

Millington, A. I.; Bowen, F.; Bayliss, B. T.

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A.I. Millington, F. Bowen and B.T. Bayliss\*

## Corporate Integration in the EU: Recent Developments

*Corporate integration was expected to play a central role in the process of industrial reorganisation which would follow the creation of the Single European Market. This article investigates the development of corporate integration in the EU and the likely impact of the Single European Market on the pattern of corporate integration.*

The creation of the Single European Market<sup>1</sup> was designed to open the national markets of the EU to intra-EU competition, encouraging greater efficiency both through improved resource allocation, and through the increased scale of operations and levels of competition which would result from the ending of market distorting barriers to trade and market fragmentation. At the same time the Single European Market was expected to provide a large domestic market in which European Multinational Companies (EMCs) could benefit from economies of scale and scope, and subsequently respond to the threat posed by international competition in global markets.<sup>2</sup>

Corporate integration was expected to play a central role in the process of industrial reorganisation which would follow the creation of the Single European Market.<sup>3</sup> In order to penetrate the essentially separate national markets, which characterised the EU before the Single Market Act, EMCs were forced to pursue multi-domestic strategies. These strategies have left a legacy of largely autonomous national subsidiaries whose location was determined by historical accident or local market considerations. For the parent companies the cost of this legacy lies in overcapacity, duplication and inefficient location.<sup>4</sup> The Single European Market is expected to provide an environment which will facilitate corporate integration, enabling EMCs to plan and coordinate production, marketing and distribution within the context of the

Single European Market rather than a set of discrete national markets.<sup>5</sup> Although these developments will assist companies, without prior commitments, to develop efficient integrated systems, the gains from corporate integration will depend, substantially, on the ability of companies to reduce costs and increase corporate efficiency by rationalising and restructuring their existing operations, replacing duplicate facilities, which service essentially national markets, with a pan-European manufacturing strategy which emphasises a centralised system of production based on products rather than geographic markets.<sup>6</sup>

In this review the development of corporate integration in the EU and the likely impact of the Single European Market on the pattern of corporate integration are investigated. It is argued here that the stimulus for corporate integration flows from global competition; but while market liberalisation in the EU may have facilitated this process, its effects are likely

<sup>1</sup> EC Commission: Completing the Internal Market, White Paper from the EC Commission to the European Council, COM(85)310 Final, Luxembourg 1985.

<sup>2</sup> EC Commission: European Industrial Policy for the 1990s, Bulletin of the European Community, Supplement 3/91, Luxembourg 1991; M. Bangemann: Meeting the Global Challenge: Establishing a Successful European Industrial Policy, Kogan Page, 1992.

<sup>3</sup> See ERA: Research on the Cost of Non Europe, Basic Findings, Vol. 7: Obstacles to Transborder Business Activity, Luxembourg 1988, for a discussion of this point.

<sup>4</sup> For a discussion of these problems see R. Collins and R. Schmenner: Taking Manufacturing Advantage of Europe's Single Market, in: European Management Journal, 13, 3, pp.257-68.

<sup>5</sup> See P. Buigues and A. Jacquemin: Strategies of Firms and Structural Environments in the Large Internal Market, in: Journal of Common Market Studies, XXVIII, September 1989, pp.53-67.

<sup>6</sup> See R. Collins and R. Schmenner, op. cit.

\* University of Bath, UK. The support of the Economic and Social Research Council is gratefully acknowledged. The work was funded by ESRC award number F00232008.

to have been rather limited. For companies the key issue is the geographic scope of the market, where this may be national, regional or global. The implications of this argument are wide-ranging. There is no reason to assume, for example, that the strategic market is the EU, or even that an integrated Single European Market will locate its production in the EU if the geographic market is global. Indeed, a consequence of the formation of the Single European Market may be that firms respond to the removal of internal barriers to trade and continuing reductions in external barriers by relocating to lower cost centres outside the Union. Such locational considerations form a major theme of this paper.

### Corporate Integration in the EU

In general the evidence suggests that a relatively small proportion of multinational production, within the EU, was undertaken within an integrated system before the implementation of the Single Market Act. Thus Hood and Young,<sup>7</sup> in a study of the UK subsidiaries of Continental European and US multinationals in three industries, find that under 10 per cent of their sample subsidiaries operated within an integrated framework. Similarly, ERA<sup>8</sup> find little evidence of corporate integration in a sample of German, UK, French and Italian EMCs in five industries, and although Doz<sup>9</sup> finds some evidence of corporate integration the analysis is limited to industries which are characterised by global competition.

Although Schmenner<sup>10</sup> suggests that EMCs have responded to market liberalisation by standardising company products and operations across the EU, the incidence of corporate integration is largely restricted to industries which are characterised by economies of scale and low barriers to entry.<sup>11</sup> The incidence of corporate integration in the EU operations of EMCs remains low, even after the implementation of the Single European Act. Most companies continue to

operate a range of separate product policies across the EU. Thus product policies with respect to pricing, packaging and product formulation remain resistant to product standardisation.<sup>12</sup>

The continuation of these differences reflects the impact of history, culture, language and climate upon consumers' preferences. Such differences diminish the gains from centralised production and require specialised marketing of products and brands.<sup>13</sup> As Wolf<sup>14</sup> pointed out, packaging printed only in English would be understood by at most two out of five consumers in the EU, and to reach nine out of ten consumers there would need to be at least five languages printed. A local brand may conform to a common corporate image, but may be most effective when it is nationally designed and fully independent. In such a case marketing needs to be decentralised at a national level.

Further, local consumers may discriminate against imported goods or choose varieties which are particular to that market. In the market for white goods, for example, French consumers prefer top-loading washing machines while German consumers show a preference for quality front-loaders with high spin speeds.<sup>15</sup> The pressure for decentralised production is accelerated when agents and distributors discriminate against imported goods, or are controlled by producers located in the foreign market. In this case firms may be forced to manufacture in the foreign market in order to gain access to marketing and distribution networks. Finally, transport costs appear to play a dominant role in the process of market segmentation in a sub-set of manufacturing industry.<sup>16</sup>

The pressure for decentralisation has been reinforced by changing patterns of demand and the development of new production technologies. As European consumers have become more prosperous

<sup>7</sup> N. Hood and S. Young: Inward Investment and the EC: UK Evidence on Corporate Integration Strategies, in: *Journal of Common Market Studies*, XXVI, December 1987, pp.193-206.

<sup>8</sup> ERA, op. cit.

<sup>9</sup> Y. Doz: *Strategic Management in Multinational Companies*, Oxford, UK, Pergamon, 1986.

<sup>10</sup> R. Collins and R. Schmenner, op. cit.

<sup>11</sup> For a detailed analysis of this point see A.I. Millington and B.T. Bayliss: *Corporate Integration and Market Liberalisation in the EU*, in: *European Management Journal*, 14, 2, 1996.

<sup>12</sup> R. Collins and R. Schmenner, op. cit.

<sup>13</sup> For a thorough discussion of the factors which underlie the choice between global or multi-domestic strategies, see Y. Doz, op. cit., and C. Bartlett and S. Ghoshal: *Managing Across Borders: The Transnational Solution*, Boston, USA, Harvard University Press, 1989.

<sup>14</sup> Wolf: *The Single European Market: National or Euro Brands?*, in: *International Journal of Advertising*, 10, 1991, pp.49-58.

<sup>15</sup> For a detailed discussion of these points see C. Baden Fuller and J. Stopford: *Globalization Frustrated: The Case of White Goods*, in: *Strategic Management Journal*, 12, 1991, pp. 493-507, and N. Owen: *Economies of Scale, Competitiveness and Trade Barriers Within the European Community*, Oxford, Oxford University Press, 1983.

<sup>16</sup> A.I. Millington and B.T. Bayliss: *Non-Tariff Barriers and UK Investment in the European Community*, in: *Journal of International Business Studies*, 24, 4, 1991.

they have increasingly demanded specialist products with an individual character. Such a development emphasises the importance of small batch production and rapid response to customer requirements. Modern production technologies have facilitated these changes. Thus the application of CAD-CAM technology and advanced robotics within lean production systems has reduced set-up times and allowed smaller batch sizes. These developments are illustrated in the car industry where companies have reacted to an increasingly sophisticated consumer demand by responding to individual consumer orders through sequenced production of individual models rather than mass producing models for sale in the market. The consequence of this new technology is to apply pressure for decentralised component production since the process demands not only that suppliers are in constant contact with the assembly line, in order to provide the components in sequence, but also that they are geographically close enough to provide the correct components within tight time constraints.

### **Corporate Integration and the Single Market Act**

The Single Market Act was expected to stimulate the evolution of integrated production systems in three ways. First, the reduction and elimination of institutional and legal barriers to trade (e.g. technical standards and regulations, customs barriers including administration costs and frontier delays, discriminatory public procurement policy and freight transport regulations) would cut transport costs, accelerate the standardisation of production and thereby reduce the pressure for decentralised production in national markets. Secondly, any decline in institutional and legal barriers to trade would raise the level of competition in national markets, providing a further stimulus for cost reduction, rationalisation and corporate integration. Thirdly, movements to harmonise company law, social legislation and taxation were expected to create an environment in which the centralised management structures which

underpin the integrated company could evolve and operate efficiently.<sup>17</sup> The impact of these measures on corporate integration is, however, likely to be limited.

### **Limited Scope for Efficiency Gains**

The majority of EMCs are located in industries which are characterised by relatively low economies of scale. In the case of the UK, for instance, some two-thirds of those companies with manufacturing operations in another EU country are located in these industries. Companies operate in a decentralised framework in these sectors but market liberalisation is unlikely to result in integrated production because the scope for plant-level economies of scale is limited in these industries. Those industries where substantial economies of scale are present were already characterised by significant levels of corporate integration before 1992. However, further increases in efficiency could be achieved through integrated production.<sup>18</sup>

### **Institutional and Legal Barriers**

Although some companies mention institutional and legal barriers as a motive for FDI in the EU, the investment decision is dominated by market-specific barriers which are unrelated to the institutional and legal barriers with which the Single Market Act is concerned. These include access to local knowledge and marketing and distribution networks, and the related problems of cultural resistance to UK exports.<sup>19</sup> In addition, transport costs have been identified as an important motive for FDI in the mineral products and basic chemicals industries. The removal of institutional and legal barriers is therefore unlikely to affect the underlying motive for decentralised production in most industries.<sup>20</sup>

### **Problems in Implementation**

By 1994, 90 per cent of the legislative proposals outlined in the Single European Act had been implemented in the member states.<sup>21</sup> However, major areas which are of crucial importance to corporate integration have been slow to progress. These include: standards, company law, social legislation and taxation.<sup>22</sup> The first area (standards) has been identified as the most important institutional and legal barriers to trade in the EU,<sup>23</sup> and the latter three

<sup>17</sup> ERA, *op. cit.*

<sup>18</sup> See A.I. Millington and B.T. Bayliss: *Corporate Integration and Market Liberalisation in the EU*, *op. cit.*, for a detailed discussion of these points.

<sup>19</sup> A.I. Millington and B.T. Bayliss: *Non-Tariff Barriers and UK Investment in the European Community*, *op. cit.*

<sup>20</sup> *Ibid.*

<sup>21</sup> EC Commission: *Report from the Commission to the Council and the European Parliament: A Single Market in 1995*, COM(95)238 Final, Luxembourg, 15 June, 1995.

<sup>22</sup> *Ibid.*

<sup>23</sup> EC Commission: *Research on the Cost of Non Europe, Basic Findings*, Vol. 2, *Studies on the Economics of Integration*, Luxembourg 1988.

underpin the creation of the centralised management systems within which integrated production can be planned and controlled. The creation of centralised management systems would enable companies to benefit not only from integrated production but also from economies which may accrue from the rationalisation and reorganisation of such areas as research and development, and marketing and distribution. Such gains could benefit duplicate TNOs, which are precluded from integrated production by structural factors, as well as independent and integrated TNOs.

Further, even in those areas where legislation is in place its performance is dependent on implementation by the nation states. Thus recent studies of deregulation in the transport sector suggest that lack of enforcement is a major market-distorting factor.<sup>24</sup> In Portugal, for example, it is estimated that about half the own account vehicles are overloaded, and that on average a vehicle is checked for overloading once every 25 years.<sup>25</sup> Similarly, in the crucial area of public procurement recent studies question the progress of market liberalisation and emphasise the problems of implementation.<sup>26</sup> Finally, instability in the Exchange Rate Mechanism (ERM) will reduce the benefits of centralisation. Some companies may choose to locate in different countries in order to minimise the risks from exchange rate fluctuations.<sup>27</sup>

### Global Pressures for Corporate Integration

This discussion suggests that the impact of the Single Market Act on corporate integration has been limited by structural factors which lie outside the coverage of the Act, and restrictions on the scope of the Act and its implementation. Where corporate integration has taken place it has stemmed from global competition in markets which were already substantially open. Thus EU firms in global industries have been forced to rationalise and integrate in order to compete with competition from Japan and the United States in industries which are characterised by economies of scale and high R & D costs. In these industries firms must internationalise within integrated systems of production in order to achieve economies of scale and spread R & D costs over international

markets.<sup>28</sup> In a real sense these competitive pressures have forced EU companies to rationalise and integrate in spite of barriers within the EU rather than because of the market liberalisation following the Single Market Act.

### Corporate Integration and Deindustrialisation in the EU

Although the EU Commission has sought to create an environment in which European Multinational Companies can develop and subsequently compete more effectively in global markets, corporate integration may accelerate the process of deindustrialisation in the EU. The gains from corporate integration are particularly significant when there are large differences in comparative advantage.<sup>29</sup> When a firm integrates its activities over a number of countries it can locate production in low cost countries according to national endowments or investment incentives. As a firm integrates and rationalises its operations it may choose to locate production in a low cost area within the EU, or, equally, outside it. This may be particularly true given that the cost differentials between the original EU members are small relative to other potential production locations (e.g. Pacific Rim, Eastern Europe), so that any cost advantage from relocation could be much larger if producers relocated to outside the EU.

The extent to which firms locate production outside the EU will depend both on comparative advantage and the characteristics of the product and market. Thus fragmented national markets will continue to be supplied from national subsidiaries while companies may choose to integrate their operations across national borders in regional or global markets. At the non-global level the appropriate market may not be the Single European Market as a whole, but regional markets within it; it would be possible, for example, to

<sup>24</sup> For a detailed discussion see B.T. Bayliss and A.I. Millington: *Deregulation and Logistics Systems in a Single European Market*, in: *Journal of Transport Economics and Policy*, XXIX, 3, 1995, pp.305-316.

<sup>25</sup> B. T. Bayliss and R. J. Coleman: *Road Freight Transport in the Single Market*, Report of the Committee of Enquiry, Brussels, European Commission, July 1994.

<sup>26</sup> See, for a detailed discussion, A. Cox and P. Furlong: *The Impact of the Public Procurement Directives on EU Contract Awards in 1993*, paper presented at the conference *Evolution of Rules for a Single European Market*, September 1994, and A. Cox: *Public Procurement in the EC, Volume 1: The Single Market and the Enforcement Regime After 1992*, Winteringham, Earls Gate Press, 1993.

<sup>27</sup> See N. Hood and S. Young, *op. cit.*

<sup>28</sup> For a discussion of the relationship between R & D and corporate integration and internationalisation see S. Kobrin: *An Empirical Analysis of the Determinants of Global Integration*, in: *Strategic Management Journal*, 12, 1991, pp.17-31.

<sup>29</sup> For a discussion of this point see J. Birkinshaw, A. Morrison and J. Hulland: *Structural and Competitive Determinants of Global Integration Strategy*, in: *Strategic Management Journal*, 16, 1995, pp. 637-655.

integrate marketing functions across Mediterranean countries or Northern Europe according to the language or culture of the countries. In any case, production would be expected to relocate from high cost to low cost countries within the Single European Market or regional market.

When the market is global EMCs may choose to rationalise and integrate their EU operations, relocating production outside the single market. In those sectors which are characterised by product standardisation (for example, computing products) the elimination of barriers to trade within the EU may create conditions which facilitate deindustrialisation within the EU. Such a process may strengthen the positions of EMCs in global markets while reducing employment in the EU. The tendency for firms to relocate the production of standardised goods in low wage regions outside the EU is particularly apparent in the market for electronic goods. Thus company case studies suggest that the production of personal computers, laser-disc players and audio equipment has been substantially relocated from the EU to low cost production centres in the Far East.<sup>30</sup> Further, the tendency for multinational companies in global industries to move the location of production to the emerging economies of South East Asia is supported by analysis of trade flows in office and telecommunications equipment.<sup>31</sup> Between 1990 and 1993 the share of EU imports originating in the ASEAN<sup>32</sup> centres increased from 9.6 per cent to 16.1 per cent. In an industry dominated by MNCs these figures provide evidence of substantial relocation within the sector.

### Implications for Policy

Although government and business have placed great emphasis on the efficiency gains which would flow from corporate integration in the EU, the Single Market Act is likely to have a limited impact on the scope for corporate integration in the EU; the impetus for further integration is most likely to flow from competition in global markets. Since cultural and economic barriers contrive to segment significant sectors of manufacturing industry in the EU, corporate decision-makers should focus on the underlying characteristics of the industry and market,

pursuing appropriate strategies at the national, regional or global level depending on the geographic extent of the market.

However, firms should consider the appropriate level of integration within each of the functional areas of the business (e.g. manufacturing, research and development, marketing and distribution). Even in cases where integrated production is precluded by structural factors corporate integration may be appropriate in other aspects of the companies' operations. For example, liberalisation and deregulation in the road freight market has encouraged the development of fast, flexible, high quality freight servicing while significantly reducing transport costs within the EU; these developments encourage companies to rationalise their logistics and distribution systems.

To the extent that the European Commission is concerned with economies of scale in production, the Commission should target those industries where potential efficiency gains are present rather than pursuing deregulation over a range of industries where success will be limited by structural characteristics. Such a policy would focus attention on those industries in which the Commission wishes to encourage the development of firms which can compete on a global scale. However, the Commission should distinguish clearly between the benefits from corporate integration in a global context which accrue to the company and the implications for the manufacturing base within the Single Market. When the firm chooses to integrate in a global context corporate integration may result in deindustrialisation within the EU. The EU is a high cost region and once a corporation has rationalised its operations at a worldwide level it may decide to take advantage of the global differences in comparative advantage it faces and transfer production to a low cost area. Under these circumstances market liberalisation, within the EU, may facilitate deindustrialisation in standardised global markets.

Further, the Commission should seek to accelerate the process of deregulation in those areas which underpin the creation of centralised management systems (e.g. company law, social legislation and taxation). Although these areas have proved resistant to the legislative process, the rationalisation and restructuring of non-manufacturing functions (e.g. marketing and distribution, research and development, financial control) may offer some scope for efficiency gains in all forms of company, including those where integrated production is precluded by the structural characteristics of the market.

<sup>30</sup> See European Commission: Panorama of EU Industry, Luxembourg 1995, p.49.

<sup>31</sup> European Commission: The European Union and World Trade, Luxembourg 1994.

<sup>32</sup> ASEAN includes Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand.