

## **COMPETITIVENESS OF DOMESTIC SMALL AND MEDIUM ENTERPRISES IN THE EUROPEAN UNION**

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**Abstract:** Competitiveness is a fairly complex concept. There is no one single indicator used to measure competitiveness, which is, additionally, very complicated to be measured. Analyzing the competitiveness from the view of small and medium enterprises, the companies questioned are optimistic regarding the quality and price of the products, but they feel their sales networks and marketing activities need some improvement. In medium sized companies a serious problem is the weakness of their own development capacities. Company experts believe the lack of capital and the disadvantageous rate of return on R&D expenditures to be the most important obstacles of innovation.

### **Defining competitiveness**

Competitiveness is a widely used concept in economics, usually it refers to the commitment in market competition in case of companies and success in international competition in case of countries. In the last two decades, in parallel with recruitment of globalization, competitiveness became one of the key concepts in which the successful participation and the phenomenon of global competition among new conditions is described in case of companies, countries and regions.

Competitiveness is a hardly definable concept, essentially it means the liability and skill for market contention and the skill for position gain and permanent commitment that are indicated especially by expansion of business successfulness, market share and profitability. As Ádám Török describes “on micro level the concept of competitiveness means the skill of position gain and self-maintenance in the market competition among companies, each other’s competitors and - in respect of macro economy – among national economies (Lengyel 2005).”

Regarding the creation of a unique concept of competitiveness, more people consider the documents of OECD - the Council of Competitiveness of USA – and EU as directives. According to more documents of OECD and the sixth regional (in 1999) and second cohesion report (in 2001) of EU, the unique concept of competitiveness is: the skill of companies, industries, regions, nations and regions above nations for creating relatively

high incomes and relatively high level of employment while they are exposed to the international, global competition.

### **The change of the micro economic index that influences competitiveness**

It is doubtless that we must be very careful with numbers but I think it is important to show some macro economic factors that can possibly influence the competitiveness of small and medium enterprises in Hungary. I compare these with the data of EU, moreover with the data of the other three countries of Visegrad Four. The indexes of competitiveness will not be fully showed, I only would like to emphasize some typical indexes to analyze the competitiveness of national companies.

#### ***The growth of real GDP***

One of the influencing factors of competitiveness of companies is that they are working in a country with growing, stagnating or possibly declining economy. The economic growth means the macro level quality change of economic system. This is the enriching process of society in that closer meaning – according to the development – that the opportunities of production, consumption and accumulation of goods are increasing among conditions determined by the quality of national economy.

Gross domestic product (GDP) is a measure for the economic activity. It is defined as the value of all goods and services produced less the value of any goods or services used in their creation. The calculation of the annual growth rate of GDP at constant prices (1995) is intended to allow comparisons of the dynamics of economic development both over time and between economies of different sizes. The growth rate is calculated from figures at constant prices since these give volume movements only, i.e. price movements will not inflate the growth rate.

The growth of real GDP in Hungary shows decrease until 2003 but 1% increase can be seen in the next year. The data referring to 2005 and 2006 on the diagram are, of course, only forecasts but these predict an increase below 4%. This highly exceeds the average that refers to 25 countries of European Union but it can not reach the level of the other three examined countries that can disadvantageously influence the competitiveness.

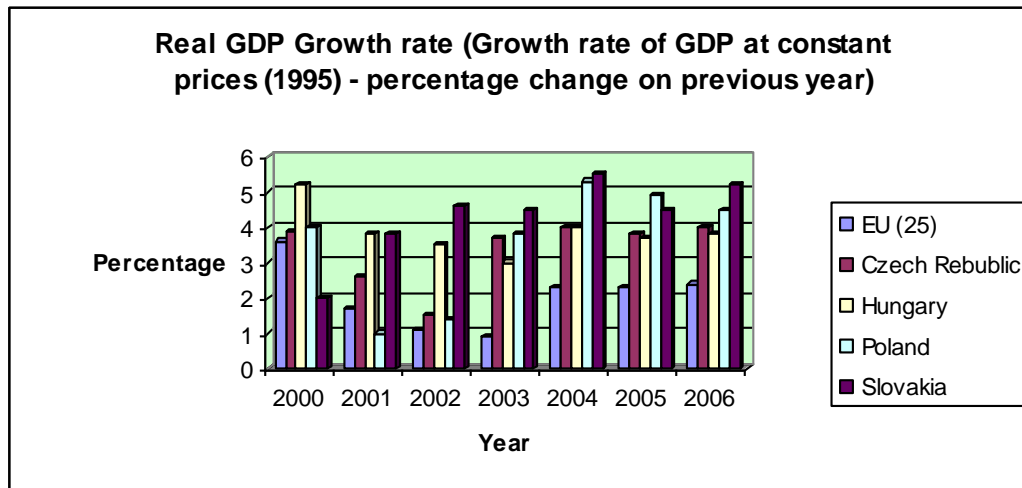


Figure 1. The growth of real GDP in percentage of last year (Eurostat)

### ***Rate of inflation***

Because of its difficulty and variable nature literature defines and explains inflation in several ways. According to its more usual explanation it means the permanent increase of price level and continuous decrease of purchasing value of money unit. In view of microeconomics, the meaning of inflation is: the same thing expressed in the same currency costs a lot more on a later date without it would be generally up-valuated compared to other products. Although the rate of inflation is usually described by the index of average increase of price level, usually a significant regroup process of price rate is going on in the background. The price increases of inflation can be very different by branches, product types, even companies. While examining a shorter period, the difference is more bigger. Because the certain managing organizations have very different opportunities, furthermore they apply different concepts of price and market policy to prevent and avoid harmful effects of inflation. (Illés 2002)

The rate of inflation has been stabilized around 2% in the European Union. In respect of competitiveness of domestic companies it is disadvantageous that we are facing a quite high level of inflation among the Visegrad Four; the highest level was measured here in 2001 and 2002 among the four countries. As a curiosity it can be mentioned that the rate of inflation – that was already low - in the Czech Republic decreased below zero percentage in 2003 so the economy of the Czech Republic was characterized not by inflation but deflation that year.

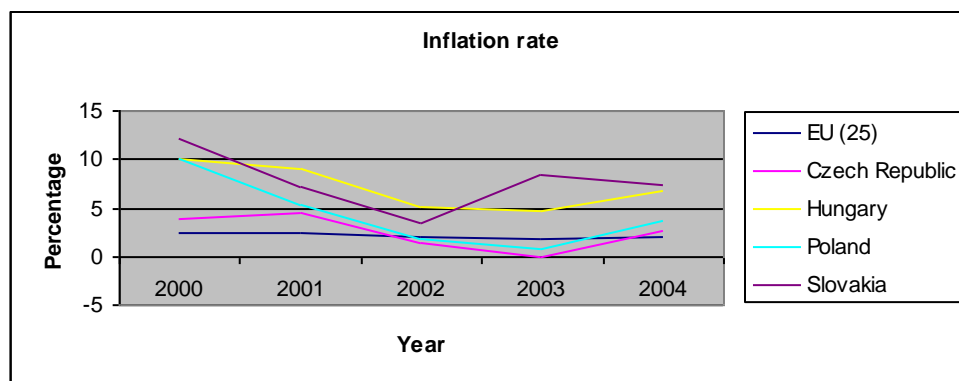


Figure 2. The changes of rate of inflation between 2000 and 2004  
(Eurostat)

### ***Productivity per employee***

Gross domestic product (GDP) is a measure of economic activity. It is defined as the value of all goods and services produced less the value of any goods or services used in their creation. GDP per person employed is intended to give an overall impression of the productivity of national economies expressed in relation to the European Union (EU-25) average. If the index of a country is higher than 100, this country's level of GDP per person employed is higher than the EU average and vice versa. Basic figures are expressed in PPS, i.e. a common currency that eliminates the differences in price levels between countries allowing meaningful volume comparisons of GDP between countries.

The productivity projected to the number of employees can play a role in development of competitiveness but we can not draw far-reaching conclusions only based on this index because the productivity is influenced by a lot of hardly measurable factors for example the level of mechanization and automatization.

Although the productivity of Hungary is behind the average of European Union, it shows slow but continuous increase that will also continue in 2005 and 2006 according to the forecasts. In respect of competitiveness it is definitely positive that the data of Hungary surpass the productivity of other countries of Visegrad Four.

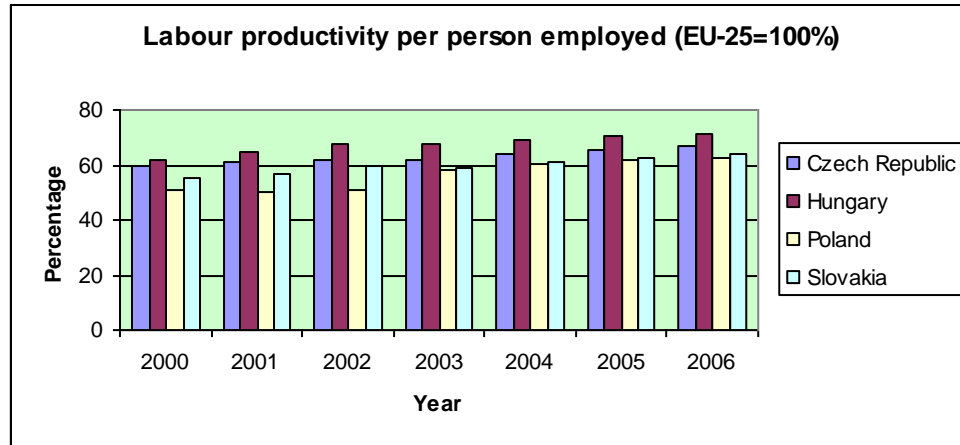


Figure 3. The change of productivity related to employees (Eurostat)

### ***Business investments***

Gross fixed capital formation (GFCF) consists of resident producers' acquisitions, less disposals of fixed assets plus certain additions to the value as non-produced (usually natural) assets realised by productive activity. GFCF includes acquisition less disposals of, e.g. buildings, structures, machinery and equipment, mineral exploration, computer software, literary, artistic originals and major improvements to land such as the clearance of forests. The private sector consists of non-financial corporations, financial corporations, households and non-profit organisations serving households. The ratio gives the share of GDP that is used by the private sector for investment.

The business investments achieved by the private sector in Hungary – in spite that those surpass the average of European Union – do not show a good picture since we only precede Poland between 2001 and 2003. The data of Slovakia and the Czech Republic, examined for four years, highly surpass the domestic business investments. Most probably it also has a disadvantageous influence on the competitiveness of Hungarian companies.

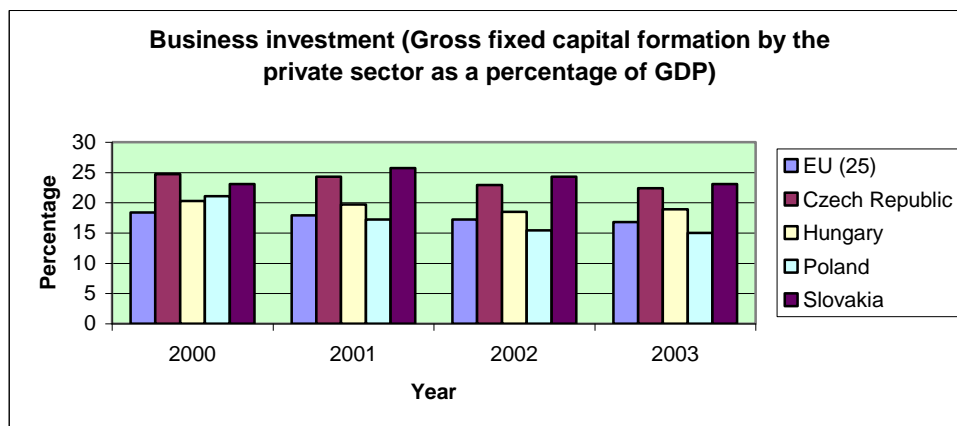


Figure 4. Gross fixed capital formation by the private sector as a percentage of GDP

### **FDI index**

In respect of a country we can approach the relationship of FDI and competitiveness especially by the influence of direct foreign investments of capital that effects on the economical growth. According to the neoclassical theoretical model of growth, the direct foreign investments of capital do not influence the schedule of long-term growth. On the other hand, the endogen theory of growth – that does not keep the condition of perfect competition – gives a bigger space for the influence of FDI on growth. In this theory the investment and so the FDI can influence the schedule of growth through the research and development and the effect on the human capital. Even if the return of equity is decreasing, it can effect on the growth of FDI through externals. In company respect the most important characters are the multinational companies that accomplish the FDI. These companies do the most research and development. By that, they are the most important sources of technological transfer. The influence of technology transfer can appear in the improvement of productivity, change of industrial structure, increase of expenses of research and development, transformation of structure of export and import and the change of human capital (Sass 2003).

The data referring to the FDI index cover a quite short period, reliable data can be found only between 2001 and 2003. The direct foreign investments of capital show decrease in Hungary in the examined period but exceed the average of European Union in those three years. Two descendant states of former Czechoslovakia became attractive for the foreign investments of capital. The FDI index of Poland stayed below the average of European Union recently.

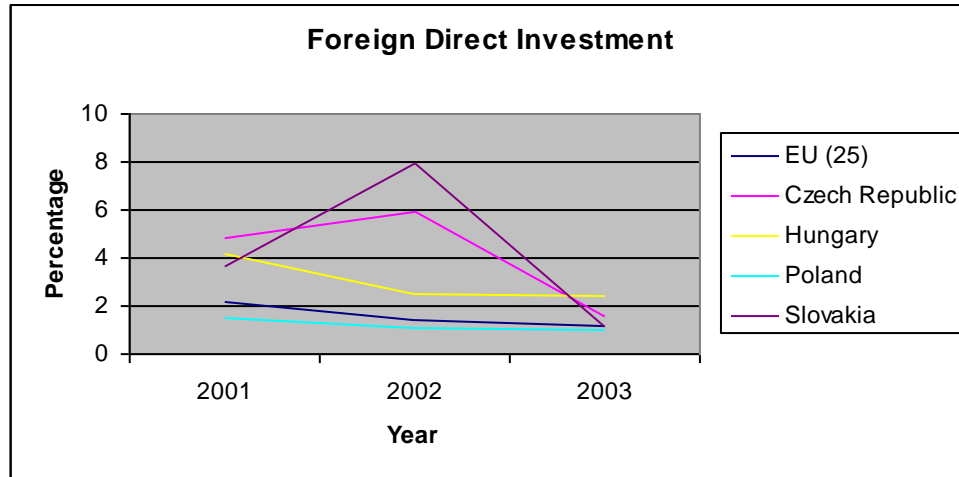


Figure 5. The change of direct foreign investments of capita (Eurostat)

### Competitiveness of small and medium enterprises in the European Union

In the followings I would like to show how the small and medium enterprises in Hungary judge their competitiveness. For that I use a survey that was made by the GKI (Economy Research Institute) in autumn of 2002.

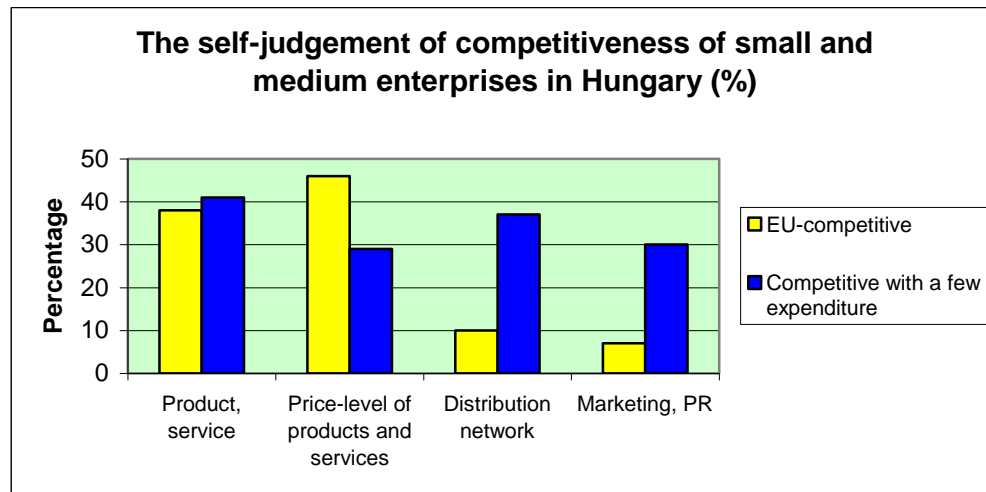


Figure 6. The self-judgment of competitiveness of small and medium enterprises in Hungary (Innovational survey of GKI in autumn of 2002)

As it can be seen on the diagram, 38% of small and medium Hungarian enterprises thought that their products have EU quality and 41% of enterprises had the opinion that the quality of their products can be increase to the quality of EU by a little expenditure. Moreover, 46% of enterprises think that the prices of their products are also competitive on the European markets. They rather find the problems in the insufficiency of their sales network and weak marketing. But unfortunately more facts contradict this self-judgment. A significant part of small and medium enterprises can not show serious export for example. Only exceptional companies can sell more than 10% of their products by using the distribution channel of export companies. And the situation is just a bit better on field of own export since at most of enterprises the return from own export does not reach the 10% of total return.

It can be a question that what could be the reason that the mentioned enterprises can not even sell those products that – according to their judgment – are produced on EU-level and competitive price. The interviews and surveys also make the explanation of latter problem probable. Because these refer to that there is no regular market research at most of small and medium Hungarian enterprises, nobody examines the lifespan of products and technologies and analyzes the trends of technical improvement. Of course, they learned about the methods of simpler trend analysis and usually they apply those also. But they do not spend time on continuous observation of activities of company, measurement of expenditures and outcomes, evaluation of measuring results and feedback of results.

### **The role of innovation in the competitiveness of small and medium enterprises**

In our age the importance of company innovational processes can not be overestimated. In the developed countries those activities and institutes give the engine of growth that belong into this sphere. Also in these economies the success of innovational processes – the modernity and competitiveness of producing area – is the key issue of future. According to the latest report of World Economic Forum, our economy – based on the level of its competitiveness – is in the front-rank (among the technology importing countries) but for the further steps in order to catch up, the innovation ability of our manufacturing sphere needs to be improved.

As it is shown in the table the purpose very often is to improve the market activity. Many companies attempt to strengthen market research, to improve distributional channels and to modernize marketing as well. At a considerable part of the companies investments (procurement of machines and instruments) and the improvement of the technological level are also found to be important. Although the commitment to own researches, patent buying and technology transfer is smaller than the desirable (normal rate among international competitors).

Actions	21 - 50	50 - 250	251 -	Total
	employees at the company			
Own research	15	6	12	11
R&D delegation	5	4	4	5
Patent buying	1	4	4	2
Machine and instrument investments	56	66	68	59
Intense market research	49	44	28	43
Development of sales networks	51	57	40	51
Dynamic advertisement and PR activity	31	27	32	31

Table 1. Rate of companies taking different actions to improve competitiveness in percentage  
(GKI 2002)

The general condition of small and medium enterprises in our country is not as favourable as it would come from the above mentioned. It is also a problem, that the type of the given information could be explained by the generational characteristics of the applied innovation process. It indicates that the innovation processes at the major part of Hungarian SMEs are first or second generational (they are started by R&D and concentrate on technology improvements and they are reactions to market demands). Those who undertake this type of innovations are mainly necessity enterprises, which were outsourced from companies wrestling with difficulties and they got their technology from their “parent company”, which also take the biggest part of their capacities. Others, recognizing market demands on time, got the necessary technologies from companies closing or going bankrupt. A considerable part of these companies know the market only partially, do not watch the newest scientific and technological explorations, do not know how to improve their products further and they do not care enough about the further improvement of their own capacities. But the above mentioned do not mean that there are no third generational innovation processes among the national small and medium enterprises (seeking for market demands and the integration of technological trends). Companies accomplishing this were founded with a base of special knowledge *ab ovo*. Many of them were established by people who had worked in scientific or generating fields earlier. Standing on more feet i.e. having two or three interesting but very often different branches of business, although a common base can always be found, is characteristic for these companies. The only problem is that there are not enough of them. As it can be seen from Table 2, the innovation activity

of the national companies (either small, medium-sized or large enterprises) is far behind the one of the firms in the European Union both in the field of industry and services.

Type of companies	European Union		Hungary	
	Industry	Service	Industry	Service
Small enterprises	40	36	26	15
Medium-sized enterprises	63	54	33	24
Large companies	80	69	47	39
Total	47	44	29	17

Table 2. Rate of companies introducing innovation in percentage

### About the competitiveness of local companies in short

Even today there are huge differences between the competitiveness of local and multinational companies in the region of Central- and Eastern Europe. As it turns out from the study of Deloitte & Touche, surveying the competitiveness of more than a hundred Polish, Czech, Slovakian, Slovenian and Hungarian large enterprises, the disadvantage in competition of local companies is considerable compared to multinationals operating in the same region. It is also confirmed by the fact that companies located in the region rarely buy up companies, moreover usually they are incorporated by the multinationals. Their advantage usually covers all areas, and it also appears on the list of winners of the Széchenyi plan: 60 per cent of the money distributed for investments to improve competitiveness was taken by large enterprises with foreign ownership in 2001.

The key factor of the lag is the higher - almost twice as much - productivity of international companies than those located in the region for example the Hungarian's. In factories of the multinationals similar to the Audi's subsidiary company in Győr the production per capita is more than 120 000 euro while the same in the countries of Central- and Eastern-Europe is average 67 000 euro. All together, the production performance by 19 per cent, the results reached in organizational and human resource questions by 17 per cent, the advancement of the supply chain by 14 per cent and the in the area of preparation for globalization by 13 per cent local companies fall behind multinational companies operating in the same region (Dóra 2005).

It is worth mentioning that not only local small and medium enterprises but also national governments are exposed to global transnational companies, which extort more and more considerable amount of supports and preferences in order to realize investments in one or another country. Taking all these into consideration statements regarding the outstanding efficiency of multinational companies must be reconsidered sooner or later. If companies do not have to pay taxes, they get business domicile free of charge, their workers are trained for nothing, they get support for their research and development activities, etc., it is not that hard to be effective and successful. So when evaluating the vulgar myths regarding

the effectiveness and efficiency of large international companies we should not forget about the supports and preferences, which are exacted from national and local governments by them possessing a considerable dominance. When these preferences and supports are taken into consideration, the efficiency and success of global international enterprises can be viewed from a different aspect (Árva 2005).

## **Conclusions**

Competitiveness is a fairly complex concept. It concerns business management processes, elements of organizational culture and macroeconomic factors at the same time. There is no one single indicator used to measure competitiveness (maybe its main reason is that even the concept of competitiveness cannot be defined in a uniform and adequate way), which is, additionally, very complicated to be measured. Although the growth rate of real GDP exceeds the EU average, it falls behind the other three countries of the Visegrad Four. The rate of inflation has stabilized on 5-7 percent for years, but it is two or three times bigger than that of the European Union comprising 25 member states. Concerning the productivity of the national companies, we precede the Visegrad Four showing up a 10 per cent improvement in the last five years, but we still attain only 70 per cent of the value calculated for the European Union. Business investments are a little bit higher than the EU average, after all Hungary falls behind the other countries except Poland. The value of the FDI indicator exceeds the average of the EU member states and the data of Poland, but falls behind the two Czechoslovakian successor states.

Analyzing the competitiveness from the aspect of small and medium enterprises, the inquired companies are optimistic regarding the quality and price of the products, but they feel their sale networks and marketing activities need some improvement. Besides the expansion of tasks connected to marketing, the improvement of their innovational ability is also needed, since the innovational activity of the national small and medium enterprises falls behind the European Union. A national research pointed up that Hungarian firms, especially the small ones are unsatisfied with the economic environment of the innovations. In the sphere of SMEs a very important obstacle on the return of innovational expenditures is overtaxing and the unfair competition. At medium sized companies a serious problem is the weakness of the own development capacities. Company experts believe the lack of capital and the disadvantageous rate of return on R&D expenditures to be the most important obstacles of innovation. It is though obvious at the same time, that the long-term objectives of both the Hungarian innovational policies and the policies regarding national small and medium enterprises must be harmonized with the innovational perspectives of the EU. The starting point is that the European Union – in order to obtain/preserve world-economic competitiveness- wishes to build a knowledge-based society. The Barcelona Summit decided in March 2002 marking out the path of the accomplishment that the R&D expenditures of the member states should reach 3 per cent of the GDP by 2010. In order to achieve this, it recommended harmonized actions in the field of research and development to strengthen technology transfer, to encourage research mobility, to increase the numbers of research co-operations over the borders, to strengthen the relationship between the government and industry, etc. It also felt necessary to build an economic policy supporting innovation better than the existing system, to make research- and innovation-friendly rules

of competition, to form a system for the protection of the modern intellectual property, to increase tax benefits for innovative small and medium enterprises and to raise the amount of state supports.

Local companies have disadvantages of competition against multinational companies. It is also revealed in the incorporation of the national companies by the multinationals or they just “simply” go bankrupt. One of its main reasons is thought to be the higher productivity of multinational companies against local small and medium enterprises. This is caused by, among others, the supports and preferences given to multinationals settled down in Hungary by the government, endangering the further operation of local companies. Experts believe that global transnational companies established through direct investments by foreigners can combine the economic resources more effectively than ever; therefore all of their efficiency indicators exceed the ones of the local SMEs. The later can only survive if they become part of the global international companies or at least they form strong contractor relationship with them.

Summarizing the above mentioned it becomes clear that both the national economic policy and the Hungarian companies have many things to do in order to increase competitiveness, but to accomplish this, weaknesses have to be recognized and determinate steps have to be made in order to reach better results.

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