

# Finnish ICT and furniture companies' strategies towards relocating operations to Estonia

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May 2004 saw ten more countries join the European Union. This implies a major impact on the whole European market not only in economic but also in political and institutional terms. For Finland the greatest opportunity, but at the same time a major challenge, will be the inclusion of Estonia into the community. Estonia because of its geographical proximity, earlier investments in the form of foreign direct investments and other collaborative efforts. Furthermore, the two countries have structural and lingual similarities as well helping inter-country trade.

Due to lower labour and material costs, Finnish companies have been rethinking their strategic position by seeking competitive advantage through relocating their activities to Estonia. For instance, Finnish textile and clothing industries have relocated parts of their manufacturing, especially sewing there (Varblane & Reiljan 2001; Alho et. al. 2001). Also companies such as Silja Line and Viking Line have moved their call centres to Tallinn (Grünthal 2003). As a current trend, the managing director of the Federation of Finnish Enterprises Jussi Järventaus estimates that thousands of Finnish firms are considering the relocation of operations. Phenomena like these

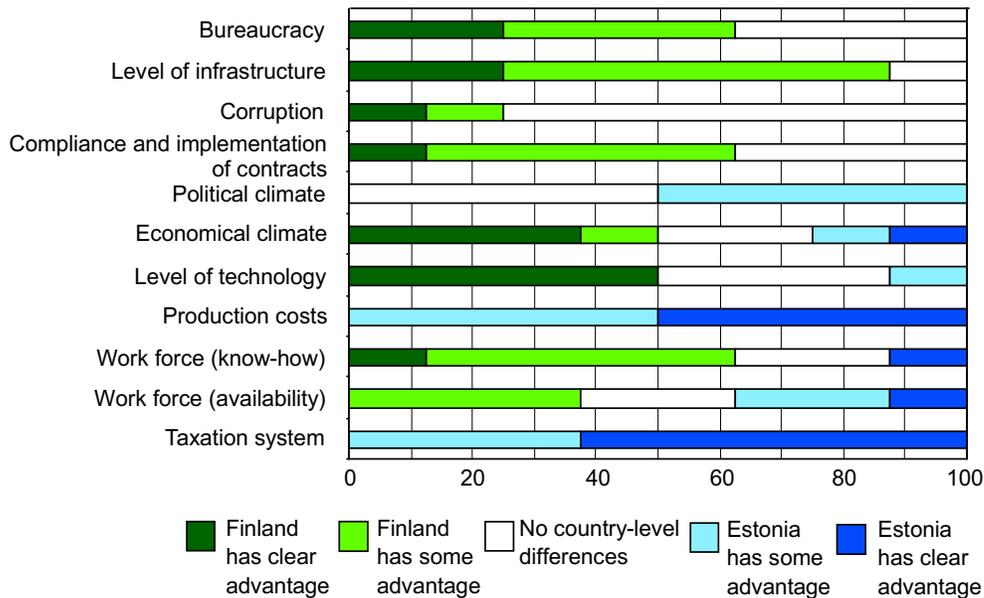
may have a tremendous impact on regional welfare, such as in the Helsinki region, by decreasing jobs and tax revenues.

The study examined eight Finnish enterprises of various size within two industries: ICT and the furniture industry. The main focus was to examine these companies' previous internationalisation strategies and gather an overall image of their relocation activities, nominally concentrating on those inclining towards Estonia. The research method employed was a case study and targeted at those executives responsible for decisions of their company's relocation or foreign operations' strategies.

## Differences in inter-country business environment

Part of the study examined the different aspects of the Finnish and Estonian business climate. The results show in general some advantages of the Finnish economy. However, the gap is constantly shrinking in various segments, such as the level of infrastructure or technology.

## Executives' ideas of the differences between certain factors in Finland and Estonia.



Source: Stöckli 2004.

## Case companies' motives for relocating operations to Estonia

This study found still many, especially cost-based advantages in the Estonian economy for Finnish companies to exploit. The greatest opportunity would seem to be the increase in or defence of competitive advantage against rivalry through the use of cheaper labour. Still, it is highly uncertain how long Estonia can sustain this advantage.

### Cost argument

Previous studies and general opinion has been based on the premise that relocation to foreign countries occurs mostly as a result of strategies focusing on cost savings. It is still the original and currently predominant reason, particularly when manufacturing is relocated from Finland. Cost structure in the Finnish furniture and ICT industries mainly consists of labour costs, which can be notably lowered through relocating manufacturing functions. Labour cost differences

between Finland and Estonia were suggested in the following manner: "if Finnish cost levels in raw materials and labour are respectively 1/3 and 2/3, then in Estonia it is 3/4 in raw materials and only 1/4 in labour costs". The use of subcontractors is also popular, but quality can vary at times.

Yet it would appear that there a notable problem relating to skilled labour will arise in the foreseeable future. Labour costs have been quickly rising and will continue to do so particularly in the early steps of EU membership. Over the same period, workforce productivity has not been able to keep up with the same pace of wage index increase. This will presumably have a negative effect on companies' interest in relocating functions or maintaining them in these markets. Also deficient productivity levels have been shown to be a setback among processes requiring merely semi-skilled labour, but not so extensively in expert services such as jobs in ICT sector.

As for the cost of production raw materials, there would seem to be no apparent cost advantages in Es-

tonia as materials are mostly imported into the country thus retaining the prices quite adequate to Finnish levels.

Case companies also noted that the available manufacturing facilities still mostly date from Soviet times as they are old-fashioned and generally in poor repair. Therefore, it is almost a necessity for companies to establish a production plant of their own, which naturally requires considerable capital.

#### *Availability of labour*

In the ICT branch, the availability of skilled labour is even more important for cost savings. Already the medium term shortfall of qualified programmers in Finland has led companies seeking them partly from Estonia, where there are still some available. Unfortunately this is limited by the small size of the economy. In comparison to Finland, labour in the ICT sector is almost equally expensive and the wage gap is radically falling due to high demand also from inside country itself. Also according to responders from both industries, the availability of a semi-skilled workforce has been considered better in Estonia. Estonians do not shun manual work and are usually more motivated in their jobs than their Finnish counterparts. This, among other things, is reflected in low absenteeism.

#### *Taxation [corporate and personal]*

The importance of taxation on relocation strategies is not currently very significant. Yet, in future years, the situation may change and taxation may become vital to maintain companies' competitive advantage. In case of larger MNEs, taxation plays a considerably more relevant role than it does for SMEs. From the personal taxation viewpoint, circumstances may be favourable for companies in a situation of expatriate relocation since personal taxation is notably more beneficial for those working in Estonia.

## **What operations should Finnish companies relocate to Estonia?**

For the case firms, the fundamental interest in practicing business in Estonia has been through manufacturing or by using subcontractors. Other forms of operation have received less attention, but will most probably become as significant as traditional production.

Two different kinds of production types emerged from the ICT firms studied. The first was programming requiring special skills, which is in a way subjective as it can be basically produced geographically anywhere. Another variation was the more traditional manufacture of cables and components, where there were no requirements for special skills. In addition to production, ICT companies had consulting services and R&D centres in Estonia.

This study shows that the opportunities created by Estonia do exist to fulfil the needs of Finnish ICT companies, despite not being effected through lower labour costs. Estonia has vigorously developed the infrastructure of its information and communication sector, which can be described highly competitive even by Finnish standards. At the same time, there has been skilful, innovative and motivated labour for productional needs. For the case ICT companies, manufacturing will still remain a preference in future years when relocation is considered. Additionally, firms are considering relocating some of their services, such as consulting, to Estonia.

With companies in the furniture industry, possible relocation will focus on productional criteria as earlier. This does not necessarily involve establishing an own subsidiary, but merely substituting a domestic manufacturing unit by an Estonian subcontractor. This is mostly justified through savings in various costs. Although production quality is still somewhat inadequate for current needs, the production infrastructure and manufacturing skills have developed greatly in the past decade, thus enabling the use of

local subcontractors. Furthermore, some furniture companies mentioned various additional functions such as marketing services to be on the list of reasons for possibly relocating to Estonia.

## **Strategic implication of EU enlargement on relocation decisions**

### *Expenses will rise*

Firstly, Estonia's membership of the EU will greatly affect prices and may prove to be a real threat to business profitability through changes in cost structure. Nearly all the firms agreed that there is pressure to increase wages, raw materials costs and the cost of end products, resulting in an increase of up to 20% in costs during the early stages of EU membership. After a couple of years, the pace of growth will continue as it was before membership.

### *Increased bureaucracy*

Another relevant problem confronted by EU membership is the growth in bureaucracy, a consequence of new legislation involving more restrictive directives and regulations than previously experienced. Most interviewees experienced there to be an upswing in bureaucracy, notably scaling up their operational burden. Over the past years, business in Estonia has been perceived as comparatively flexible and pro-company. Yet in future, business will likely to become tougher and levels of freedom lower as a result of greater and changing standards and regulations.

The responders considered other anticipated changes in Estonia as being the stabilisation and westernisation of the economy and growing proportion of foreign investments. Yet, it could be read between the lines that the positive factors above will not outweigh the negative ones. Otherwise the responders did not see Estonia's EU membership as creating any changes in their relocation strategies. To date, Estonia has been a popular target for manufacturing and

services, thus making the changes brought about by EU enlargement more cosmetic than fundamental.

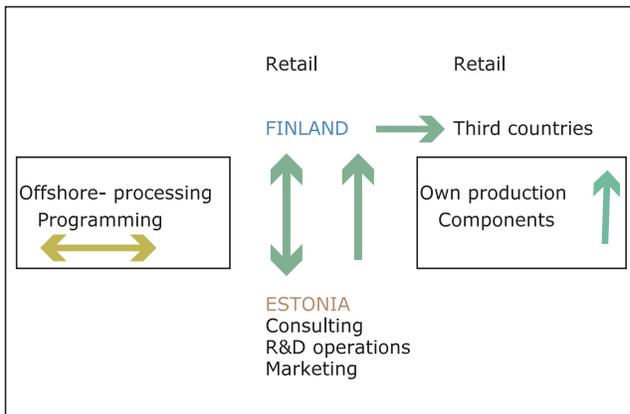
## **Industry-specific view**

It has to be noted that by focusing only on two industries the study involved quite a small niche. Yet those industries are exceptionally dissimilar in their history, organisational structure, labour, expansion views and, most importantly, in their relocation strategies. This is why it has been possible to create nominally better assumptions than if only one industry had been focused on.

The following illustrates the future prospects of the ICT companies researched regarding the Estonian and related markets. It would seem highly likely that firms are not going to progressively further exploit the opportunities offered by the Estonian business environment. The reasons given were rapidly rising cost levels and the poor availability of skilled labour. Especially the latter would seem to be of fundamental importance for relocation considerations both from the viewpoints of in- and outbound directions. Estonia has a considerably smaller population than Finland, setting the limits for educational system for education of required labour force even in a longer-term time frame. At present, the demand for and wages of the available workforce continue to grow so fast that companies may not necessarily consider it viable to expand their functions there.

Still, for processes, such as cable manufacturing, requiring only semi-skilled labour there will be labour available also in foreseeable future. Wage levels have also sustained a very favourable level in comparison to Finnish standards, thus making it well justified for companies relocating these functions to Estonia despite rapidly rising local salaries. To make business even more profitable, production plants can also be located outside Tallinn to take advantage of even lower labour and real estates costs.

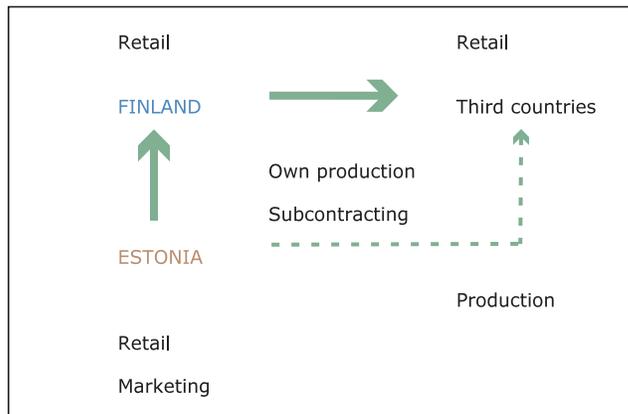
### Examined ICT companies' trade in Estonia in the upcoming years



Furniture companies' activities in Estonia would not seem to experience any major changes in the upcoming years. Phenomena in respect of production location and activities concentrate on decreasing own local manufacturing on the one hand, and on increasing subcontracting agreements on the other. It is not certain whether these subcontracting agreements are implemented through Estonian, Finnish or third country manufacturers.

If inflation or the EU itself causes cost levels to rise too much, it will swallow companies' contribution margins and erode competitiveness. Therefore, it may well be that production will cease in Estonia and be relocated elsewhere, most likely to extra-EU country such as Russia or an Asian country, where cost levels are considerably more attractive, but problems emerge with corruption, the political climate and labour.

### Examined furniture companies' trade in Estonia in the upcoming years



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