

# Subsidiary Upgrading? Strategic Inertia in the Development of German-owned Subsidiaries in Hungary

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## *Document Version*

Final published version

## *Publication date:*

2004

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## *Citation for published version (APA):*

Gammelgaard, J., & Dörrenbächer, C. (2004). *Subsidiary Upgrading? Strategic Inertia in the Development of German-owned Subsidiaries in Hungary*.

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CKG WP 8/2004**

**CKG Working Paper No. 8/2004**  
**ISBN: 87-91506-23-9**

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**Subsidiary Upgrading? Strategic Inertia in the Development of  
German-owned Subsidiaries in Hungary**

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## **Abstract**

This study reports the results of interviews with 65 managers in 11 German headquarters and in their 13 Hungarian subsidiaries. We focused on the role of the subsidiary with regard to market, product and value-adding mandates. Further, we investigated whether the Hungarian subsidiaries had experienced an upgrade of their role during the first 10 years of transition. The host country economy was supportive to role development, but inadequate subsidiary capabilities and headquarters' assignments prevented the subsidiaries from being upgraded. We propose that the corporate immune system, ie, ethnocentric behaviours emanating from the headquarters should be included in future upgrading analyses.

# **Subsidiary Upgrading? Strategic Inertia in the Development of German-owned Subsidiaries in Hungary**

## **1. Introduction**

This paper examines German-owned subsidiaries in Hungary during the first 10 years of transition and questions how far and for what reasons the subsidiaries are in a position to upgrade their role in multinational corporations (MNC)<sup>1</sup>. Former surveys, conducted in a West European context, have revealed that some subsidiaries have upgraded their role over time with regard to market, product and value-adding activities (Birkinshaw & Hood, 1997; Delany, 1998; Egelhoff et al, 1998; Hood et al, 1994; Jarillo & Martinez, 1990; Pearce, 1999; Taggart, 1998, 1999; Williams, 1998).

The purpose of this paper is to question whether the same degree of upgrading has occurred in a Hungarian context. Taking the point of departure in White and Poynter's (1984) subsidiary role hierarchy, we define upgrading as a subsidiary going upwards from a lower level role to a new higher-level role. One example could be a subsidiary over the time developing from a marketing outlet to a strategic independent unit; being responsible for product development. Our data, acquired through 65 interviews in 11 German headquarters and in their 13 Hungarian subsidiaries, though showed a much lower rate of upgrading when compared to former surveys. Even though market opportunities were promising, inadequate subsidiary capabilities on the one hand and the German headquarters ethnocentric behaviours on the other resulted in a lower

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<sup>1</sup> This paper presents some results from an empirical research project on "Exogenous Influences in path dependent transformation processes" funded by the Volkswagen foundation. M. Fichter (Free University, Berlin), L. Neumann, (National Labour Centre, Budapest) A. Tóth (Hungarian Academy of Sciences, Budapest) and M. Wortmann (WZB, Berlin) cooperated in the process of data collection.

upgrading rate. Consequently, the two latter mentioned reasons led to insufficient allocation of needed resources and reluctance to give the Hungarian subsidiary the authority to make decisions and act upon them. Thereby, this paper introduces the concept of 'corporate immune systems' as an influencing factor in upgrading surveys.

We proceed with the following steps. We begin by summarizing reasons for subsidiary upgrading. In succeeding sections, we discuss methodological issues and examine the 13 case studies. Finally, we conclude and discuss implications for management practices.

## **2. Subsidiary upgrading factors**

White & Poynter (1984) grouped subsidiary roles into five main categories and their classification has since been a central reference point for several upgrading studies (Hood et al, 1994; Delany, 1998; Taggart, 1999). White & Poynter (1984) differentiated between subsidiaries according to three criteria: 1) *market scope*, ie the number and extent of geographical markets the subsidiary is involved in, 2) *product scope*, ie the sum and scope of product markets the subsidiary engages in and finally 3) *value-adding scope*, ie the value adding activities available to the subsidiary, eg development, production or marketing. Based on these criteria, the authors described five different roles that the subsidiary can play. *Marketing satellites* are those subsidiaries, which market single products or a whole range of products in the host country and that provide only limited customers services. *Miniature replicas* not only deal in the foreign country, but also manufacture single or range of products, or a variety of products for the parent company there. *Rationalised manufacturers* produce individual products or product ranges for the world market. Other MNC units carry out R&D, marketing or necessary

production steps. *Product specialists* have comprehensive responsibility for a product within the MNC, since they develop and manufacture the product and sell it worldwide. Finally, *strategic independent units* have, in addition, the freedom to develop and manufacture new products and to set up new markets. Beyond these five roles, Schmid (2000) has shown the existence of a large number of incommensurable role typologies; though they will not be investigated further in this study.

Several researchers have brought the changes in such roles over time into focus emphasizing the extent and reasons for upgrading. Hood et al (1994), Delany (1998) and Taggart (1999) all used White & Poynter's (1984) terminology to analyse role changes, ie the transformation of the subsidiary from one role to another. Hood et al (1994) found three upgrades in a sample of 16 Japanese-owned Scottish subsidiaries. Delany, (1998<sup>2</sup>) reported 19 upgrades out of 28 foreign-owned (US, UK and Sweden) subsidiaries. Finally, Taggart, (1999<sup>3</sup>) saw 33 upgrades in a group of 131 US or European-owned UK-based subsidiaries. Further, Jarillo & Martínez (1990) and Taggart (1998) have tested upgrading in relation to Porter's (1986) 'coordination-configuration' framework and both articles reported increases in the subsidiaries internal integration with other MNC units. Operating with his own definitions of market and product mandates, Pearce (1999) established the fact that within different groups of subsidiaries, upgrading took place in between 13 % and 21 % of the cases (190 UK-based

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<sup>2</sup> Delany modified White & Poynter's typology by using a *rationalised operator* role instead of a rationalized manufacturer, encompassing product development. Product specialists in Delany's survey were not totally autonomous. Finally, a new role was introduced: the *enhanced mandate*, defined as 'one that does not have control of the entire value chain of a business unit but has activities in a number of parts of the value chain' (p. 246).

<sup>3</sup> Taggart also modified the typology. The marketing satellite and miniature replica role were united into (1) miniature replicas with no or some R&D and (2) miniature replica with substantial R&D. The

subsidiaries). Furthermore, Egelhoff et al (1998) operated with three development paths for 16 Irish-based subsidiaries. Five aggressive subsidiaries built up unique value-creating resources and gained strategic responsibilities; four incrementally developing subsidiaries only gained extended product positions and finally, the remaining (status quo) subsidiaries did not widen the scale and scope of their activities. Williams (1998) concentrated his survey of 452 UK-based subsidiaries on whether these had changed in respect to the number of value-creating activities and autonomous-based actions and he discovered changes in 44% and 52% of the cases respectively. Furthermore, Walsh et al (2002) took out the survey in a Chinese context and experienced that 66 North American or Asian-based subsidiaries in China had extended the scope of market activities in 56% of the cases. Recently, Meyer & Lieb-Dóczy (2003) provided a specific insight into the improvement of acquired firms in the former German Democratic Republic and Hungary, but did not look into role changes *per se*. The authors presented nine Hungarian case-studies in which only one subsidiary had been upgraded to be a global centre of excellence for R&D.

This overview gave rise to the following kinds of questions: To what degree do subsidiaries change their role over time and why and when do they change? Which organisational and institutional structures cause these effects? Investigating prior surveys a pattern stood out where explanations to upgrading were to be found in *host country factors*, ie the local market economy and the actors related to this market, *subsidiary resources*, ie resource-based characteristics of the upgrading subsidiary and, finally, *MNC organisational and structural factors*, which included specific

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strategic independent and product specialist-oriented subsidiaries were pooled into a *strategic mandate*

circumstances regarding both the configuration of the MNC and headquarters behaviours. Birkinshaw & Hood (1997) also found evidence for this tripartition. The following paragraphs present a discussion of the three factors.

Subsidiaries are likely to upgrade when the host country's level of development improves because of the spill over effects derived from governmental subsidies and improved market opportunities. One 'classic' example is the development of Canadian subsidiaries. White & Poynter (1984) investigated Canadian subsidiaries and described a development from market-oriented to more production-oriented and strategically independent units. This development was caused by spill over effects from the Canadian governments improvements of the host country's level of development to avoid negative effects of a high proportion of US ownership in the Canadian industry; early documented by Safarian (1966). Rugman & Douglas (1986) provided an example of such a spill over effect showing how subsidiaries benefited from the introduction of better management training programmes. Egelhoff et al (1998) described how the Irish government initiated development programmes targeting, for example, physical infrastructures and universities and, thus, indirectly supporting the technological development in foreign-owned subsidiaries. Further, Walsh et al (2002) pointed out how improvements in the Chinese economy provided the opportunity for subsidiaries to be upgraded, because the subsidiaries focused on developing internal capabilities instead of seeking cost efficiencies by utilizing low labour cost. Secondly, governments can also *directly* influence subsidiary strategies through subsidies and tax concessions (Birkinshaw & Hood, 1997). Thirdly, improvements of the host country's economic

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role.

stage level of development typically improve market conditions and, in consequence, offering the subsidiary, more opportunities for establishing business relationships (Ivarsson, 2002, Delany, 1998, Ferdows, 1997) and, as shown by Egelhoff et al (1998), utilising new sales opportunities helped the subsidiary to grow and start up research processes. In relation, Holm et al (2003) showed how access to skilful personnel combined with pressures from local competitors and customers had a positive effect on the subsidiary's ability to develop capabilities.

The subsidiary's stock of resources and capabilities, and their administration, have determined the development of firms – as argued through the resource-based view (Amit & Schoemaker, 1993): starting with Penrose's (1959) pioneering work, which demonstrated how the growth rate of a firm was constrained by its reservoir of resources and how these resources were administrated. The resource-based theory has later been used to establish the conditions for sustained competitive advantage. For instance Barney (1991) theorized the need for resources to be value adding, rare, and hard to imitate and substitute. Christensen (2000) pronounces such rare and value-adding resources as capabilities. Capabilities have been described as being many-faceted, containing both the individual skills of employees and the organizational routines and learning processes (Nelson & Winter, 1982). Capabilities such as specialized technologies (Egelhoff et al., 1998), product portfolios (Hood et al., 1994), managerial expertise (Rugman & Douglas, 1986), entrepreneurial efforts (Birkinshaw & Hood, 1997) and especially internal R&D processes have been central in upgrading processes (Pearce, 1999; Florida, 1997; Taggart, 1998).

Finally, the role of subsidiaries is not only the result of environmental influences and the capabilities available to the subsidiary, but also an outcome of headquarters' strategy and the autonomous stage of the subsidiary (Morrison & Roth, 1993). Egelhoff et al (1998) provided the insight that headquarters' assignment was central for the subsidiaries' evolution. However, headquarters' willingness to allocate the subsidiary the needed resources and strategic responsibilities for upgrading has been depending on several conditions. When headquarters' home markets matured or its technological advantages disappeared, a need for corporate resource reallocation was created (Prahalad & Doz, 1980; Birkinshaw & Hood, 1998). In relation to this, Delany (1998) showed that the closing down of one subsidiary - in some cases - would result in the upgrade of another subsidiary. Therefore, changed market conditions, poor management, etc, elsewhere in the MNC gave headquarters an incentive to reconfigure resources and strategic responsibilities. These strategic redeployments have been either parent-driven (Birkinshaw & Hood, 1998) or subsidiary-driven (Birkinshaw and Hood, 1997; 2001). Furthermore, the product, market or industry area in which the subsidiary obtained its mandate, is also been dependent on the headquarters own interest and qualifications. D'Cruz (1986) explained the subsidiary's ease of achieving strategic responsibilities in, for instance, obscure products with limited global prospects. To win mandates was more difficult if headquarters had taken a stake through heavy investment in the particular product. Finally, autonomous-based strategic positions has helped subsidiaries to position themselves in relation to other subsidiaries, to build up capabilities through internal R&D processes and to tap into external networks not accessed by other units of the MNC. Autonomy can be seen as an outcome of an evolutionary process where capital, technology and management skills have become

vested in subsidiaries, thus establishing a space in which the subsidiary can develop without impact from headquarters or other MNC units (Prahalad & Doz, 1981). Some case studies have pointed towards this relationship between autonomy, initiatives and upgrading (Egelhoff et al, 1998; Delany; 1998; Ferdows, 1997).

### **3. Data collection and methodology**

#### 3.1 Data collection

The data collection started with a comparison of around 194 German investments in Hungary, representing one half of all German foreign direct investments in this country<sup>4</sup>. Out of these 194 subsidiaries, 13 cases were selected for a more detailed study of the upgrading processes. These cases on the whole represented the main structural features present in the total sample with regard to: the size of the German investors (mainly small and medium sized enterprises, the choice of sectors (mainly labour intensive sectors), the type of market entry (mainly acquisitions), the basic market orientation (both home market and export orientation) and the size of the Hungarian subsidiaries (both large and small subsidiaries)

Interviews were carried out in these companies between 1999 and 2002; both at the German headquarters (or at the divisional headquarters supervising the Hungarian subsidiaries) and at the Hungarian subsidiaries. Interview partners, either acquired by the cascading or the snowball approach (Welch et al 2002), were usually top managers of the Hungarian subsidiary, including both expatriates and inpatriates together with the

executive responsible for the subsidiary at the headquarters or the owner, in case of some small or medium-sized enterprises. In total, we interviewed 65 managers: twenty-six of the interviews took place in the headquarters, 36 in the Hungarian subsidiaries and three in competing subsidiaries. Furthermore, we conducted 10 stakeholder interviews, for example with representatives of the German Chamber of Commerce in Hungary or with a representative of the investment promotion agency. In some cases, telephone follow-ups took place. Interviews were semi-structured using an interview questionnaire. Interviews usually lasted an hour and a half, they were taped, transcribed and integrated into individual short cases studies. In these case studies document information was integrated. Information given in the interviews was basically triangulated in interviews carried out elsewhere in the same MNC and in stakeholder interviews and document data. Case studies were sent back to one interviewee (usually our ‘sponsor in the company’) for correction and additional information. In about half the cases feedback meetings with several interview partners took place.

### 3.2 Descriptive Statistics

German MNCs owned the 13 Hungarian subsidiaries surveyed. In two of the cases examined, the same German firm took the ownership of two different Hungarian subsidiaries. The sample, therefore, included 11 German MNCs and 13 of their subsidiaries. Six of the German MNCs employed between 600-5,000 individuals. Another group of four MNCs had between 25,000 and 42,000 employees. Finally, one MNC consisted more than 200,000 employees. In the last case, two subdivisions were investigated, employing 5,000 and 39,000 individuals respectively. Nine of the MNCs

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<sup>4</sup> In terms of the overall employment at German subsidiaries in Hungary as given by the Deutsche

operated within the manufacturing industry. Four of the German firms had only located production sites in Germany and Hungary. Two other MNCs had placed production sites regionally in Europe and finally, the remainder produced globally. Two firms within the service industry were globally oriented.

The Hungarian subsidiaries employed between 150 and 1,100 individuals. In this sample, the mean was 501 employees, with a standard deviation of 287. The German MNCs acquired eight of these Hungarian subsidiaries, whereas the remainder was greenfield establishments. The German companies took the ownership in between 1989-1997. Nine of the subsidiaries exported their products. Local executives managed five of the subsidiaries, German expatriates led five other subsidiaries, and in the last three cases we observed a shared management between German and Hungarian executives.

## **4. Main Empirical Findings**

### 4.1 The cases

ELEC<sup>5</sup> has more than 400 employees and operates within the electro mechanic industry. Main products are sensors for machine tools. The subsidiary started out and has remained as a rationalized manufacturer. In 2002, the subsidiary took care of some R&D activities for new products - but not enough to be judged as a product specialist, since no innovative research took place. R&D activities were mainly process-oriented and involved only six people. However, production activities in ELEC grew in volume and further the subsidiary introduced high-tech manufacturing machines and

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Bundesbank (2003)

<sup>5</sup> All names are pseudonyms in order to maintain anonymity

technologies (such as “chip on board-technology” or “SMD pick and place-technology) that were not implemented in headquarters.

TELE, conducts its business within the telecommunications equipment industry and employs 250 people. This company began as a miniature replica, with a local market focus and an assembly oriented product scope, and since has conducted applied R&D activities while adapting headquarters technology to Hungarian market requirements (for example in fast internet access-technology). In 2002, the subsidiary was downgraded to a marketing satellite when production activities were closed down. However, before this closure there was marked progress in production activities and in the technological level of the activities performed.

The third case was SOFT. This company is located in the communications software industry, employs 500 people and is owned by the same MNC as TELE. SOFT was founded initially as a rationalized manufacturer and has remained in that role within its main activities. However, the entity has initiated R&D activities and created capabilities within very narrowly defined technologies (for example in core processing) and products requested by particular Hungarian customers. This indicates a role change towards a product specialist, though, within an obscure activity. The role change is seemingly partial, since the headquarters still monitors strictly whether the subsidiary fulfils its rationalized manufacturing mandate.

ERP functions within the ERP-Software industry, and has 150 employees. ERP was established as a marketing satellite and has remained in that position ever since. The predominant task is to market headquarters products to the local market, though some activities in production adaptation towards local regulatory requirements have been initiated. Follow-up consulting services such as on line trouble shooting have been

extended, which might lead to a future upgrading within this specific area. Otherwise, the subsidiary is likely to continue to operate primarily as a marketing satellite.

The fifth case is ITSERV that provides IT services and employs 300 people. The subsidiary started as a miniature replica following acquisition. However, in 2002, a regional innovation centre focusing on the convergence of information and telecommunication technology was founded and headquarters decided to upgrade the role of the subsidiary in the direction of a product specialist. The R&D unit initially employed 50 people but is planned to provide work for 250 people.

AIR is active in pneumatic technology and employs 320 people. AIR was launched as a product specialist having corporate-wide responsibilities within specific product lines (air preparation devices used in process control). From the beginning AIR also acted as a rationalized manufacturer for the production of some auxiliary components. Although an increase in production and enhancements in the technological level of production and R&D activities performed took place during the investigation period, the subsidiary retained the role as a rationalized manufacturer.

FOOTW1 is in the footwear industry with 850 employees. This subsidiary commenced as a rationalized manufacturer since all R&D, procurement, logistics and production planning occurred at the headquarters. As in the other cases described, no upgrading in role came about even though the scale of activities has increased (for example part of the logistics has been relocated from the headquarters) Further, the subsidiary undertook part four (production of travel prototypes) and five (development of process technology for mass production) in a five-phased R&D process. Headquarters then decided to relocate part three (production of coloured prototypes) to the subsidiary. In general, production enhancements have taken place.

FOOTW2 is owned by the same MNC as FOOTW1. The subsidiary employs 1,100 people. The subsidiary's development path was quite similar to FOOTW1 despite only slight improvements in technology and the quality level of production. FOOTW2 won a mandate for the production of kid shoes and thus extended the product scope. However, due to a market slump, inefficient production at the subsidiary and unprofessional marketing management at the headquarters, this mandate was managed unsuccessfully. Headquarters then decided to close down the subsidiary in 2003 and to relocate parts of the production to FOOTW1.

The next case presented is MOTOR that produces electrical motors for household appliances and employs 620. Since its acquisition in 1992, the subsidiary has played the role of a rationalized manufacturer. The scale of activities has, however, increased tremendously; for example production volume doubled in the years from 1999 to 2001 - as a result of further relocations from headquarters. Today, the subsidiary faces threat of a closure due to cost driven reconfiguration of the production in the MNC.

KNIT is involved in the knitwear industry and has around 450 employees in the production of high quality pullovers. The subsidiary was a true rationalized manufacturer since all R&D, marketing, logistics, distribution, purchasing, production planning and steering functions were located in the headquarters. Technicians sent from the headquarters even maintained the machines. The subsidiary still plays the role of a rationalized manufacturer, though it is approaching the product specialist role, but without being responsible for particular products *per se*. However, increases in the production volume, quality and flexibility have been seen; further, the subsidiary introduced more advanced technologies in production processes. Finally, additional

tasks in R&D (for example the production of prototypes) have been assigned to the subsidiary.

Case number 11 is CLOTH, a subsidiary that operates in the work clothing industry and employs 380 people. This case again showed the stability of the rationalized manufacturing role. All value added activities besides production have been done from the German plant. Despite the fact that during recent years some marketing tasks in the Hungarian market were mandated to the subsidiary, headquarters of this family owned company still controlled marketing activities for the Hungarian key customers. There has been no upgrading in role, but again increases in the production volume, technology and quality took place.

PLAST operates in the plastic packaging industry for consumer goods and employs 270 people. This subsidiary, which was built up as a state of the art greenfield plant, can be characterized as a product specialist - though with a restricted market scope – producing and marketing for the European market. A dedicated R&D unit in Germany carried out basic R&D. Also major process innovations were transferred from Western European or US sites. This has not been changed since the establishment of the subsidiary.

The final case is CEMENT, a cement producer employing 550 workers and staff. This subsidiary played the role of a miniature replica, producing for the local market. Basic R&D was done in a specialised German-located R&D unit. Furthermore, major process innovations - such as the creation of plant wide maintenance units - were transferred from Western European or US sites. Subsequent to the acquisition, major investments were made both in the modernization of the production and in environmental protection

equipment. Again, production volume and quality have increased dramatically, but there was no upgrading in role.

#### 4.2 Upgradings?

Departing from White & Poynter's (1984) terminology, the Hungarian subsidiaries were not able to make substantial role shifts, measured as going from one role to another. Seven subsidiaries remained in their role as rationalized manufacturers (ELEC, SOFT, FOOTW1, FOOTW2, MOTOR, KNIT and CLOTH), two continued their role as miniature replicas (ITSERV and CEMENT), two went on as product specialists (AIR and PLAST) and one stayed in the role as a marketing satellite (ERP). The remaining subsidiary (TELE) even faced a downgrading in role, from a miniature replica to a marketing satellite. However, most of the subsidiaries were able to extend their scale of production and marketing activities and substantially increase the quality and flexibility of their production or service delivery. To explain this simultaneous inertia in role but upgrading in scale, flexibility and quality in Hungarian subsidiaries, host country factors, issues related to subsidiary capabilities and MNC structural factors are subsequently discussed.

Host country factors were the primary cause of the changes that took place in those subsidiaries where a marked expansion and improvement of operations was observed. Governmental policy and access to local knowledge were supportive to improvements of the subsidiaries' operations, whereas increased labour cost sometimes was an obstacle to development. One important host country factor was the liberal investment regime of central government including huge tax alleviations, the right to declare any

company premises a special economic zone and different kinds of direct subsidies for the creation of workplaces<sup>6</sup>. In some instances, local government had been supportive to subsidiary activities. In the TELE-case, where the subsidiary for an interim period improved its productive and technological level, the local authorities showed their willingness to help the subsidiary to earn a European mandate for a specific product line by signalling that they would allow large scale production in a predominantly residential area. Another important host country factor explaining the strong increase in the scale of operations at Hungarian subsidiaries was relatively low labour costs. Increasing labour costs, due to the overvaluation of the Hungarian currency Forint and due to the rise in the minimum wage was, however, seen as a major problem for the development of some subsidiaries. Such was the case in MOTOR that had built its competitive advantage exclusively on cost efficiency. In another case (AIR), the rise in labour costs probably prevented a further expansion of economic activities while in the cases of FOOTW1 and FOOTW2, parts of the production processes were relocated to cheaper locations in Asia and other Eastern European plants. On the other hand, access to labour that was simultaneously cheap and skilled (compared to Western European standards) was vital for development in the SOFT and the ITSERV cases. In both situations, headquarters decided to locate innovative activities in Budapest hosting the highest level of technical education in Hungary. Furthermore, relationships established to local universities, like in the SOFT case, were supportive to development. Here, an outpost in Szeged was founded in order to bypass the labour market shortages for engineers in Budapest. Secondly, the subsidiary cooperated with the Szeged University

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<sup>6</sup> This is also supported by two comparative studies of the Economist Intelligence Unit In both studies, (1) on the costs of doing business and (2) on the quality of the business environment, Hungary was among the leading countries (Economist Intelligence Unit, cited according to OECD 2002: 113-4)

to draw on resources that were outside the functional needs of the MNC. Collaborating with this association helped the company to develop its technological capabilities. ITSERV also established close connections to the Budapest Technical University.

While host country factors were by and large supportive to upgrading, inadequate subsidiary capabilities in combination with strategic inertia were determining causes for the ineffectiveness in upgrading. In many cases, the subsidiaries missed the opportunity to develop resources that were value-adding, rare, inimitable or hard to substitute, compared to the rest of the MNC. PLAST, being a product specialist, lacked the size and the technological potential to develop into a strategic independent unit. The same is true for AIR, the second product specialist in our sample. In both cases, achieving satisfactory performance in production consumed most resources. However, in one case (SOFT), the subsidiary possessed state of the art technological knowledge and within minor areas, it employed the leading experts within the MNC. However, lack of headquarters' assignment and fierce MNC internal competition prevented an upgrading in role. In particular, subsidiaries with a strongly restricted value adding activity scope - such as the rationalized manufacturers - lacked basic lobbying skills and/or an effective access to the headquarters: in many cases the managers of these subsidiaries had no or only little knowledge of who the key actors were in headquarters' decision processes, relevant decision criteria or which management fraction in the headquarters supported which position. Frequently, interviewees in headquarters also stressed insufficient organizational capabilities in the Hungarian subsidiaries as impediments to subsidiary upgrading.

A second determining cause for the strategic inertia of Hungarian subsidiaries was the MNC structural factors – one example is the headquarters decision of allocating resources. MNC-wide reconfigurations were observed in the cases of MOTOR, KNIT, ELEC and CLOTH, where headquarters relocated production from Germany to Hungary, but this did not lead to allocating of more demanding steps in the value chain (such as R&D) - potentially triggering a change in role. Furthermore, even though the relocation of production was the initial reason for settling down in Hungary, the relocation was done stepwise: Headquarters eagerly governing whether the subsidiary met quality and performance standards.

Only in three cases (ERP, ITSERV and FOOTW2), were autonomy and managerial initiatives, two basic structural preconditions for a subsidiary-led upgrading, present simultaneously. In ERP, a strong entrepreneurial initiative was demonstrated in order to develop centres with specific responsibilities. Secondly, the subsidiary attempted to position Hungarian employees in leading projects worldwide. Thirdly, subsidiary top management desired to improve ERP to be a know-how centre. In this case, managers in the subsidiary reported enough room and resources to develop strategies on their own within the mandate given. Managers in the ITSERV subsidiary also showed considerable initiative to promote upgrading and headquarters assigned the needed autonomy to develop independent strategies. In the case of FOOTW2, headquarters' managers felt that subsidiaries were much uncontrollable, which demonstrated autonomy. Nevertheless, the local managers here won a specific product mandate. Later, headquarters closed down FOOTW2, mainly for reasons, which lay beyond the subsidiary's influence. In the three cases, the combination of managerial initiatives and

autonomy to build up new insights helped the subsidiary to develop towards upgrading, though an upgrading in role was not achieved during the time of our inquiry. In other cases (such as SOFT), a high degree of managerial initiatives were shown, but the needed autonomy was not granted from headquarters<sup>7</sup>.

This leads to the question of why did several of the German headquarters show such a strong absence in assigning autonomy and mandates to their Hungarian affiliates? Birkinshaw and Ridderstråle (1999) have suggested the *corporate immune system* as a reason for absencing assignments. Here, headquarters opposes subsidiaries proposals because of strict funding criteria, bureaucratic inertia or due to political reasons. Sometimes the subsidiary becomes a victim of the Not-Invented-Here syndrome (Katz & Allen, 1982). In many cases investigated, the German headquarters showed ethnocentric attitudes towards the Hungarian top managers: in one case, they were disparaged as the ‘mafia’ or ‘old socialists’. In another case the German owner stated: ‘all Hungarians only want to become rich without working and thus must be tightly controlled’. Here, the German owner found it too risky to transfer crucial elements, such as production planning, to the Hungarian subsidiary. In other cases, resources and mandates stayed at headquarters, even when sites in Hungary were considered as being better equipped to perform certain tasks. In yet another case, a subsidiary, run by inpatriates, could not overcome jealousies from their sister subsidiary in Hungary, which was run by German expatriates. Large investments in logistics, originally planned for

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<sup>7</sup> It further turned out, that only local managers/inpatriates advocated initiatives for a change in role. Most of the expatriated managers took no such initiatives. The pros and cons of using expatriates instead of inpatriates have not been an issue in previous upgrading studies. Our results pointed towards the fact that the use of inpatriates favoured subsidiary upgrading. However other surveys, for example Blazejewski & Dorow (2003), have spoken for expatriates leading upgrading processes.

the subsidiary, managed by the Hungarian managers were finally made at the subsidiary managed by expatriates.

## **5. Conclusions and discussions**

Upgrading of German-owned Hungarian subsidiaries has only taken place to a limited degree and mostly in terms of scale, quality and flexibility of operations. Even though the external environment was generally supportive, the subsidiaries were not able to develop the needed capabilities for a role shift. The main reason why was to be found in absents headquarters assignments and in ethnocentric German behaviour. We, therefore, suggest that future research should include investigations of slackness in subsidiary development. One question to address is the importance of the corporate immune system for lack of upgrading. A second question is the weight importance of the three pillars supporting subsidiary role changes, ie host country factors, subsidiary capabilities, and MNC structures. Further, the interrelatedness of the three factors needs to be established.

We foretell a future upgrading of especially SOFT, ERP, ITSERV and KNIT. Coming from different roles, these subsidiaries have the potential to upgrade to product specialists. On the one hand, these firms have not made a role shift in respect to White & Poynter's (1984) categorization, in view of the fact that all three above-mentioned factors were not simultaneously present. On the other hand, subsidiaries were able to evolve when only some of the needed conditions were in place. SOFT established unique relationships to the local environment, developed capabilities, and managers took initiatives. However, headquarters decided so far not to assign the needed autonomy and resources for upgrading. ERP was also a very initiative-oriented firm and

lived rather uncontrolled, but lacked the efficiency in using the local market or start up internal procedures, to create capabilities. KNIT showed a promising development, even without local economy support or through initiatives taken, but headquarters was in this case ready to assign future mandates. ITSERV was the case where headquarters decided to place a Regional Innovation Centre. This case came closest to the current theoretical understanding of why subsidiaries upgrade, though this subsidiary's superiority rather had to be found in its external relationships to local counter partners rather than internal in the firm.

The fact that we chose to collect data in a very narrowly defined context limits our findings. Several studies have revealed the fact that headquarters' national origin influenced the development path of subsidiaries (Taggart, 1999; Pearce, 1999; Delany, 1998; Hood & Taggart, 1999). The absence of assignment might in our sample be an outcome of the dyadic relationship and the related narrow national context investigated.

This leads us to the managerial implications of our study. Examples of Hungarian subsidiaries being upgraded through headquarters assignment do exist, such as Nestlé's plans to disperse new roles to its Hungarian subsidiaries as a preparation for Hungary joining the EU. Centre of competences will here be established, based on the know how of the factory in Szerencs/East Hungary (Oláh, 2003). A similar case is the Audi plant in Győr/West Hungary. Based on an initial success of a small car engine production, the headquarters of Audi assigned the worldwide mandate for all engine production of Audi to the Győr plant. Furthermore, a mandate was handed over to Győr for the assembly of the high-end roadster Audi TT (Keune/Tóth 2001). Despite these individual cases of

headquarter assignments an important question remains: what Hungarian managers can do to support an upgrading in role of their firms? This is an especially pressing question since rising wages, an increasing labour market shortage together with a deterioration of the investment regime due to Hungary's EU-accession<sup>8</sup> means for many Hungarian subsidiaries today to upgrade or to die. In this situation, Hungarian subsidiary managers have to simultaneously following two strategies. For one they must convince their headquarters that the subsidiary is capable to perform tasks beyond manufacturing. Secondly, since 2002 through subsidies governments has tried to attract R&D and have further promoted human capital formation by modernizing its educational sector. This shift in the investment regime has to be actively promoted at the headquarters by the Hungarian subsidiary managers since - as we pointed out earlier - Hungary still has the reputation of being a low cost agrarian country, which is burdened by corruption and bureaucratic red tape. The second strategy to be simultaneously followed by Hungarian subsidiary managers is to make use of new government programs that aim at a gradual deepening of linkages between domestic suppliers and MNC subsidiaries in Hungary. These programs encompass matchmaking activities, technical and financial support to do business with foreign subsidiaries, hand-in-hand with subsidies for the co-operation of Hungarian research centres with foreign subsidiaries in Hungary. Integrating or developing Hungarian suppliers can be a way to support internal knowledge creation processes at foreign subsidiaries, which might be effective in building up capabilities and autonomy, needed for the gain of headquarters mandates.

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<sup>8</sup> With the EU accession the generous tax concession the Hungarian government used give, will be abolished. The same is true for the right to declare any plant a free-trade zone (OECD 2002).

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