular importance during the last few years. See Birkinshaw and Hood (1998).

15.3 A case study on centres of competence in Central and Eastern Europe

Some earlier studies already provided some evidence that, within MNCs, foreign centres of competence do exist.[5] The present study extends this research. In contrast to previous studies, this research is an intensive case study of one single MNC. I will first describe the study (15.3.1) as well as the company and its industry (15.3.2). Then I will focus on the company's activities in Central and Eastern Europe (15.3.3), before investigating how the company established a centre of competence in Central and Eastern Europe (15.3.4). Finally, the findings from the case study will be discussed (15.3.5).

15.3.1 The empirical study

About 40 foreign subsidiaries of a German MNC were investigated to ascertain whether and in what way the MNC had set up foreign subsidiaries as centres of competence.[6] Hence the aim was to determine not only which subsidiaries could be interpreted as centres of competence, but also how foreign subsidiaries have become or are becoming centres of competence.

For the purposes of the study all the subsidiaries were initially defined as centres of competence, and the three elements of the definition – specific competences or capabilities, responsibility for the markets in several countries, and a high degree of integration – were assumed to be in place. Managers of the subsidiaries were then asked to describe their competences and capabilities, responsibilities and degree of integration. They were also requested to provide information on the dynamics of becoming a centre of competence. The research method included a semistructured questionnaire for subsidiary managers, personal interviews with some subsidiary managers, interviews with management at headquarters and intensive investigation of archival data at headquarters. The study was carried out during the years 2000 and 2001. There is insufficient space to present the whole case here, so we shall concentrate on the company's activities in Central and Eastern Europe.

15.3.2 The company and the industry

The company, which for reasons of confidentiality will be called Alpha, is a German MNC that ranks among the top three companies in the world in terms of market share. It manufactures products that are used by end-consumers as well as industrial clients, car manufacturers. Currently Alpha owns production facilities in 18 countries and sells its products in more than 140 countries. Its annual turnover amounts to more than C=4 billion and it employs more than 30 000 people worldwide. Fifty per cent of its turnover is generated in North America, about 30 per cent in Europe and the remaining 20 per cent in Latin America, North Africa and the Asia-Pacific region.

Alpha operates in an industry that can be characterized as mature and traditional but offers the possibility of continuous innovation and the chance to integrate high-tech activities. The industry is rather oligopolistic. As far as Central and Eastern Europe is concerned, in Alphás industry some of the former communist countries had their own state-owned production facilities. These concentrated more on products for end-consumers than on products for industrial clients. When the transition process started in Central and Eastern Europe the industry changed as well. For instance Alphás biggest European competitor bought a company in Poland that had considerable manufacturing facilities, and its main US-based competitor took over a very well known Hungarian company whose manufactures enjoyed a reputation for good quality in the West. Alpha, however, hesitated to buy a company in Central and Eastern Europe and instead chose to set up sales representatives, sales

affiliates and sales subsidiaries. A closer look at Alphás activities in the region will give additional insights.

15.3.3 Alphás activities in Central and Eastern Europe

At the beginning of the 1990s (former) Czechoslovakia was one of the first markets in Central and Eastern Europe to be entered by Alpha. Its principal aim was to sell products, but quite early in the 1990s it also considered acquiring a Czechoslovakian manufacturing firm that exported its products to other countries in the former communist bloc. For reasons of confidentiality this firm will be called Beta. However Alpha eventually decided not to acquire Beta as the restructuring its operations was judged to be too difficult due to Alphás lack of experience with restructuring and the unavailability of suitable human resources.

In Czechoslovakia Alpha restricted its operations to the sale of products via sales representatives, affiliates and subsidiaries. The same was true of its operations in Poland, Hungary, Romania, Bulgaria, Russia and Croatia. In some cases the main reason for establishing a sales facility was to follow customers who had 'gone East', for instance to follow a German wholesale and retail chain that carried Alphás products. While it was decided to serve most countries via sales facilities or representatives located in the host country, sales in Slovenia would be organized by the Austrian subsidiary and sales in Macedonia by the Greek subsidiary.

A few years later Alpha realized that in the long run it would be difficult to remain competitive without setting up manufacturing operations in the region. While it could outperform its competitors in innovative products and the upper market segments, it had problems in the mass-market segment. The reason was that Alpha, unlike its national and international competitors with local production facilities in the CEFTA (Central European Free Trade Agreement) countries, did not manufacture at low cost. Furthermore in most countries in the region there were still high tariffs on imported products. Thus Alpha seized its chance when Czechoslovakia was divided into the Czech Republic and Slovakia and Beta, the company Alpha had decided not to acquire a few years ago, was split up. One of Betás two factories in Slovakia (Gamma) was bought by its local managers. Shortly after this management buy-out Gamma was offered for sale by its new owners, and after careful consideration Alpha decided to take it over.

The most important reason for acquiring Gamma was not to serve the Slovakian market, which – compared with other Central and Eastern European markets was rather small, but to gain access to a low-cost manufacturing site in the region. Alpha then decided that Gamma should be integrated into the corporate network, and as we shall see, this was the start of Gammás evolution into a centre of competence.

15.3.4 The development of the Slovakian subsidiary into a centre of competence

After the acquisition of Gamma the first objective was to raise its quality standards to the level required by headquarters. Therefore Alpha transferred production lines from its units in other countries and purchased other equipment from third parties for installation in Slovakia. In addition personnel from headquarters and Western subsidiaries were transferred to Gamma, and specialists in different fields (for example, operations and human resources) were sent on short-term assignments. Nonetheless, the restructuring of Gamma took longer than expected.

During the first years after Gammás acquisition (that is, during the second half of the 1990s), its purpose was to manufacture low-cost, low-price, mass-produced products for the CEFTA countries and Alpha subsidiaries located there. Only a relatively small percentage of the output was designated for the local Slovakian market. Over time Gamma developed and improved its manufacturing competences and ability to meet the requirements of the mass

market. While the inflow of knowledge from other Alpha units was very important to this process, most of the knowledge was tacit and could not be codified, and therefore the expatriate workers and specialists played a crucial role.

Gamma was soon given another very important mission. Before becoming part of Alpha, Gamma had gained experience in the mechanical engineering of production lines. At present Alpha had only one unit in Germany and one in the United States to carry out this activity. Gamma was chosen as the third unit and it was given the task of overhauling existing product lines, building new machines (investment below C=100 000) and carrying out simple but labour-intensive construction tasks. As well as extensive knowledge transfers from Germany to Slovakia, the development of Gammás mechanical engineering capabilities was considerably aided by an expatriate from one of Alphás sites in Germany, who took over the management of the mechanical engineering division in Slovakia.[7]

In 2000 it was decided to increase Gammás production lines to 40, and for some products Gamma would become the sole producer. This would involve some product lines being transferred to Slovakia, and as a consequence a number of Alpha units in Germany, Italy and the United States would lose some of their responsibilities. It is important to note that not only simple products but also very complicated and innovative ones are designated to be manufactured by Gamma in the future. Some of these will be targeted at the consumer market and others at industrial markets.

15.3.5 The findings of the study on Gamma

The findings of the case study show that Gamma can be considered a centre of competence. Its responsibilities include both functional and process-oriented activities, and it has regional responsibility for the manufacture of some products. In the future it will have worldwide responsibility for other products, and for certain activities in mechanical engineering it already has such responsibility.

Some of Gammás competences and capabilities are unique within the Alpha group, and while others also exist at headquarters or in other subsidiaries they cannot be delivered at the same price. It is important to note that manufacturing a certain product or carrying out a certain service at a high level of quality can be viewed as a distinct competence or capability.

Gamma is also highly integrated into the Alpha network. It has high outflows of products to units in other CEFTA countries, and in the future there will be increasing outflows of products to corporate units worldwide. Furthermore it provides mechanical engineering services for Alpha units all over the world, resulting in the transfer of products, people and knowledge. The reverse is also true, that is, Gamma is dependent on inflows from headquarters and other subsidiaries. Hence it constantly receives parts, staff and knowledge from abroad.
[5]One study was on German MNCs (Schmid *et al.*, 1999), the other on Japanese MNCs (Schmid, 2000). For a comparison of these studies see Schmid (1999). There is also evidence on the existence of centres of excellence, which are similar to centres of competence. See for instance Kutschker *et al.* (2001).

[6]I gratefully acknowledge the important work done by Christian Fischer, who collected the data for the case study.

[7]Mechanical engineering is considered to be a process-oriented activity.

15.3.5.1 The general process of becoming a centre of competence

The case study demonstrates that becoming a centre of competence can take several years and is linked to the building up of competences and capabilities. For any MNC, a crucial question is whether a subsidiary should have the requisite competences or capabilities before being designated a centre of competence or whether it should develop them after being chosen to become one.[8] Both alternatives can be found in practice and different centres of competence have different histories. A subsidiary might have developed superior competences and capabilities of which headquarters and other subsidiaries are not fully aware. Only after significant changes in the environment and diverse subsidiary initiatives are these competences and capabilities recognized as being very important for the whole MNC. At this point the parent company might decide that the subsidiary should become a centre of competence. In other cases, as with Gamma, an MNC might realize that it has to develop specific competences or capabilities in order to be competitive. However it should be noted that in Gammás case, Alphás original intention was to make it a low-cost production site. Only later was it made a regional centre of competence for the manufacture of some products and given worldwide responsibility for others. The influence of single individuals on this process must be highlighted. For instance an expatriate from Italy shaped Gammás development into a centre of competence for manufacturing, and another from Germany was instrumental in building up its mechanical engineering capability. According to Gammás top management, employees transferred from other subsidiaries were more important to Gammás development than were those from the headquarters.

15.3.5.2 Deliberate planning or evolution?

Linked to the above findings is the question of whether centres of competence are generally the result of detailed planning or the consequence of accidental evolution. It is realistic to assume that they are usually the result of both forces.[9] If we look at the roles of headquarters and subsidiaries, it seems desirable for top management to orchestrate the upgrading of subsidiaries and designating centres of competence, as was done in the case of Gamma. But at the same time top management can never have complete control over organizational processes. The more important the subsidiary, the more competences and capabilities it will have and the more it will try to become autonomous, or at least in some areas. This means that very mature and powerful subsidiaries can do much to turn themselves into centres of competence, for example by developing particular competences and capabilities and then drawing the headquarters' attention to them. Sometimes, however, these remain hidden until headquarters or other subsidiaries recognize that they might be of use to themselves. Finally, becoming a centre of competence can often be the result of conflicts, struggles and collisions of interest within MNCs (see Dlugos *et al.*, 1993, on political perspectives on the firm).

The process of acquiring a mandate (world mandate, regional mandate or country-portfolio mandate) does not necessarily mean that headquarters makes an inventory of all subsidiaries, compares their competences and capabilities, picks out what it considers to be the best one and then grants it a mandate. Becoming a centre of competence is not an engineering process, but to some extent can better be seen as a political process driven by various actors within and/or outside the firm.[10] For instance in the case of Gamma it was competitive pressure that led to its acquisition and subsequent development into a centre of competence. However a number of other units in the Alpha group opposed the idea of Gamma becoming a centre of competence as the planned extension of its product lines meant that units in Germany, Italy and the United States would lose some of their responsibilities. To sum up, there are limits to the deliberate planning of centres of

competence by top management.

15.3.5.3 Acquisition or greenfield investment?

Takeovers are often a very quick way for an MNC to acquire new competences or capabilities, including technologies (Zander, 1999; Inkpen *et al*., 2000) and skilled work forces. However competences and capabilities not only have to be acquired, they also have to be integrated into the MNC since a basic feature of any centre of competence is full integration into the MNC network. Centres of competence do not operate autonomously, but make their competences and capabilities available to other parts of the organization.

It is known that the failure rate for acquisitions is high, and some observers have put the figure at 50 per cent or more. Failure is often due to problems with integrating the acquired company, and integrating a company located abroad and assigning it the role of a centre of competence can be an even more challenging task. On the one hand, centre of competence status can aid integration since a newly acquired company may be proud of its prominent position in the international network. On the other hand other subsidiaries in the network might fight against the newcomer being awarded centre of competence status. In Gammás case the integration problem was aggravated by the fact that its competences and capabilities first had to be developed or modified. Thus, it is definitely more difficult to make acquired subsidiaries centres of competence. However, sometimes there are no possibilities for greenfield-investments, for instance because of legal restrictions or timing problems.

15.3.5.4 Geographical location of centres of competence

Generally speaking the reasons for being or becoming a centre of competence vary a lot. Reasons include superior production capabilities, access to certain types of customers and embeddedness in favourable external networks, as well as possession of particular management or functional skills.[11] Hence it would be wrong to suggest that there is an overarching theory about where best to locate centres of competence. This is an important message since some MNCs believe that centres of competence should always be located in advanced countries or large markets such as the United States, Japan or Germany. As our case study has demonstrated, centres of competence can also function well in small countries.

At the moment Gamma is Alphás only centre of competence in Central and Eastern Europe. However the situation may change in the future. For example its unit in Poland, which is basically a sales subsidiary, has developed particular competences in information technology and marketing, and some of these competences are already being utilized by other subsidiaries in the region.

[8]This question was also put forward by Moore (2000).

[9]This is in line with the general development of firms, which could be described as ‘guided evolution’. See Lovas and Ghoshal (2000). On the international development of firms see Kutschker and Schmid (2002, pp. 1045–179).

[10]Birkinshaw (1998) differentiates between subsidiary-driven development and parent-driven development.

[11]Some of these reasons are also mentioned by Ferdows (1997). However, unlike Ferdows, we do not consider that the possession of skills and knowledge is the only reason for the centre-of-competence role.

15.4 Conclusions

Areas of competence exist in all MNCs. Some MNCs, however, have not yet recognized the option of upgrading foreign subsidiaries by establishing centres of competence. In the future it will not be enough for subsidiaries merely to have certain competences and capabilities. The challenging task for MNCs will be to develop ways of fully exploiting these competences and capabilities. In terms of managing centres of competence, the basic challenge will be to find the right balance between autonomy and independence on the one hand and integration and interdependence on the other. Centres of competence should have as much freedom as possible within their areas of competence and geographical responsibility. At the same time they should be highly integrated into the MNC network. As far as autonomy is concerned, this should not only involve autonomy over certain decisions, it is also crucial for subsidiaries to have the freedom to use their resources to build up or strengthen their competences and capabilities. In many cases the possession of excess resources is a basic prerequisite for the competence-building process.

In the long run centres of competence might also wish to be an integral part of the overall strategic processes in the MNC. This is similar to what Kim and Mauborgne (1998) call ‘procedural justice’, which means that subsidiaries should not only be involved in strategy implementation but also be able to influence strategy formulation. They should be able to perceive the strategy-making process as fair, and as taking into account their own competences and capabilities. Centres of competence want to play an active role in overall MNC development, not just subsidiary development. Thus it would be wrong to manage centres of competence only from the top down. Bottom up and horizontal processes are also required, be this for MNC strategies, structure, culture or any other area.

The very existence of centres of competence suggests that it is not standardization but radical individualization that is needed in headquarters–subsidiary relations. Each centre of competence requires a different approach because of its distinctive competences, capabilities and resources, but all have a decisive influence on headquarters and other subsidiaries. Headquarters can still be seen as strategic centres that help to integrate widely dispersed units (Lorenzoni and Baden-Fuller, 1995), but they are becoming less important. At the same time some subsidiaries’ role in overall MNC development is increasing. This is true not only of subsidiaries located in traditional markets but also of those in transition economies.

With respect to Central and Eastern Europe, centres of competence allow new insights into the transition process.[12] Not only do Western MNCs influence subsidiaries in Central and Eastern Europe, but the latter also influence MNC units in other parts of the world. If MNCs are portrayed as intraorganizational networks it becomes clear that there are various interdependencies between units in different countries. These units can and should feed and bolster each other.

Notes

1. In this chapter ‘multinational’ is used as a generic term for companies operating in more than one country. It should not be interpreted in Bartlett and Ghoshal’s (1989) way, who differentiate between international, multinational, global and transnational firms. For a discussion of Bartlett and Ghoshal’s work see Schmid (1996, pp. 27–33) or Kutschker and Schmid (2002, pp. 281–93).

2. Bartlett and Ghoshal (1986, 1989) differentiate between ‘implementers’, ‘contributors’, ‘strategic leaders’ and ‘black holes’. For a review of the various typologies see Schmid *et al.* (1998).

3. The distinction between primary and secondary activities is made by Porter (1986, pp.

15–60), but not all authors share Porter's view on how to differentiate between primary and secondary value-adding activities.

4. It is surprising that subsidiaries have long been neglected in the literature. Research on subsidiaries has only become of interest in the last 15 years, and has only gained particular importance during the last few years. See Birkinshaw and Hood (1998).

5. One study was on German MNCs (Schmid *et al*., 1999), the other on Japanese MNCs (Schmid, 2000). For a comparison of these studies see Schmid (1999). There is also evidence on the existence of centres of excellence, which are similar to centres of competence. See for instance Kutschker *et al.* (2001).

6. I gratefully acknowledge the important work done by Christian Fischer, who collected the data for the case study.

7. Mechanical engineering is considered to be a process-oriented activity.

8. This question was also put forward by Moore (2000).

9. This is in line with the general development of firms, which could be described as 'guided evolution'. See Lovas and Ghoshal (2000). On the international development of firms see Kutschker and Schmid (2002, pp. 1045–179).

10. Birkinshaw (1998) differentiates between subsidiary-driven development and parent-driven development.

11. Some of these reasons are also mentioned by Ferdows (1997). However, unlike Ferdows, we do not consider that the possession of skills and knowledge is the only reason for the centre-of-competence role.

12. There is a vast body of literature on the transition process in Central and Eastern Europe, including Buckley and Ghauri (1994).

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[12]There is a vast body of literature on the transition process in Central and Eastern Europe, including Buckley and Ghauri (1994).

Chapter 16: Klaus E. Meyer and Camilla Jensen

Abstract

This chapter discusses the impact that Central and East European countries' accession to the EU is likely to have on their FDI inflows. Based on a combination of theoretical arguments and empirical observations on German–Polish FDI, various developments for individual industries and investor types are proposed. EU membership is likely to have an immediate effect on the FDI inflows of new member countries that offer competitive locations and a high degree of legal and institutional alignment with the present EU countries. The short-term impact is likely to be largest in service industries and sensitive manufacturing industries such as food processing. Rationalized FDI in the wake of membership may in some cases favour CEE locations, in other cases not. In the long run membership is expected to prompt structural changes and boost economic growth, which will in turn drive FDI flows.

16.1 Introduction

This chapter assesses the likely effect of EU membership by the Central and East European (CEE) countries on the corporate strategies of direct investors. However, given the complexity and diversity of the motives that underlie FDI there can be no simple answers.

Most legal barriers to trade and investment have already been removed by the Europe Agreements, along with the gradual removal of tariff barriers during the accession process. EU membership is the natural continuation of the process of integration that is already taking place. The existing patterns and trends of integration are likely to deepen and eventually change the industrial landscape of Europe. In most industries membership is unlikely to trigger fundamental changes in the pattern of integration, though it may accelerate processes already under way. However the business environment for investors in CEE may improve for two reasons:

- EU membership implies the deeper integration and harmonization of institutional structures, which will lower the adjustment costs incurred by those operating across borders and thus stimulate new and stronger business cooperation.
- EU membership may lower country risks, and hence risk premia. Therefore more projects with moderate expected returns might be undertaken.

However in some industries EU enlargement will do more than accelerate existing processes. In these industries the regulatory regime established by the Europe Agreements falls short of the principle of free movement of capital and goods among EU members:

- The pre-accession international trade agreements, including the Europe agreements, have a number of industry-specific regulations that fall short of the ideal of free trade. Their liberalization will have a profound impact on the industries concerned, particularly traditional industries such as agricultural products, textiles, and coal and steel (World Bank, 1999).
- The postsocialist liberalization and privatization efforts in CEE have created regulatory regimes for some industries that do not conform to the ideal of free capital flows and will have to be adjusted (European Commission, 2001a). Thus industries such as utilities and telecommunications can be expected to see increased FDI in the near future.

These changes will affect corporate strategies and consequently the location of industry in Europe. In this chapter we consider various types of investor and how they might react to the CEE countries' membership of the EU. Based on current bilateral trade between Germany and Poland, we also consider how membership will affect investors' strategies for specific industries. The picture developed is complicated as different operations in CEE play different parts in investors' global strategies.

Section 16.2 briefly illustrates the impact of accession using data for countries that joined the EC in the 1980s. Sections 16.3 to 16.5 establish a typology of FDI, briefly review the international economics literature on the relationship between international trade and FDI, and relate recent research on institutional development and corporate strategies in emerging markets to the transition context. Based on the available industry-specific data, Section 16.6 reviews FDI in Poland and assesses the impact of EU enlargement on German FDI in selected industries. Finally, Section 16.7 brings together some of the theoretical and empirical arguments developed in the chapter.

16.2 Past accessions and FDI

The impact of EU enlargement on FDI inflows has varied according to industry. The liberalization and harmonization of the regulatory frameworks has particularly facilitated FDI in service industries, while most manufacturing industries have continued to integrate along the paths established during the 1990s.

We undertook a simple analysis of the changes in German FDI flows to new member countries after past accession rounds, namely Greece in 1981, Spain and Portugal in 1986 and the EFTA countries in 1995.2 The pattern of FDI from Germany to the new member countries in the 1980s was plotted separately for manufacturing and non-manufacturing, and indexed to the pre-accession year of 1984. We then compared this index across host countries for the years following accession. Figure 16.1 was calculated on the basis of German FDI to all EU member countries for which data were available (Deutsche Bundesbank annual statistics).

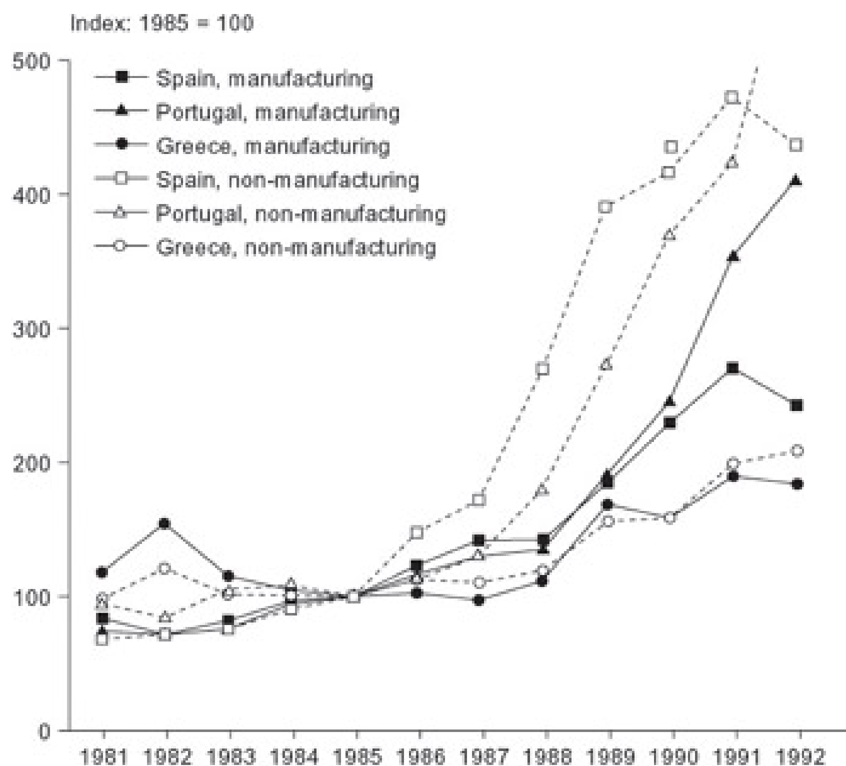

Figure 16.1: German FDI flows to South EU accession countries. *Source*: Deutsche Bundesbank (annually).

The breakdown of FDI flows to the Southern EU countries upon accession shows the following trends:

- In general non-manufacturing FDI grew faster than manufacturing FDI.
- In Spain and Portugal, after accession non-manufacturing FDI accelerated substantially faster than the EU-wide trend for nonmanufacturing FDI. The growth of manufacturing FDI was also above the EU-wide trend, but its acceleration appears to be less linked to accession.
- In Greece, the growth of FDI from Germany slightly exceeded the general trends in the

early 1980s and then closely followed the overall trend for both manufacturing and non-manufacturing.

This means that accession had a substantial effect on Spain and Portugal in the late 1980s, but there was a smaller impact on FDI flows to Greece in the early 1980s. We conducted a similar analysis for countries that joined the EU in the 1990s. Their FDI inflows closely followed the general trend around the time of entry. FDI to Sweden accelerated above the general trend in both manufacturing and non-manufacturing in the early 1990s and again in 1999, but this cannot be directly linked to its accession in 1995.

These trends indicate that EU membership may create opportunities for accelerated integration via FDI, notably in service industries. Yet these effects are unlikely to emerge immediately upon accession, but will develop gradually before and after that date. Bevan *et al.* (2001) even argue that commitment to accession is more decisive to FDI flows than actual accession. In the following section we review differing theoretical perspectives on the relationship between FDI and such underlying factors.

16.3 FDI typologies

16.3.1 Market-seeking FDI

The removal of trade barriers and the consequent economic integration facilitate access to the markets of new EU member countries. Hence West European businesses will be able to serve CEE markets as an extension of their existing European operations. For some businesses this will require the establishment of sales or service operations, which may lead to FDI in distribution or services.

However other businesses may already be present in the accession countries and be serving the local markets from their local operations. These operations may have been established to overcome trade barriers – so-called 'tariff-jumping FDI'. As the trade barriers are removed their operations across Europe will be integrated to a higher degree, which in turn may lead to the centralization of production facilities and therefore the closure of peripheral operations. This will mainly affect smaller operations with few economies of scale, production sites in unfavourable locations in terms of Europe-wide logistics, and locations with high production costs. At the same time the main European production sites may be extended.

The net effects of this aggregation on any particular country are hard to predict. However they may be small because of the countervailing effects of labour cost differentials and the establishment of Europe-wide logistical operations.

16.3.2 Resource-seeking FDI

The removal of trade barriers facilitates the location of production wherever production costs are lowest. Hence accession countries may benefit from their relative cost advantage in respect of semiskilled labour, as long as this advantage is not overly counteracted by lower productivity or higher transport and logistical costs.

Given their geographical proximity to Western Europe, there will be considerable scope for the accession countries to exploit their comparative advantages. Theoretical considerations as well as experiences in East Asia suggest that the combination of cost differentials and close geographical proximity may trigger considerable regional FDI (Meyer, 2001). Firms may increasingly break up their production processes and locate specific stages of production in different countries to take advantage of relative cost advantages, especially small and medium-sized firms that have no experience in global operations and would find it difficult to take advantage of the lower production costs in East Asia.

However for this option to be attractive the cost advantages of regional vertical integration will have to be larger than the additional costs incurred for coordination and transportation. Empirical studies, such as that by Bevan *et al.* (2002), confirm the attractiveness of low unit labour costs to foreign investors. Resmini (2000) has found that lower factor cost is a motivational factor for investors in scale-intensive and science-based industries but not in traditional industries.

The acquisition of relatively low-cost production bases with access to EU markets has also provided opportunities for non-European businesses to enter EU markets with a cost-competitive product. Korean firms such as Daewoo and Samsung pursued such a strategy in the 1990s, until the Asian crisis of 1997 brought a (perhaps temporary) halt to their aggressive international expansion efforts. Similarly American and Japanese investors who do not yet have a manufacturing base in the EU may find this option attractive.

In the long term, the attractiveness of locations in the accession countries for cost-sensitive

operations will depend on the evolution of their labour costs and productivity. If, as is widely expected, wages and nonwage labour costs rise faster than productivity, then manufacturers may continue to seek new locations further east, especially in such costsensitive industries as textiles.

However cost-oriented production relocation accounts only for a small part of global FDI capital flows. Access to cheap labour may not even require any FDI, as a subcontracting arrangement with an independent firm may suffice.

16.3.3 Service-related FDI

Service industries in CEE offer investment opportunities for West European businesses as there is considerable potential to create value by transferring technology and organizational methods. The attractiveness of this is likely to increase upon the CEE countries' accession since trade barriers and differences in standards will be reduced when they assume the European Acquis. At the moment manufacturing accounts for only 41 per cent of the total FDI stock in Poland, and service industries are gradually taking over the lead in respect of FDI (see Section 16.6). The leading industries in Poland and other countries are telecommunications, banking, insurance and trade, including retail trade, and services such as utilities and tourism-related activities are clearly lagging behind in terms of foreign investment.

Privatization and speed of opening has so far determined the flow of FDI into East European service industries. Expansion may be increasingly constrained by the capacity of Western European firms to absorb and restructure new acquisitions in the east. However acquisition opportunities will decline with the completion of the privatization process in several countries. Accession to the EU will also open up sectors that are considered politically sensitive by local politicians, such as service industries that have not yet been fully liberalized or privatized. However the volume of FDI may decline if investors choose less capital-intensive greenfield projects when entering new markets.

16.4 International trade and FDI

Recent theoretical and empirical work has focused on the interdependence of foreign investment and trade (Markusen, 1997). FDI and trade can be viewed as competing or as complementary modes of serving a particular market, depending on the strategy of the parent firm. Strategy is directly related to the reason for the investment: market-seeking investments tend to compete more with exports as a servicing mode whereas natural-resource-seeking investments tend to generate intrafirm trade flows.

The impact of economic integration on FDI inflows depends to a great extent on subsidiary import and export patterns and on the relative importance of intrafirm trade. Most commentators expect economic integration to accelerate international trade between the member countries. In industries where trade and FDI are already substitutes the relationship is unlikely to change substantially, although integration may favour trade as a mode of serving foreign markets because the transaction costs may be lowered by integration. Hence it is possible that local production in FDI plants will be discontinued if the removal of trade barriers results in imported products being cheaper than the locally produced ones.

In contrast, where trade and FDI are non-substituting modes of serving a particular market, as is typically the case with services, or where FDI supports trade (for instance local sales offices, distribution networks and marketing operations), integration is likely to increase both FDI and trade. Integration beyond a free trade agreement can pave the way for FDI in services because most services are difficult to sell when customers are located at a distance or across borders. At the same time service FDI may pave the way for intrafirm trade in goods and services.

Finally, if trade and FDI are complementary, in that they sustain each other or tend to reinforce each other integration is likely to promote FDI. This will apply especially to industries that are already vertically integrated across borders. In such industries, regional specialization may accelerate, as different stages of the production chain will be located at different sites according to specific resource endowments. FDI could be used to enhance this specialization, and would increase both imports and exports as goods are moved between locations. But horizontally integrated subsidiaries may also support a complementary pattern of intrafirm investment and trade based on product mandates and task divisions.

The literature discusses a further effect of integration called ‘ investment diversion’, which is analogous to trade diversion. Investment diversion results when a favourable investment location in a third country is rejected due to the ‘artificial’ advantages of locating production or trading with a partner inside the integrated area (Baldwin *et al.*, 1996). Due to the large cost advantages of East European locations, it is possible that their accession to the EU will divert some FDI from other lowcost locations, for instance the CIS and North Africa.

Overall, from a theoretical viewpoint it can be concluded that integration will increase the flow of FDI to the newly integrated area and support a complementary relationship between trade and FDI. However the divestment of FDI projects could occur in industries where FDI and trade are alternative modes of serving a market.

16.5 Institutional changes

Institutions are widely seen as crucial to the operations of a market economy and as facilitating business operations in emerging markets (see for example Harriss *et al*., 1995). In Central and Eastern Europe the emergence of smoothly operating institutions has so far been sporadic, slow and uneven across countries. The widespread use of barter throughout the former Soviet Union, opaque legal and regulatory frameworks, the underdeveloped political and constitutional court systems of many countries, as well as corruption and bureaucratic inefficiency (see EBRD, 2001) imply high transaction costs when establishing new business relationships, which may inhibit future transactions. Weak institutional frameworks also increase search, negotiation and enforcement costs.

The development of laws regulating the establishment of businesses, competition, capital markets and other business transactions will reduce the transaction costs incurred by firms doing business in transition economies. The harmonization of the institutions, rules and regulations of accession countries with those of the present EU member states will have two consequences for business strategies. First, the lower transaction costs that will result from improved institutions will change the structure of industry, both domestic and foreign. Second, the lower transaction and entry costs incurred by foreign investors will lead to increased FDI inflows.

16.5.1 Changes to the structure of industry

In emerging markets around the world, from Chile to Korea and from India to Poland, large and diversified domestic conglomerates are major players in the domestic economy. In contrast, over the past three decades mature market economies such as the United States and Western Europe have seen the demise of such conglomerates. Khanna and Palepu (1999, 2000) argue that the prevalence of diversified firms is a result of high transaction costs in markets for financial and human capital. To overcome market failures, these firms rely on internal markets for capital and labour.

Market failures adversely affect financial markets that lack adequate disclosure rules or accounting and auditing standards, and where intermediaries such as investment bankers, venture capitalists and financial analysts may not exist. This increases transaction costs on the local capital market as investors have to invest more heavily in securing information and face a higher risk of debtor default. Large conglomerates can bypass this by setting up internal capital markets and creating internal labour markets for highly qualified personnel where external recruitment is difficult or costly (Khanna and Palepu, 2000). At the same time large conglomerate groups have a stronger bargaining position *vis-a-vis* corrupt bureaucrats (Shleifer and Vishny, 1993).

These transaction costs decline as countries reduce the scope for corruption and improve the efficacy of the institutions that regulate the markets and provide information on potential partner firms and employees. Hence the need for internal markets diminishes, as does the extent of unrelated diversification.

Diversified groups are particularly important in Russia, including the so-called financial–industrial groups, and firms with high horizontal or vertical integration are also common in Central Europe. In part this is a pre-1989 inheritance as central planning raised the cost of interfirm transactions (such transactions either had to involve the planning authorities, or had to be conducted in informal, semilegal ways). However there have also been examples of industrial conglomerates evolving during the industrial restructuring process, for example the Skoda Industry group.

The Khanna–Palepu argument suggests that the establishment of market institutions in

accession countries will increase competition while lowering transaction costs in crucial markets (Khanna and Palepu, 2000). Capital and skilled labour will be readily available at competitive prices, and the exchange of intermediate products will be based on appropriate contracts in specialist markets. What will bind operations together in the business organization of the future will be shared knowledge-based assets and strategic interdependence in such operations as R&D, production and marketing. As a consequence diversified conglomerates will be reorganized into focused, specialist businesses and become subject to the global merger and acquisition activities that were behind the acceleration of global FDI in the 1990s (UN, 2000).

However in a defensive reaction domestic firms might merge in order to withstand increased foreign competition, as seen in some West European countries around 1992 and more recently in utilities sectors earmarked for liberalization. This would increase the barriers to entry and reduce domestic competition, which would in turn harm consumers. As a defensive measure such mergers would prolong the survival of domestic firms, but they would also hinder the development of new technological and managerial capabilities as there would be less competitive pressure to engage in innovation. As a consequence the firms would not be prepared for the dynamics of competition when it eventually arrived. In the longer term, such defensive conglomerates would face a second restructuring process when they were pushed by investors and by competition to focus on core competences – often after a substantial financial crisis.

Whichever course is taken, the restructuring of industry towards more specialized, globally operating businesses is likely to accelerate both inward and outward FDI in the accession countries. Mergers and acquisitions are likely to increase as conglomerates sell non-core businesses while strengthening their core business areas.

16.5.2 Institution building and inward FDI

For firms contemplating foreign investment, the restrictions and incentives created by national and multilateral institutions

shift the playing field favoring some deals and opportunities while disadvantaging others. They force the investing firms to think strategically about how to avoid the limits imposed by domestic laws as well as how to reap the benefits that the law and particular circumstances are capable of providing. (Spar, 2001)

The range of policies of concern to foreign investors is wide. Direct investors have to adapt their strategies to local institutions (Peng, 2000), and Western businesses entering the transition economies face higher transaction costs than in mature market economies because of the incomplete institutional framework. Moreover these costs vary across the transition economies because their rates of progress differ and impact differently on potential source countries, whose firms have varying degrees of experience in operating in such environments.

The harmonization of institutions and the related liberalization of regulatory regimes will benefit service industries such as finance, telecommunication, utilities and transportation infrastructure. These industries are opening up to competition across Europe, while preferential treatment for national incumbents is gradually being eroded. In the accession countries many of these sectors require substantial upgrading, which may trigger considerable investment by suppliers to these industries, notably construction businesses.

On an aggregate level the effect of institution building on FDI flows to the CEE countries has been demonstrated in empirical studies. For instance Brenton *et al.* (1999) have shown that economic freedom is positively related to FDI flows from Western to Eastern Europe. Later Bevan *et al.* (2002) disaggregated the pertinent institutions and found that some but not all institutional changes have enhanced FDI receipts in transition economies. They have

prompted (a) the development of privately owned businesses in place of state-owned firms, (b) the development of the banking sector but not necessarily the non-banking financial sector, (c) the liberalization of foreign exchange and trade but not necessarily of domestic markets and prices, and (d) the development of legal institutions but not necessarily competition policy.

Consequently FDI to accession countries can be expected to increase in industries where standards are harmonized and informal and formal barriers to FDI are being reduced.

16.6 Present and future prospects for FDI in Poland

Poland was relatively slow to attract FDI during the early years of transition, lagging behind Hungary and the Czech Republic. However since 1997 it has become the largest recipient of FDI in Eastern Europe, which is to be expected given its market size, although in terms of FDI per capita, in 1999 it ranked eighth behind many of the smaller accession countries (UNCTAD, 2000).

Early foreign investors often acted in response to supply-side factors, particularly the opportunities created by the privatization of firms. Such factors and the political economy of privatization in Poland *vis-a-vis* other Central European host countries explain its tardiness in attracting FDI. Later FDI inflows focused on privatization-related service acquisitions or greenfield manufacturing projects. Here Poland has performed comparatively better than its neighbours.

From 1989 until the present, Germany has been the largest investor in Poland in terms of the number of investors, with 207 projects valued above US$1 million in 2001. For several years the United States led in terms of invested capital, but in 2001 France took the lead, accounting for 19.23 per cent of total invested foreign capital in Poland, followed by the United States (14.7 per cent) and Germany (13.43 per cent). But Germany is still engaged in the largest number of projects overall (PAIZ, 2002), especially if we take into account the large number of German SME investments that are not included in the above statistics.

16.6.1 Motives for investing in Poland

There have been many studies, especially during the early years of transition, on the motives of investors, often focusing on the typologies of market-seeking and natural-resource-seeking investment. However there have been few follow-up studies and not many focus on the service sector in CEE, where investment motives are presumably more singular (Holland *et al.*, 2000). Meyer (1998) found that for five transition countries, including Poland, 97 per cent of investors (British and German) were attracted by local market opportunities and only 31 per cent by low factor costs in 1993–94.3 Most of the latter also sought access to local markets.

A recent survey in Eastern Europe and other emerging markets (EBRD, 2001) found that an attractive host market ranked highest among investment motives, followed by cheap skilled labour. Access to raw materials was the least important factor. Perhaps surprisingly the survey found that investment motives varied little across the various emerging markets. The only factor with major variations was the proximity of the host and home markets. In combination with EU membership, geographical proximity and institutional convergence were found to be the most important reasons for investing in CEE countries rather than in other emerging markets. Hence EU membership cannot be viewed as unimportant in respect of attracting FDI in the future.

Overall, market-seeking has been the dominant motive in the manufacturing and service sector. What does this imply for future sectoral patterns of FDI? Does it imply that FDI will shift towards trade-related investment when market access is fully liberalized? Table 16.1 shows the industrial distribution of FDI stock and current trends, as reflected in the most recent annual inflow figures.

Table 16.1: Polish inward stock of FDI, by industry, 2001

	Stock (US$ millions) (1)	**Stock by shares (%)(2)**	**Share of inflow[1] (%) (3)**

Manufacturing:			
Food processing	5505.7	10	9
Automobiles	5395.0	10	3
Other non-metal goods	3060.0	6	5
Electrical machinery	1683.2	3	3
Paper and paper products	1567.3	3	2
Chemicals and chemical products	1304.6	2	1
Wood and wood products	1290.7	2	3
Rubber and plastics	612.0	1	0
Furniture	479.2	1	1
Metals and metal products	447.7	1	1
Machinery and equipment	271.7	1	–0
Textiles and clothing	248.3	1	–0
Leather and leather products	16.3	0	–0
Total	21 881.7	41	28
Services:			
Financial intermediation 12 251.9	23	27	
Trade and repairs	6054.3	12	29
Transport, storage and	5710.6	11	3
communications			
Construction	2764.8	5	4
Social services	1624.1	3	0
Power, gas and water	1491.8	3	6
Real estate	627.8	1	2
Hotels and restaurants	617.8	1	–0
Total	31 143.1	59	72
Primary:			
Mining and quarrying	87.0	0	1
Agriculture	40.4	0	–0
Total	127.4 0 1		
Grand total[2]	53 152.2	100	100

Notes: 1. The inflow in 2001 amounted to US$7.1466 billion of FDI, or 13 per cent of the total stock at the end of the year, excluding SME investments. 2. Excluding US$3.7 billion of FDI in smaller projects below US$1 million. *Source:* Column (1) – PAIZ (2002).

Market-seeking investment in Eastern Europe often serves as a regional platform, while tariff jumping motivates only a few projects. Many of these investments do not focus exclusively on local markets, and market demand is viewed as the most important of a number of other factors, such as agricultural inputs for food processing or highly skilled and competitive labour in automotive and engineering-based industries. Hence a further shift towards pure trading operations is unlikely.

The synergy between cost and market attraction is likely to be enhanced by the stability and economic growth that Poland's membership of the EU is expected to generate (European Commission, 2001b). Therefore we suggest a continued trend in leading industries where investors are primarily market-seekers, with some scope for increased investment when sales operations are upgraded.

Contrary to the expectations of many (reviewed in Meyer, 2002), FDI has not been the favoured mode of exploiting advantages in labourintensive industries. This finding is supported by studies on investment motives in Eastern Europe and the industrial breakdown of Polish FDI stock in Table 16.1. It is unlikely that EU membership will change this situation fundamentally. While there are considerable opportunities for specific regions to develop specific competences and cluster advantages in particular niches in light industries, such as the wood–paper– furniture complex in Poland, cheap labour alone cannot guarantee the sustainability of a cluster. FDI may contribute to the development of export industries employing more advanced technologies than in the past. Consequently FDI patterns may diverge across Eastern European countries as specialization increases in the region.

16.6.2 FDI and rising and declining industries in Germany and Poland

Figure 16.2 plots the investment and trade position of Germany *vis-a-vis* Poland, drawing on an industrial typology developed by EUROSTAT (1998), which to some extent corresponds to the FDI typology described above. Industries with a positive trade balance (from the viewpoint of Germany) and a positive FDI position are industry leaders, while industries with a negative trade balance and a positive FDI position are declining industries where export platforms will increasingly be established in the host country. FDI serves different strategic purposes in these two types of industry – in rising industries it is mainly used as part of an offensive strategy (market or cost leadership) while in declining

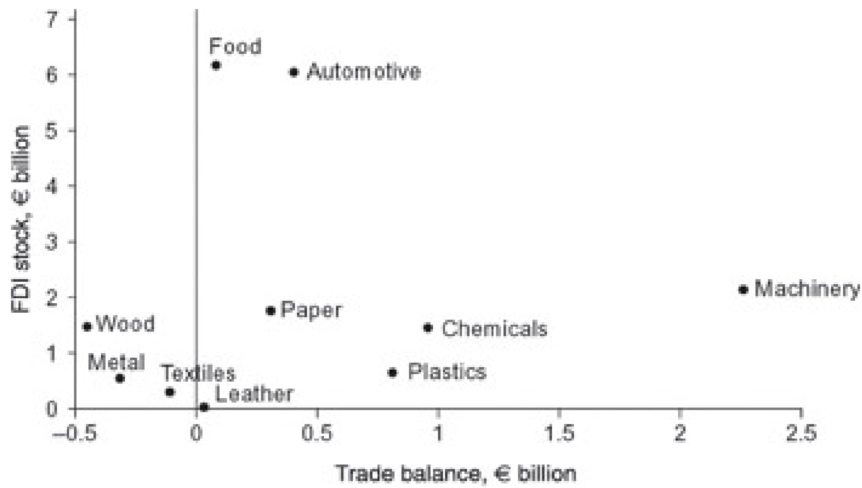

Figure 16.2: The trade and investment position of Germany *vis-a-vis* Poland. *Sources*: PAIZ (2002); Eurostat Comext Database.

industries it may be used as a defensive strategy (cost 'followership'). Even though the countries with the largest investment in Poland enjoyed a major trade surplus4 with the latter during the first ten years of transition, there must be a shift towards a more equitable position if the transition and accession process is to be successful. This implies that Poland will become increasingly export competitive, including in EU markets.

Note that only the trade balance registers the bilateral position of Germany *vis-a-vis* Poland in Figure 16.1. The FDI data on the Y-axis reflects the general industry composition of German FDI abroad.

Only three industries are presently using a defensive FDI strategy, namely metal, wood and textiles. However these are not necessarily among the industries that are likely to develop into German export platforms from Poland. With liberalization of trade in agricultural products the food industry may move towards such a position. German strongholds such as chemicals, plastics and electrical machinery can be expected to continue to be industry leaders and to maintain a high FDI profile. The extensive intra-industry trade in electrical and other machinery and equipment between Germany and Poland also suggests vertical integration. The food and automotive industries are in the strongest position in terms of FDI stock, which may provide the basis for exporting both to the west and to the east.

Team LiB

16.7 Conclusion and perspectives on EU enlargement

While we shall refrain from making specific predictions about the effect of EU integration on the aggregate flow of FDI capital to the accession countries, we expect that many of the associated changes will be industry specific and will necessitate deep structural reforms in the short to medium term. In some industries EU integration will strengthen current trends, leading to closer cooperation and regional specialization. The effects of enlargement will vary considerably in accordance with factors such as labour intensity, economies of scale, service content and past tariff protection. Furthermore specific investor strategies and rivalry between firms inside and outside the EU will complicate the picture further, so the FDI potential of countries such as Poland will depend on industry- and investor-specific characteristics. Some institutional changes will facilitate FDI, but there will also be countervailing effects.

In most industries FDI can be expected to continue to expand. Several arguments in this chapter point in this direction. Firstly, formal integration is likely to have a large impact on FDI flows to service industries. Secondly, accession will give investors the opportunity to redesign their FDI strategies, for instance in the food processing industry, where foreign investors have already established a very significant position. Thirdly, accession involves institutional alignment, which will reduce the transaction costs of entering and operating in accession countries.

On the other hand production rationalization may in some cases disfavour sites in Eastern Europe, particularly in the case of capital- and labour-intensive industries such as chemicals and automotives. Here businesses are likely to centralize their production operations, leading to fewer but larger operations across Europe.

Finally, investors in declining industries may move their FDI to host countries further to the east in Europe. This would affect light industries that at present receive little FDI, such as textiles, in which the accession countries possess few industry-specific competences or natural resources.

In the long term, industrial specialization and clusters are likely to emerge in the region as a result of the structural changes that are already under way in the transition countries. Such clusters, including the wood–paper–furniture complex in Poland, will attract investors from both inside and outside the European Union. At the same time FDI in service- and market-seeking activities will expand if EU membership fosters stability and dynamic growth.

Notes

[1] We thank the Danish Social Science Council (SSF) for supporting the research for this paper under grant number 24-00-02-02, and Jana Penzes for her research assistance.
[2] Significant differences between past accession rounds and the present rounds limit our ability to use past experiences to forecast future developments. The southern European countries serve as a reasonable group of comparator countries in view of their lower level of income at the time of their accession to the EU. However their geographical distance from Germany speak against a comparison. In contrast the EFTA countries' incomes were slightly above the EU average upon accession but they are located closer to Germany. Finally, the CEE countries are similar to the EFTA countries in respect of having extensive free trade arrangements with the EU prior to accession.
[3] Note that a factor-cost motive is included in the natural-resource motive (as one normally includes raw materials and unskilled labour in the natural endowments of a country), however it is narrower since it does not necessarily include motives associated with other natural resources, such as fish, arable land, mines and so on.
[4] In 2000 France's export to import ratio was 185 and Germany's was 122. In 2001 that for

the US was 83 (Eurostat Comext Database).

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4. In 2000 France's export to import ratio was 185 and Germany's was 122. In 2001 that for the US was 83 (Eurostat Comext Database).

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