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Vienna and the CENTROPE Region: An International Business Perspective

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Methodology

This research study was based primarily on ten in-depth interviews, conducted from June to October 2005, with senior regional executives of large multinationals either currently or formerly based in Vienna. Most of the interviewees have a long-standing relationship with the Economist Intelligence Unit's Corporate Network, which brings together around 180 multinationals operating in the Central and Eastern Europe region. We also spoke with senior officials at the Austrian Business Agency, AmCham and the Boston Consulting Group.

Senior consultant Delia Meth-Cohn, the author of this paper, has been examining trends on the topic of corporate structures and locations in the region over the past three years. She has had dozens of discussions with regional managers from a wide range of industries and locations. She has written white papers on corporate structures and shared service locations in Central and Eastern Europe.

[1] The Economist Intelligence Unit is a specialist publisher serving companies establishing and managing operations across national borders. For over 50 years it has been a source of information on business developments, economic and political trends, government regulations and corporate practice worldwide. The Economist Intelligence Unit (EIU) delivers its information in four ways: through its digital portfolio, where its latest analysis is updated daily; through printed subscription products ranging from newsletters to annual reference works; through research reports; and by organising seminars and presentations. The firm is a member of The Economist Group.

Executive Summary

- Vienna's role as a hub for Central and Eastern Europe has changed dramatically over the past 15 years. The size and scope of regional headquarters has shrunk over the years as local subsidiaries took on more management and support responsibilities. Now most Vienna-based hubs are small, high-level, strategic management units.
- Vienna's attractiveness as a location for these hubs has also changed. Although initially the obvious choice for international companies starting operations in Eastern Europe, a combination of poor Austrian policies and the emergence of new locations, weakened Vienna's position. These weaknesses remain, but selecting the right location is no longer a key issue. More important are which functions the strategic hubs should carry out, which markets they should cover and whether they need to exist independently of European headquarters (HQ) at all.
- From the perspective of multinational companies, Central Europe's importance as a growth market is diminishing. Not only is the market maturing rapidly, but other markets in the Eastern Europe Middle East and Africa (EEMEA) region are taking the limelight and at least two of them – Russia and Turkey – are coming to be seen as global growth markets. At the same time, multinational interest in Central Europe as a high-value, low-cost manufacturing and services location is growing.
- These changing business realities threaten to make the traditional Vienna hub irrelevant, with operations easily assumed by more autonomous local subsidiaries and/or European headquarters. But pressure to constrain costs in emerging markets is pushing companies to keep local subsidiaries lean and to share services wherever possible. That has created a niche for small hubs, staffed by experienced managers who can provide strategic services to a broader range of markets.
- As a result, from an international business perspective, the real opportunity for Vienna is not in servicing a narrowly defined CENTROPE region, but in providing high-level support for a much wider region. CENTROPE is just too small to be an internationally relevant region.
- Several large international companies already use their Vienna hubs to cover Russia, Turkey, the Middle East and Africa. More recently, companies have started using Vienna to take responsibility for western Central Europe, including Austria, Switzerland and even Germany.
- But if this is to be more than a temporary solution as corporate structures respond to changing markets, Vienna needs to support the continued geographical and functional development of regional hubs by focusing on finding solutions to three key problems: weak transport infrastructure, work permits for senior management from the U.S., Japan and Central Europe, and expat tax treatment.

1. Central Europe and the Vienna Hub: An Overview

Business realities have changed rapidly in Central Europe over the past decade and each new facet brings different challenges to Vienna's role as a business hub for the region.

Only 15 years ago, Central and Eastern Europe (CEE) was a haven for business pioneers, who usually explored the new markets of the Czech Republic, Slovakia, Hungary and Poland from a comfortable base outside the region. From the late 1980s to the mid-1990s and even beyond, the choice of Vienna as a location for CEE headquarters was what one regional manager described as a "no-brainer". Proximity, infrastructure and quality of life were the main criteria:

- Vienna was not drab Eastern Europe, but it was close both physically and in mentality to its neighbours.
- It was traditionally seen as neutral and had simpler visa regulations.
- It had a network of service industries (lawyers, consultants) and managers who had experience in the region.
- It had Vienna International Airport and Austrian Airlines.

Time and again, regional managers reiterate that the rapid build-up of unrivalled air connections did more to build Vienna's reputation over the years as a business hub than any other factor. Sadly, government policy failed to go beyond rhetorical support for Vienna as the "gateway to the East". Instead of embracing that role, successive governments were defensive about the implications. They decided against the rapid development of modern road and rail connections to cities like Prague, Brno, Bratislava and (for rail) Budapest. They also failed to ensure that international companies could easily hire expatriate managers for their regional operations. Not only was it time-consuming to organise work permits, since they fell under restricted immigration quotas, but procedures were untransparent, leaving companies to the mercy of inaccessible bureaucrats.

Non-European companies were particularly frustrated at the months of battling through lawyers to bring in senior managers from the U.S.A. or Japan, or from the region itself. A few large companies – AIG, Marsh, Oracle among others – gave up and shifted their regional operations to Brussels or Geneva. Numerous others, no doubt, decided against locating in Vienna to avoid the problems.

> "We needed 25–30 top people to set up a hub, but we couldn't get the permits. Now we are in Geneva and it took us just six weeks to get 25 work permits."
> *U.S. IT company which gradually shifted its entire CEE hub out of Vienna*

But that dissatisfaction was disguised by new companies pouring into Vienna. In 1995, Austria joined the EU, making life considerably easier for European companies and expats to operate out of the city. Austrian companies had also started to do serious business in Central Europe, which they came to define as their extended home market, becoming major players in sectors like finance, retail, industry and logistics.

A new flurry of business excitement was sparked in 1998 by the start of negotiations with the first wave of ex-communist countries to join the EU. When newcomers looked for a location to base their CEE regional HQ, Vienna was always on their list, accompanied by places like Budapest, Prague, Munich, Amsterdam and London. Companies with developed regional operations saw sales growing phenomenally and started to invest in growth, shifting resources into building up stronger local operations.

In some ways, it was the heyday of Vienna's career as a business hub for the region. Between 1999 and 2001, the Austrian Business Agency helped around 20 large companies to set up CEE operations in Vienna, compared to only one in 2004, according to managing director, Rene Siegl. In addition, dozens of companies acquired Austrian firms, largely to get their hands on a well-developed business in Central Europe (CE). Or they gave their Austrian subsidiaries more resources to develop business in the region.

But the Vienna regional HQ concept was already on its way out, for two reasons:

- First, Vienna's competitive advantage was eroding as Central European cities became more pleasant and accessible. In addition, locations like Brussels, Geneva or London were increasingly seen as alternative options, as they built up connections and Vienna failed to address its shortcomings.
- Secondly, the CEE pioneers were localising their operations, building up the capacity of subsidiaries in Warsaw, Prague and Budapest. While sales growth was good, the rising overhead costs of full local operations were easily justified. As a result, regional headquarter operations were scaled down not only in size, but also frequently in scope, shifting away from a legal holding company structure towards a much smaller support office.

1.1 The Vienna Hub after EU Enlargement

The arrival of EU enlargement sparked the latest phase of development for Vienna's hub operations. Instead of viewing the CEE region as a homogenous whole, companies began to see a group of very different markets, maturing at different paces and in different ways. Using experience of grouping small markets in western Europe, multinationals started to think of the CEE region as a number of clusters – New EU Member States , Central Europe, Baltics, Southeastern Europe (SEE), Commonwealth of Independent States (CIS).

As a result of this splintering of the CEE region, the question exercising most regional managers and corporate boards these days is not where to put the CEE hub or whether Vienna is better than Prague. The hot issues are:

- What kind of functions makes sense for existing Vienna hubs?
- Is a separate HQ necessary at all now that Central Europe is part of the EU? Isn't a CE cluster reporting to European HQ sufficient?

- Can the Vienna HQ expand its strategic oversight beyond Central Europe and Southeastern Europe (SEE) to a wider range of clusters?

> "The basic question is what exactly an HQ should be. Does it play a management function or a support function? If it's support, it will have to move out of Vienna – that's a pure cost question. For us, HQ means management capacity and its location will be wherever the most important leader wants to be."
> *U.S. high-tech company with CEEMEA HQ in Vienna*

Companies are still responding to this new set of questions and there is constant flux while they try to find appropriate structures for the new business challenges they face. But the initial indications suggest a wide variety of possible and overlapping outcomes for Vienna's role as a hub:

- Some companies have shifted or are planning in the next few years to shift all responsibility for the CEE region to European HQ, frequently in Geneva or London.
- Several companies have expanded the geographical scope of their Vienna HQ to justify the high overheads. Many now cover SEE; a few still have reporting responsibility for Russia and CIS and others are taking over that responsibility; some of the largest companies have concentrated reporting and strategic responsibility for Middle East and Africa in Vienna (the Central and Eastern Europe, Middle East and Africa (CEEMEA) region); a new trend is to include Switzerland and even Germany as part of the Central Europe region.
- Most companies have turned large regional HQ operations into a small, flexible management unit – focusing on overall strategy, finance, marketing, human resources. Functions like back-office, IT support and so on are handled in the market or in competence centres within the region.
- Many companies expect their Vienna HQ to become increasingly virtual. The location is little more than a centre of gravity and depends on the wishes of the regional manager. Other top managers need not be in the same location.

> "Maintaining expats in Vienna is very expensive, so we are working on a virtual model. It's already happening to an extent – our EEMEA marketing director recently moved back to London. If you bring an expat over from the U.S.A., then perhaps you need to make a decision about where to locate them. Otherwise in Europe, they can pretty much choose."
> *U.S. pharmaceutical firm with CEEMEA HQ in Vienna*

2. Business Outlook in Central Europe: the Multinational Perspective

2.1 Central Europe as a Sales Market

EU enlargement in 2004 has clearly been positive overall for multinationals operating in the region, bringing predictability and boosting the chances for sustainable growth now and in the long term. But accession has also brought increased competition and, consequently, an extra push to consolidation, reshaping the way many companies view their business in the region.

Although most trade and investment reforms took place before 2004, accession itself brought three significant changes:

- it gave legal and macroeconomic security and predictability;
- it removed customs barriers (and long delays for lorries at the border); and
- it brought an influx of EU funds (around EUR 10 billion a year) directed at infrastructure, farmers and small business.

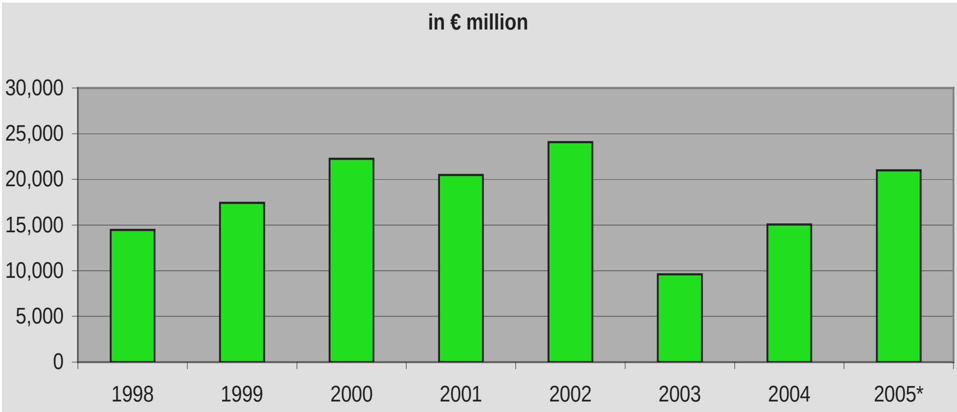
That brought a new spurt of international interest in the region. Companies that had avoided the risky east now feel safer moving into the new EU Member States. Some are coming in to take market share as the window of opportunity for entering the region closes, mostly by buying up existing players. Others are relocating manufacturing, R&D, call centres or back-office services to take advantage of strong skills and low labour costs (see page 12). Foreign direct investment flows, which had started shrinking as privatisation came to an end, are now picking up again (see chart next page).

EU enlargement has also kick-started the growth of small and medium-sized enterprises (SMEs), with an increasing number investing in modernisation and expansion. The renaissance of the SME sector, particularly visible in the more advanced markets like the Czech Republic, is a result of increased competitive pressure at home and growing opportunities abroad, as well as greater access to financing through bank credits and EU funds.

Small and medium-sized enterprises' development is vital to the economic future of Central Europe – it is the missing piece of the transition puzzle. It is also key to sustaining international corporate interest in the region over the long term as SMEs finally start to play a significant role as customers, suppliers and partners. But the best local businesses are also becoming formidable competitors to international companies, with good products and strong marketing savvy but much lower overheads.

The increased competitive pressure is accelerating the process of consolidation in Central Europe, where markets are still far more fragmented than in the EU-15. How strongly the impact is felt differs by sector. For most industrial sectors, consolidation is just beginning as pan-European distributors start to penetrate the market and regional players emerge out of national heroes. Central Europe is finally booming for companies selling capital goods, which are now focusing on building up the capacity of local subsidiaries. The IT industry and services sector is growing strongly too, helped by SME growth and the push to modernisation.

Chart 1: FDI Flows in the New Member States



*Source: EIU *projection.*

Consolidation in these sectors is clearly happening, but it is boosting the business of international companies by improving distribution channels and allowing them to swallow up smaller competitors. The consumer goods sector enjoyed a similar boost in the late 1990s as retailers simplified trade structures and international companies wiped out local competition. But consolidation is now squeezing multinational companies hard. Not only are they fighting against each other, but also against the surviving local companies and new entrants to the market. The latest consolidation push represents what many companies see as the final battle for market share in a maturing Central Europe – the winners expand; the rest sell up, go bankrupt or retreat into niches, just as in the rest of the EU.

Look at the retail sector to see the pace and scale of the consolidation that is raging throughout the consumer goods sector. In 2001, the top 10 retailers accounted for about 40% of sales. That increased to around 60% in 2004, but 2005 has already seen massive concentration as retailers juggle to ensure they have sufficient scale to be in the top three or four – or get out of the market. Tesco, for example, is swallowing up Carrefour's Czech and Slovak hypermarkets. Meinl recently sold its Czech stores to Ahold and its Polish ones to Tesco. Meanwhile, discounters have moved in, with Lidl making a very successful debut last year. Walmart, the U.S. giant, started moving in this year, buying up parts of the Belgian Delhaize chain in its first, but certainly not last, acquisition. And to cap it all, local retailers have formally clubbed together in purchasing groups to streamline their supply chains and compete with the international giants.

The increase in competition and consolidation has changed the way consumer goods companies view the region, and the situation is most extreme in the Czech Republic, Hungary and Slovakia. While for now industrial and services companies are enjoying strong sales growth and often good profit margins too, international companies in the consumer goods sector see Central Europe as a tricky hybrid market. As in mature markets, prices are under pressure, competition is high, costs are rising – and sales growth is sluggish as markets saturate. And yet, there is still emerging markets potential since per capita sales levels are low and market shares are still shifting.

That dilemma makes corporate strategy in the region a balancing act between maintaining a sufficiently strong local focus to exploit the growth potential, while keeping costs in line with the small size, sluggish growth and low prices of the markets. For now it is consumer goods companies that are most affected, but it is only a matter of time – five, ten years at most – before the pressures of competition squeeze other sectors too. In other words, the CENTROPE region is losing its emerging markets status and becoming just a collection of small EU markets – much like Austria, but poorer.

2.2 Central Europe as an Investment Market

EU enlargement may mark the final spurt of interest in the more mature Central European countries as growth markets. But that maturity has opened up a new medium and long-term perspective perspective for Central Europe as an investment market, by prompting international companies to rethink their footprint across Europe, as they are doing globally.

The shift towards lower-cost production locations is not new, but the terms of the debate have shifted with EU enlargement. Much of the first wave of cheap assembly production has already moved on to places like China, Romania or Ukraine. And many companies have also consolidated production facilities that were scattered around the region into one location, now that border delays have disappeared. But far from representing the end of investment interest in Central Europe, this is the start of a new focus on bringing higher value-added parts of the supply chain to a region with relatively low costs, high skills levels, strong workforce motivation and favourable tax regimes.

Central Europe has already managed to carve out a significant niche as an automotive manufacturing hub. Almost USD 25 billion has been invested in the Czech Republic, Slovakia, southern Poland and Hungary over the past ten years. A further USD 5 billion or more has been committed since EU enlargement, as Asian companies – Hyundai, Kia, Toyota and their suppliers – see the region as the perfect EU manufacturing location.

This is Europe's answer to the coming influx of Chinese-made cars. Auto production will rise from 2.3m cars a year now to 3.8m by 2008, including Romania and Turkey, which are both growing fast as auto investment pours in. That still only represents about 20% of European car production, but with all new plants opening in the region and some closing in the west, that could ultimately rise to as much as 60% over the next 15-20 years.

Central Europe has also developed a fledgling electronics production cluster, largely in the Czech Republic and Hungary, led by outsourced manufacturers like Flextronics, Foxconn and Solectron. But in this sector, the region is still battling to compete with China. That is partly because of lower transport costs but also partly because Central Europe lacks an efficient network of basic suppliers for parts like metal casings which are still imported from China.

This points to a key element in maintaining Central Europe's competitiveness with China: expanding such networks beyond the core Central European countries to take advantage of lower costs, natural resources and sufficient skills. Already, auto suppliers have started shifting labour-intensive parts of production to cheaper locations like Romania, Turkey and Ukraine as wages in Central Europe rise and the availability of skilled labour shrinks.

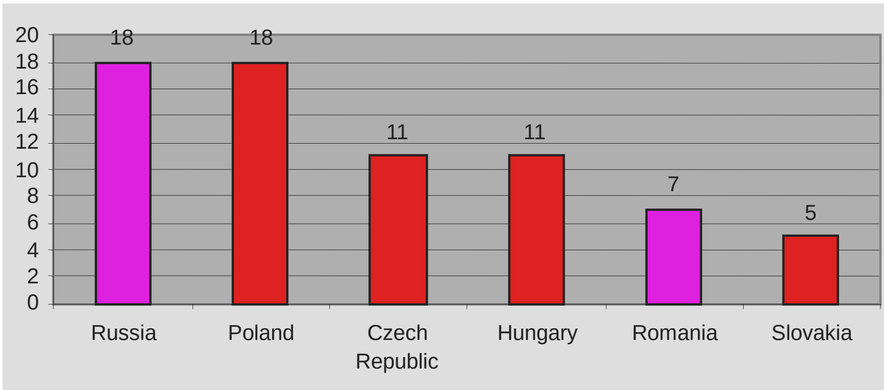
It is not only in production that international companies are rethinking their portfolios in Europe. Budapest, Bratislava and Prague have become hot locations for companies looking to locate or outsource competence centres for back-office functions, call centres, R&D and IT services. More pioneering companies are now moving into provincial cities and cheaper locations like Riga and Bucharest. In these sectors, Central Europe is competing with the other emerging giant, India. Its success at promoting "nearshoring" as an alternative to "offshoring" has eve prompted the big Indian outsourcers, like Tata, Wipro and Progeon, to open offices in the region to set up their own nearshore operations.

2.3 Central Europe's Place in the Broader EEMEA Context

Until recently, Poland, the Czech Republic and Hungary were the biggest markets in the CEE region and the main focus of management attention. That is now changing fast as new growth markets – Russia, Turkey, Southeastern Europe and even the Middle East – compete for resources. The shift in strategic weight away from the Central European core has already brought big changes for the Vienna hub, but the process is only beginning.

According to a survey of Economist Intelligence Unit (EIU) Corporate Network clients in June 2005, average sales in Russia were around the same size as in Poland, which has about five times fewer people. Next year's survey will already show a different picture. The Russian market is growing in leaps and bounds – on average around 25-30% a year. Within less than ten years, it will be the largest market in Europe (by volume at least) for many companies. For a select few, Heineken for example, it already is. And for virtually all multinational companies, Russia is a key global growth market, a place to focus senior management attention and resources.

Chart 2: Country as a % of CEE Sales, 2004



Source: Corporate Network survey 2005.

Turkey is the other large market to have pushed its way on to the agenda of senior management. For decades, Turkey was an opportunistic, roller-coaster market, with excellent sales one year followed by a crash the next, due to a political or financial crisis. That pattern has changed with responsible government policies and the straitjacket of EU negotiations and IMF agreements. In a world where many companies see salvation in emerging markets, Turkey offers size (70 million people), youth, relative wealth and relative predictability. Although Austrians tend to view Turkey as part of the Middle East, international companies increasingly view it as part of their European operations. Indeed, a few companies have recently located their CEE hub in Istanbul and Turkey is a natural expansion market for companies and managers with experience in Central Europe.

A third growth pole in the CEE region is Southeastern Europe. And although the long-term potential here is small (the official GDP of the entire region is only half that of Austria), current growth, especially in booming Romania, requires a special focus and the medium term outlook for the smaller markets is buttressed by the shift words EU accession. Finally, the Middle East Africa region, long tacked on to EEMEA as an afterthought for most companies, has taken on a new dynamic, driven by massive oil revenues that show little sign of dwindling, plus a push to reform and open up to foreign companies.

3. Outlook for Vienna's Role in the CENTROPE Region

From the perspective of multinational companies, Central Europe's importance as a growth market is diminishing. Not only is the market maturing rapidly, but other markets in the EEMEA region are taking the limelight and at least two of them – Russia and Turkey – are coming to be seen as global growth markets. At the same time, multinational interest in Central Europe as a high-value, low-cost manufacturing and services location is growing.

These business developments hold significant threats for the continued relevance of Vienna as a strategic location for international companies. If Central Europe is merely the poorer end of EU markets, then there is no need for significant hub operations. And since investment planning is part of a broader reshuffling of global corporate assets, it is decided at global or at least European headquarters – not in the regional hub itself.

But the new business realities also hold an opportunity for Vienna. The pressure to constrain costs in emerging markets is pushing companies to keep local subsidiaries lean and to share services wherever possible, much as in western Europe. Equally, recent attempts to dissolve regional structures in favour of functional or vertical divisions have proven inadequate in developing emerging markets. That has created a niche for small regional hubs, staffed by experienced managers who can provide strategic services to a broader range of markets, simplifying reporting lines and management in the European or global HQ.

As a result, from an international business perspective, the real opportunity for Vienna is not in servicing a narrowly defined CENTROPE region, but in providing high-level support for a much wider region. CENTROPE is just too small to be an internationally relevant region.

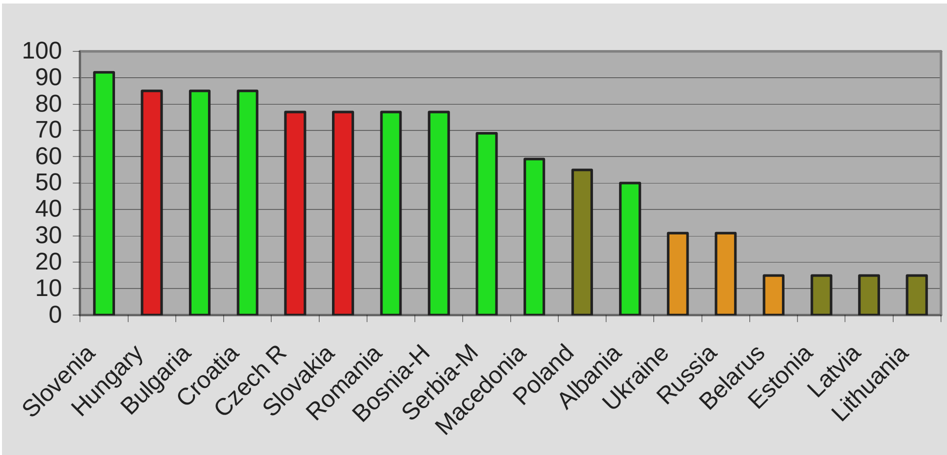
3.1 What Regions Can a Vienna-Based Hub Realistically Service?

Could Vienna become a broader hub for international companies? The potential is clearly there. Most companies with a hub in Vienna have taken on the running of the South-East European region or cluster, where the markets are too small to warrant large local operations. A 2005 survey by Boston consulting Group shows that around 80% of CEE hubs in Vienna manage the larger SEE markets.

The location was helped by excellent air connections to all Balkan capitals, otherwise lacking both within the region and from other west European locations. It was also helped by latent animosities which made a neutral headquarters ideal and by Austria’s high-profile political role as a champion of the region in the EU. And, as in Central Europe, the emergence of international companies’ hubs for SEE has been encouraged by the success of Austrian companies, which moved rapidly and strongly into these markets. Indeed, Austrian business has taken a pioneering role in virtually all of the Balkan countries.

Chart 3: Countries Serviced by Vienna-Based Regional HQ

(% of responses)



Note: Differently shaded bars refer to regions.

Source: Boston Consulting Group, 2005.

The current need for a SEE hub acts as an anchor for keeping Central European operations in Vienna. But the window of opportunity for SEE could be relatively short. Once Romania and Bulgaria join the EU in 2007 (or latest 2008), most companies will absorb them into a "new Member States" or "Central Europe" cluster – and will probably take that opportunity to include the remaining SEE markets in that structure too. This will be a turning point for Vienna. Will it be in a position to expand its strategic focus to other growth markets? Or will it become obsolescent?

Vienna's experience with servicing Russia is mixed. As the Russian market has grown, most international companies have shifted increasing responsibility for Russia and other CIS markets to the Moscow office. The reason is simple: Russia's potential overshadows all other CEE markets: either its development is restrained by the need to share resources or the other markets are suffocated.

As a result, many companies have split their CEE operations into two halves: Central Europe and CIS. With EU enlargement, these two parts sometimes even report to different organisations – the Central European cluster to an EU HQ and the CIS cluster to an EE or *Eastern Europe Middle East and Africa* (EEMEA) rump. But despite Moscow's growing autonomy, the Russia manager still reports back to around a third of CEE hubs in Vienna, according to the Boston Consulting Group survey. And it is not just a leftover of the early CEE HQ days. Several European companies have brought their Russia operations into the Vienna hub recently–Henkel shifted responsibility for Russia from Germany to Vienna; Heineken brought its enormous Russian operations into a newly established CEE hub in Vienna, relieving HQ in Amsterdam.

> "The CEMEA hub is a temporary way to add flexibility until markets are more mature. Russia will report directly in a few years."
> *U.S. IT company, based in Vienna*

In future, as the Russian market grows bigger, it could start reporting directly to European or global HQ, taking on the status of large markets like China and India, which sit uncomfortably in standard regional structures. But since these uncomfortable markets will become key global growth markets, companies are trying hard to find structures to embrace them, allowing for dynamic sales growth while keeping costs under control.

For several large companies in Vienna – IBM, Kraft, Eli Lilly, Hewlett Packard – that structure is *Central Europe Middle East Africa* (CEMEA), embracing the whole of CEE, plus Turkey, the Middle East and Africa. Financial services provider, Western Union, even covers the whole of Europe and Asia from Vienna. The usual set-up is to have a handful of CEMEA directors, plus CE managers physically based in Vienna. Russia is more autonomous with responsibility for other CIS markets, and Middle East Africa managers also report in from sub-regional hubs in places like Dubai and Johannesburg.

But Vienna has no monopoly on this structure. Geneva and London boast the most CEMEA hubs and are far better placed to take on an even broader role in supervising emerging markets, a structure some companies are now developing. Brussels and Amsterdam also compete with Vienna.

Vienna's advantages are limited: in addition to the usual complaints, Vienna's air links to the Middle East and Africa are relatively weak. That it has still managed to play this role is largely down to the ability of CEE managers to leverage their experience into other emerging markets. If Vienna is to expand its broader CEEMEA role rather than gradually lose it, it will need significant developments in creating an expat-friendly environment and a more supportive political stance towards key markets like Turkey.

Over the past year, the Vienna hub has seen a new development. Instead of just looking east, regional managers have taken on new responsibility for the western part of Central Europe – Austria, Switzerland and, in some cases, even Germany. IBM, for example, has brought Austria and Switzerland into its CEMEA structure. A U.S. food company, has split its Vienna-based CEMEA HQ into two groups. Central Europe, includes the new EU Member States (in a cluster), Austria, Switzerland and Germany. EEMEA covers Russia, the Balkans and Middle East Africa. That corresponds more to the organisation of its main customers and allows the new EU Member States to learn about how to work in maturer markets from German management. Heineken has also brought overall responsibility Germany into its new Vienna HQ, arguing a similar case of synergies.

In the long term, this geographical understanding of the Central European cluster will increase in importance. And Vienna's advantages are several: it is centrally located, it is an EU member, it has a significant business role in all markets, it's business environment and performance is improving and it is not big enough to squash the interests of other markets.

3.2 How Can Vienna Improve its Attractiveness as a Hub Location?

For companies, the location of CEE regional hubs is no longer a key issue. They are small – they frequently employ less than 10 people and rarely more than 30, mostly key strategic managers. They are also increasingly organised on a virtual basis, with a leading manager in one location and others elsewhere, supervising functions like finance, human resources and IT for the region.

> "It doesn't matter where the HQ is these days because it's so small."
>
> *U.S. pharmaceutical company, with two EEMEA clusters located in Paris*

But if Vienna wants to retain its position in the CEE market, these hubs are crucial. They help shape business in the region, bolster management expertise and act as champions for Austrian business. Although they employ few people, they are important players.

So what can Vienna do to encourage their development? The new characteristic of these small high-level hubs is that they are dependent on the wishes of a few key players. If the top managers do not want to stay in Vienna, then chances are the location will shift. In this respect, Vienna's strengths are threefold:

- The availability of senior management with experience in the region and personal ties to Austria
- An attractive location for expats to live in
- Proximity by air and road
- But as management changes take place and virtual hub models become more standard, these factors alone will not be enough to sustain Vienna's position. Expatriate managers are put off by three big factors in Vienna:
- Income tax and the tax treatment of expat perks like housing, schools and cars in comparison to location like Geneva or Brussels.
- Bureaucratic delays in getting work permits for non-EU expat managers (and from new EU Member States)
- The lack of rapid road and rail connections (and absence of urgency in developing them)

> "The lacking infrastructure is a catastrophe. And trying to hire highly qualified employees at short notice is a fiasco."
> *German consumer goods producer, with large CEE operations in Vienna*

As one Austrian regional director puts it: “Regional headquarters came to Vienna, but what are we doing to keep them? There’s nothing happening in this respect.” If Vienna is to grasp the full potential of its current position, it must do two things:

First, do something about the irritants that push companies to look at leaving Vienna or limiting their operations. True, there have been attempts to address these issues – but these fail to get to the core of the problem. Moves to reduce corporate tax and introduce Gruppenbesteuerung came far too late for most multinational companies, which long ago opted to tax their European operations in locations like Geneva and Amsterdam. And attempts to improve the process for granting expat work permits are still stymied by bureaucratic delays.

Secondly, Vienna needs to look at how it can encourage and support the further development of international companies running CEE operations in the city. That means looking at the anchors hubs can develop to maintain their relevance. One anchor, as discussed above, is to service a wider geographical territory from Vienna. Another is to expand the functions Vienna provides for the mother company.

For pharmaceutical companies, for example, this might be shared R&D facilities or medical trial capabilities linked to Central Europe. U.S. pharmaceutical company Eli Lilly has had its CEE HQ in Vienna for around 20 years and took on HQ functions for Middle East Africa in 2002, with the idea of sharing EEMEA directors for key functions. The true costs of that decision turned out to be much higher than expected: now the hub is becoming more virtual and considering moving everything to European HQ in London. But what keeps the company in Vienna is a medical trials unit and research centre, with strong links to the Vienna university and doctors around Central Europe. This is an anchor that makes Vienna valuable as the costs of maintaining an HQ operation rise. Unless the expat issue is solved, Lilly’s hub will probably continue to shrink. But it will maintain a presence in Vienna.

For manufacturing companies, the anchor could be logistical, taking advantage of Austria’s central location. German detergent producer Henkel, for example, which covers the entire CEE region, opened a central warehouse in Vienna in 2005, serving Austria and all the neighbouring countries. But this kind of strategy will not become more widespread without a rapid improvement in infrastructure. The slow pace of build-out reflects government failure to grasp the role that Austrian-based business are capable of playing in an enlarged Europe. If the CENTROPE region is to have any real meaning for Austria-based business at a local or international level, it requires concrete backing with roads, improved rail connections, labour market flexibility and language training.

> “The infrastructure needs to get much better before the CENTROPE economic space can develop dynamically.”
> *U.S. consumer goods producer, with CE hub in Vienna*

Appendix

Statistical Information

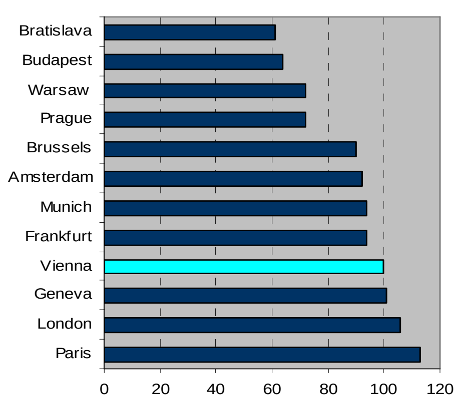
Table A1: Road Connection from Vienna to Other European Destinations: (Distances and Travel Time)

City	km	hours
Bratislava	68	1.00
Brno	127	2.10
Budapest	247	2.30
Prague	296	4.00
Munich	435	4.15
Krakow	467	5.45
Berlin	627	8.15
Warsaw	705	10.45
Frankfurt	719	6.30
Zurich	757	7.20
Brussels	1,108	10.00
Amsterdam	1,159	10.30
Paris	1,241	11.00
London	1,421	14.00

Source: Michelin route planer.

The capitals of Slovakia, Hungary, Czech Republic and Poland are closer to Vienna than most other European capitals. Three capitals – Bratislava, Budapest and Prague – are within a 300km radius from Vienna. However, the travel time by road or rail is comparatively long to these cities due to the lacking infrastructure.

Chart A1: Overall Cost of Living Index

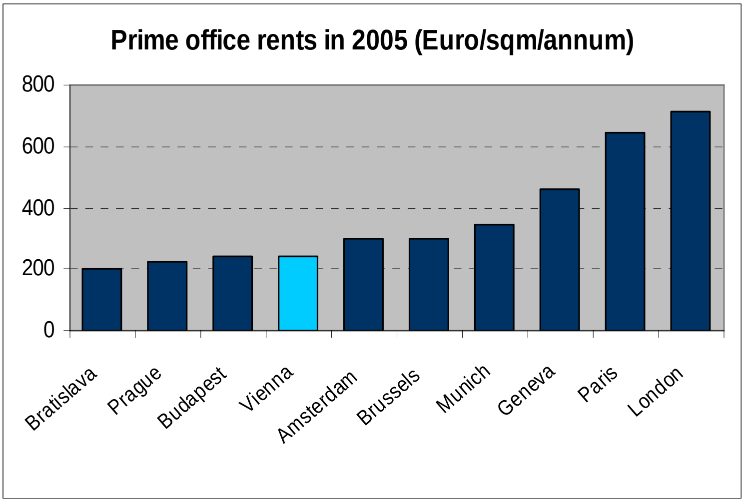


Note: Vienna=100.

Source: EIU 2005.

The EIU's most recent study on cost of living shows that Vienna is slightly more expensive than many Western European centres such as Brussels, Amsterdam, Munich and Frankfurt. Vienna is on average 25% more expensive than capitals in Central Europe.

Chart A2: Prime Office Rents in 2005



Office rents in Vienna do not differ considerably from the ones in Central European capitals. With an annual rent of Eur240 per sqm, Vienna is far more competitive than other Western European cities. Cities like Geneva, Paris and London cost at least twice as much.

Source: CB Ellis 2005.

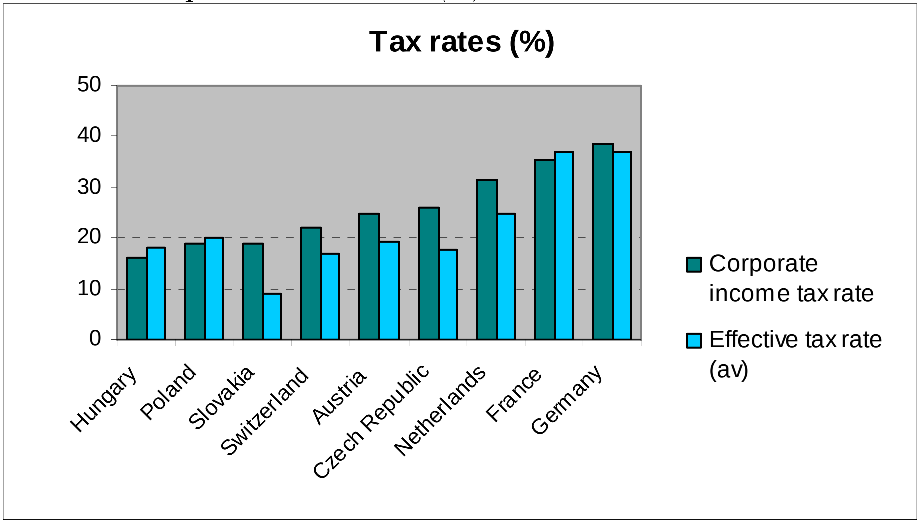
Table A2: Top Statutory Personal Income Tax Rate 2005

Country	%
Austria	50
Belgium	50
Germany	42
Poland	40
United Kingdom	40
Hungary	38
Czech Republic	32
Slovakia	19

Source: Eurostat 2005.

Although Austria has made an attempt to bring tax levels down and increase the country's competitiveness by amending taxation legislation, both personal and corporate income tax levels remain relatively high. For foreign companies, high personal income tax and the difficulty to bring in staff from non-EU-countries remain obstacles that reduce the attractiveness of Vienna as a HQ.

Chart A3: Corporate Income Tax (%)



Source: CD Howe Institute.

Note: The marginal effective tax rate is the tax paid as a % of the pre-tax rate of return to capitalbased on the assumption that the after-tax rate of return is sufficient to cover the cost of equity and debt finance provided by international lenders.

Abbreviations and Acronyms

CE	Central Europe
CEE	Central Eastern Europe
CEMEA	Central Europe Middle East Africa
CEEMEA	Central and Eastern Europe, Middle East and Africa
CIS	Commonwealth of Independent States
EEMEA	Eastern Europe Middle East and Africa
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HQ	Headquarters
SEE	Southeastern Europe
SME	Small and Medium Sized Enterprises
R&D	Research and Development

Questionnaire

Why does Your Company have Its Regional HQ in Vienna?

- Since when has you company been based in Vienna?
- Why did your company choose Vienna and who was responsible for this decision? Was it an objective (objective advantages) or subjective choice (personal preferences)?
- How many people work in the Vienna office? Is it a legal entity? Who does it report to?
- How much autonomy do local operations in each country in the CEE region have? How is this changing – more power, less power?
- What is the region the Vienna hub is responsible for? Have there been changes in the past few years – more countries, less countries?
- What functions/activities are run from your Vienna office?
- Has this changed in the past few years (clustering, shared service centres, IT competence centres etc)? If so, why? Are there such changes planned? Are these changes linked to EU enlargement?
- How have changing strategies towards the CEE markets affected the Vienna HQ?
- How has EU enlargement affected Vienna's role in the enlarged EU or in the CE region?

What Are Vienna's Strengths and Weaknesses as a Regional Centre from a Business/Strategic/Financial Perspective?

- What makes Vienna a good place for a CEE base?
  (possible pros)
  – Airport/flight connections
  – Geographical proximity to the region
  – Cultural proximity to the region
  – HR/skills
  – Taxes
  – Quality of life
  – Government support
  – R&D
  – Banks
  – Critical mass of companies
- What are the arguments against Vienna?
  (possible cons)
  – Taxes

  – Bureaucratic hurdles
  – Infrastructure (roads, rail)

- What is the government doing to keep companies here? What is missing?
- Are there any discussions in your company about moving to a different location? If so, which locations are mentioned?
- What would be arguments for your company to move your headquarters to another city?
- What would make Vienna the natural location for CEE? What would stop your company from moving?
- Which other locations in Europe do you consider to be good bases for CE business?

What's the Outlook for Vienna and CENTROPE?

- How important is the region Vienna-Bratislava-Brno-Györ for international companies? Do you consider this to be a business region?
- How do you think this region will develop over the next years?
- What is the likelihood of Vienna becoming a financial centre of greater importance and how does its closeness to Bratislava affect further development?
- What does Vienna have to do to strengthen its position as a regional hub?
- Where do you see growth areas and potential in the region?