The Impact of Industrial and Regional Differentiation on SMEs in Slovak Republic[1]

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Abstract

The main aspiration of the submitted paper is to offer a view on impact of industrial and regional differentiation on small and medium enterprises (SMEs) in SR. In spite of it SMEs have entire development their regional differentiation depends not only on regional, but also on industrial policy and differentiation. One of the new possibilities how to improve the new entrepreneurial environment in Slovak republic are different kinds of cooperation strategies, but it is rather questionable if those strategies bring positive results without simultaneous influence of other important factors as is for instance structural changes of Slovak industry.

Key words: *cooperation strategy, industrial differentiation, labour productivity, regional differentiation, SMEs*

JEL Classification: L50, R12, L25

1. Dynamic Changes in the Forms of Corporate Cooperation: a Challenge for Slovak SMEs

The transformation of the Slovak economy has brought a long-term need for the modernization of its production structures and enterprise re-structuring. To be successful, such a process needs to be accompanied by changes in the forms of corporate cooperation and by attracting foreign investors. With foreign direct investment (FDI) inflows some new challenges for local firms are expected to appear soon.

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Cooperation strategies of companies have been formulated with respect to their regional allocation of activities, scope, nature and length of duration of co-operation, market opportunity analysis and division of labour among regional affiliates. The nature and scope of diversification of business activities related to financial management and the use of mergers and acquisitions is a part of these strategies. The internationalization of marketing, research and development and production also represents an important component in corporate development strategies. Some companies use their characteristic strategies. The key for distinguishing marketing strategies is the orientation to cost or to quality leadership, and product, price and communication and distribution policies connected to it.

The above-mentioned factors are subject to change given structural, institutional and broader socio-economic changes. The factors affecting decisions to invest in Slovak Republic, can no longer be expressed by a set of quantitative macroeconomic indicators only. In addition, difficult-to-define and non-quantifiable positive and negative effects, which can be termed corporate and local competitiveness, come into play. One of these additional factors is institutional density, which means a broadly conceived institutional framework and infrastructure. The quality of this factor remains a problem, which has yet to be fully understood by Slovak policymakers.

Strategic clusters of transnational corporations TNCs and cooperation between small and large-scale enterprises and the formation of clusters are a reflection of the corporate effort to increase effectiveness especially through the minimizing of transaction costs. Cooperation thus has mostly economic reasons and companies therefore analyze the impact of taxation on corporate divestitures, mergers and takeovers. The development of financial tools and legislation form the nature of these processes. Strategic clusters can originate based on equity and cooperative links. Preconditions for this have been developing gradually since the early 1990s in SR as more and more foreign investors locate their production capacities and other facilities close to main producers (e. g., the Bratislava VW plant) and form themselves into supplier hubs.

The dynamics and competitiveness of the corporate clusters depend on the ability of the firm to control the network and to efficiently use the specific advantages of its member companies combining them with its own international or global activities. Sharing knowledge is the key factor in this process and also helps in defining the organizational form and cluster boundaries.

With increasing competition, substantial changes in structure, strategy and control of SMEs and large companies take place. Various forms of cooperation have gradually replaced the intense competition of the past. At the same time, there is an ongoing enforcement of horizontal and vertical links in company

structures. Leading firms (e. g., Matador Púchov or Volkswagen – VW) build relations with competitors on the horizontal level and with key suppliers and customers on the vertical level. Cooperation is also developing with other subjects, especially with the non-business infrastructure. Decisions leading to integration into clusters or networks of small companies are particularly based on the specialization factor and limited mobility of production equipment. Such processes have been rather limited in number so far. As far as large-scale companies are concerned, cooperation is fuelled by an effort to survive in competition with other clusters, decrease costs of research and development, spread risks and obtain knowledge, technology and foreign markets from partners. Large-scale companies should stimulate technological development not only in the companies they acquire or cooperate with (internal transfer), but due to the demonstrated effect generated by the fluctuation of employees within and beyond their structures.

The simple presence of TNCs or the existence of clusters in the Slovak economy would not automatically have meant positive changes. These corporations and clusters are present in numerous countries around the world and substantial differences among them remain. On the other hand, the trend of the liberalization of measures affecting FDI inflow into host countries continues. M. E. Porter (1998) shows that firms oriented on the production of high-tech products need an adequate infrastructure and institutional environment. They are primarily determined by economic policy and traditions. The paternalistic approach combined with weak policy-making in some areas – partly a heritage from the past – and under-investment in human resources are probably the main barriers to more dynamism in our economy. The nature of these problems, however, is not only a short-term issue, but rather a paradigm shift in economic policy at the national and European levels.

Corporate strategies have been developing from simple integration forms to ones that are more complex. The strategies of complex integration can include the segmentation of the production process into specific activities or functions, each of them located in the most suitable and cost competitive place. Here, however, we should be rather skeptical as concerns the ability of peripheral and underdeveloped regions, without substantial state intervention policy, to succeed in attracting the kind of FDI they need. So far, the state policy for stimulating undeveloped Slovak regions has become focused on local development center support there rather than on wide-scope assistance to such regions.

Nowadays, complex integration strategies allow TNCs to maximize the competitiveness of their corporate systems as a whole. Transnational corporations reach their goals of strategic location and restructuring not only through mergers

and acquisitions, but also through inter-firm agreements. The agreements include technology-related activities and are reactions to the increasing level of production knowledge and the shortening of production cycles. With respect to their focus on technology or joint development in research and development, it is no surprise that inter-firm agreements have been successfully used in knowledge-intense industries, like the pharmaceutical and automobile industries.

Changes in organizations also require changes in their management. In general, because of company participation in networks, the size of production units has been decreasing globally but company size has been growing. They try to orient themselves on the building of a competitive advantage through shifting from production lines to specific corporate assets, outsourcing or narrowing their production base (higher specialization). Management is no longer a routine activity and has become a permanent adaptation of key assets to changes in demand and on the management of complex processes. The reformation of the Slovak education system should generate managers in the near future who are able to supply the vision for a company's long-term focus, especially in their key areas of activity. Companies are facing fluctuations in demand and as a result, they must use sophisticated analytical tools to identify the behavioural patterns of consumers. So far, the progress in this area in Slovakia has not been substantial but there are good prospects that the situation will improve in the near future.

2. Prospects and Risks of Slovak Industrial Development

2.1. Structural Characteristics of Slovak Industry and the Role of Industrial Policy

The current status of Slovak industry is not only a result of historical development but also reflects the post- 1990 economic transformation strategy, which was based on a strong macroeconomic policy aimed at cost and price competitiveness through low wages and a long term under-valued currency. These unpretentious conditions enabled the survival of companies with low prices without striving for a rapid labour-productivity increase. This development has recently resulted in high unemployment. The industrial share of the Slovak Republic's GDP is considerable. After 1989, the branch structure of the Slovak economy has been changing fundamentally. The share of the tertiary segment has been increasing to the detriment of the primary (agriculture and mining and quarrying) and secondary segments (manufacturing, power supply and building industries). This trend has continued after 1995 especially to the detriment of the secondary sector (see Table 1).

Table 1

GDP Share According to Sector

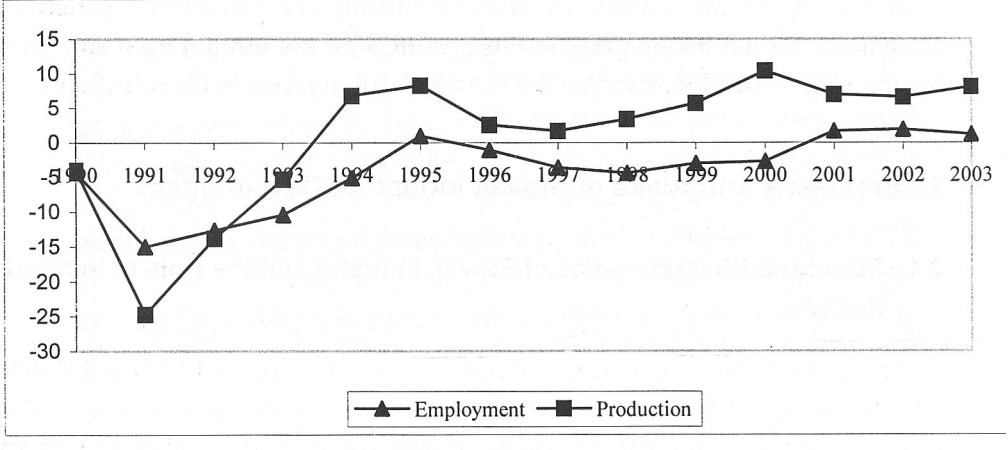
Sektor	1995	1996	1997	1998	1999	2000	2001	2002	2003
Primary	6.5	6.1	6.3	6.5	6.4	6.1	5.6	5.7	5.7
Secondary	34.4	36.1	32.5	31.0	30.5	28.6	28.6	28.8	26.4
Tertiary	59.1	57.8	61.2	62.5	63.1	65.3	65.8	65.5	67.9

Source: Statistical Office of the SR: Macroeconomic Indicators of Quarterly National Accounts and Value Added in first and second Quarter 2003.

Since manufacturing is decisive in the framework of the secondary sector, its share of GDP formation in recent years has declined from 25.1 per cent to 23.3 per cent. Along with its declining GDP share, employment in industry, as a share of total employment, has dropped. In the last decade it has undergone even more dramatic changes, than those in industrial production. It has declined much more than production as a whole (see Graph 1).

Graph 1

Manufacturing Production and Employment – Annual Trends (previous year = 100%)



The slowdown of the employment decline and its modest growth in the last two years is a signal that industrial companies have entered a new era of expansion connected to a restructuring phase. In other words, for the time being it has not contributed significantly to a drop in unemployment (Lubyová and van Ours, 1997). It does not mean that industry has not created new jobs. The point is that old jobs were disappearing and this development can be expected for the next few years. Concerning total industrial output (including mining, quarrying and power utilities), its pace has been very favourable in comparison with selected Eastern and Central European EU candidate countries (see Table 2).

Table 2

Industrial Output in Selected Central and Eastern Europe Countries

Country	Industrial Output (indexes the same period of the previous year = 100, constant prices)				
	1999	2000	2001	2002	2003
Czech Republic[1]	96.9	105.4	106.7	104.8	105.8
Hungary	110.4	108.1	103.6	103.1	106.4
Poland[2]	104.4	107.1	100.0	101.5	107.9
Slovak Republic[3]	97.4	108.8	106.8	106.6	108.1
Slovenia[4]	99.5	106.2	102.9	102.4	101.4
Romania[5]	97.6	107.1	108.2	106.0	103.2

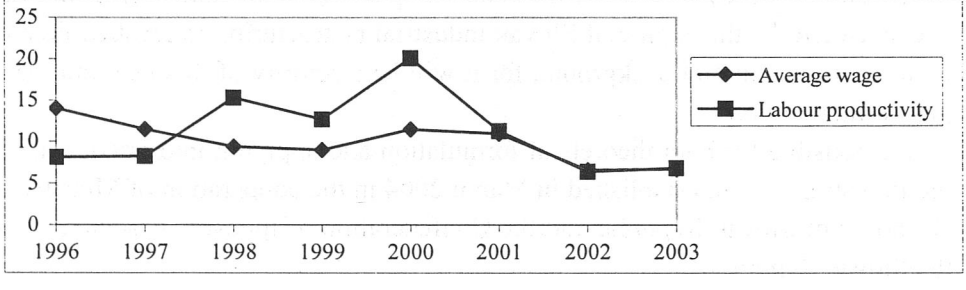
Notes: [1] Enterprises with at least 20 employees.
[2] Turnover from industry up to 1999 enterprises with at least 5 employees, since 2000 enterprises with at least 9 employees.
[3] Enterprises with at least 20 employees and selected enterprises with no more than 19 employees; indexes do not include the influence of the number of working days.
[4] Enterprises with at least 10 employees.
[5] Enterprises with at least 50 employees.

Source: Statistical Record on Basic Developmental Tendencies in the Economy of SR 2002.

With the exception of 1999, SR has achieved higher growth than the three other members of the original V4 group (Vyšehrad group). Compared with these countries Slovak industry has therefore developed as successfully as its GDP, which at 4.4 per cent in 2002, was the highest growth rate in this region. Labour productivity is another important criterion of industrial development. Its upswing may be connected with the increasing technological standards of industrial production. The technological level of Slovak manufacturing is not only lower compared to that of EU member countries (it is one tenth of the standard of the EU-North countries – Belgium, France, Germany and Great Britain) but also – according to some authors – to that of other EU candidate countries (Baláž and Williams, 2000). Compared to the other V4 countries, SR has the cheapest labour force; the average salary is two thirds of that in the Czech Republic. A comparison of the average wage and labour productivity in manufacturing in the SR gives the following picture:

Graph 2

Average Wage and Labour Productivity (annual development)



The analysis shows a positive development of the correlation between wages and labour productivity. The turning point came in 1998 when labour productivity significantly surpassed wage growth. Among other things, this development is a result of the previous industrial restructuring. In 2001, 2002 and 2003, annual average wage growth was nearly the same as labour productivity growth.

In recent years the largest and most important manufacturing sector has been the transport equipment industry, which share of total manufacturing production has raised from 4.6 per cent in 1993 to 18.0 per cent 2002. Its share is expected to grow in next years too above all due to continually expanding automotive industry.

The second largest branch in 2002 was the manufacturing of basic metals and fabricated metal products. According to skill intensity classification are these two largest branches of Slovak manufacturing considered as medium skill industries. In according with this classification 37.6 per cent of the total numbers of employees in manufacturing were in 2002 ranked to low skill intensive jobs.

Manufacturing of textile and textile products has been the most labour-intensive industry; while it has contributed in total manufacturing output with only 2.7 per cent it has engaged 12.3 per cent of the total manufacturing employment. In recent years, the structure of Slovak industry has begun to show signs of convergence with the more advanced EU countries; the share of labour and energy-intensive branches is significantly higher while the share of more sophisticated production has remained relatively low.

Even if the recent development has confirmed the improved performance of Slovak industry, upon EU entry it is going to be confronted with a number of tasks that will have to be resolved in order to stand up to the competition. Slovak industry itself can manage some of these tasks, but the public authorities and the adopted form of economic and industrial policy will be needed to develop a favourable business environment.

At present, the Ministry of Economy of Slovak Republic is working with the business environment on elaborating a comprehensive draft of an economic policy, a part of which will deal with industrial policy. As the automotive industry is expected to be the engine of Slovak industrial restructuring to create a favourable environment and background for it will be a priority of this new industrial policy alternative.

Responsible for both theoretical formulation and applying into praxis will be the Industrial Forum established in March 2004 in the cooperation of Ministry of Economy of Slovak Republic and the Confederation of Industry Associations of the Slovak Republic.

2.2. Industrial and Regional Differentiation

Between 1996 and 2001 only three regions – Bratislava and Trnava in the west and Košice in the east – recorded industrial productivity levels above the national average. These three regions are also areas in which total regional productivity and overall regional per capita GDP are highest and closest to, if not higher than, the Slovak average. In the mid 1990s, Bratislava, as its industrial composition indicates, was specialized in sectors with productivity above the national average, but less so than in Trnava and Košice.

Over time, Bratislava has seen a quite dramatic degree of improvement in its degree of specialization in sectors with high national productivity; at the same time its relative productivity score declined, suggesting that its industrial performance declined in comparison with the same industries at the national level.

In Trnava and Košice, falling positive composition scores indicate a decreesing level of specialization in sectors with productivity above the national average. However, in Trnava, total relative productivity growth was related to a significant shift in relative productivity, suggesting that the region's industries performed increasingly better than the same industries at the national level. In Košice, the relative productivity shift remained negative, suggesting a relatively poorly performing regional industrial structure.

In 2000, the Bratislava district, in particular, contributed to the sharpest annual labour productivity increase. According the Statistical office of SR, labour productivity in this district compared with 1999 grew by 29.9 per cent and its share of industrial output as a whole was higher than 40 per cent. The only other region to record increased industrial wages in 2002 was Košice. And along with the Bratislava district they were the only districts with above average labour productivity. Bratislava held the dominant position in terms of the remaining indicators of industrial activity as shown in the Table 3.

Table 3

Selected Indicators of Industrial Activity According to District in 2002

District	Number of Enterprises (%)	Average Number of Employees (%)	Average Monthly Wage[1]	Labour Productivity per Employee[1]	Turnover from Industrial Activity	Added Value
Bratislava	13.7	17.2	136.8	242.9	37.7	38.5
Trnava	10.8	8.4	99.9	91.4	8.6	8.6
Trenčín	16.4	17.5	88.2	54.8	10.1	11.1
Nitra	12.0	9.6	86.7	63.6	6.9	6.3
Žilina	14.4	12.4	93.1	79.3	9.7	10.1
Banská Bystrica	12.1	13.0	89.3	59.9	8.5	8.2
Prešov	11.8	10.0	78.3	51.7	5.7	5.6
Košice	8.8	11.9	112.3	101.5	12.8	11.6
SR total	100	100	100	100	100	100

[1] Relative to SR total (100 per cent).

Source: Yearbook of Industry in SR 2003. Bratislava: Statistical Office of SR 2003.

The Table demonstrates the lasting disproportional location of industrial capacities. While the Bratislava district accounted for less than one fifth on the total number of employees, its share of the turnover from industrial activity and added value was more than one third. In comparison with the average, the Bratislava district again had the highest wages, however its labour productivity was more than twice the average level. It was four times higher than that in the Prešov and Trenčín districts. Košice was the only other district to record above average labour productivity in 2001. As stated in the table above, the major loser in 2001 was the Prešov district. The Nitra and Trnava districts did somewhat better.

These differences across districts have been also increasing due to the disproportionate inflow of foreign direct investment. Once again, the Bratislava district led the way with more than two-thirds of the FDI. At first sight, it seems paradoxical that investors considered districts with the highest unemployment rate and thus the most extensive supply of disposable labour as unattractive. The explanation lies in a soft and deficient infrastructure, an underdeveloped industrial base and an unqualified labour force (one fourth of the working population in Bratislava is composed of graduates (university) while in the eastern part of the country the percentage is only eight to nine per cent).

From 1996 to 2001, total industrial productivity in the five other regions fell in relation to the national average. This drop was most dramatic in Prešov in eastern Slovakia, which maintained an only marginal degree of industrial specialization in sectors with productivity above the national level. In the other relatively poorly performing regions of Nitra, Trenčín, Žilina and Banská Bystrica, the regional industrial composition were generally positive, suggesting specialization in sectors with productivity above the national average. In these regions, however, the weak industrial productivity was largely due to a negative relative productivity shift. The growth rate of relative regional industrial productivity is expressed by two elements: the intra-sector and inter-sector shifts (Smith, 2001). The intra-sector shift identifies the contribution of changing productivity within each sector relative to the changes in overall national productivity compared to the relative performance of the regional economy. The inter-sector shift however identifies the contribution of the changing shares of employment in different sectors to the performance of the regional economy.

In all Slovak regions from 1996 to 2001, the intra-sector shift is much more important than the inter-sector shift, suggesting relative improvements in productivity or upgrading in existing sectors rather than a large scale movement of labour to performing sectors. In Bratislava, the relatively strong but certainly not the largest relative productivity growth was the result of both a relatively strong

intra-sector shift, suggesting productivity improvement in the industrial sectors relative to the economy as a whole and the strongest inter-sector shift suggesting the movements of labour to sectors associated with higher value added activities. Indeed, almost 90 per cent of the inter-sector shift in Bratislava was accounted for by the car industry. Much of this transformation is associated with the expansion of Volkswagen's activity in Bratislava, which is a key force behind improved regional industrial productivity levels, and which is driven by employment shifts and productivity upgrading. However the marginalization of the old Slovak component production system during the first part of the 1990s in Bratislava and Trnava has meant that a large number of domestic suppliers have either collapsed or are close to bankruptcy. From 1996 to 2002, productivity in this sector in Bratislava has doubled, placing the car industry as the third most productive sector among all Slovak regional industries. At the same time, employment has increased from fewer than 3 000 employees in 1996 to fewer than 8 000 in 2001 (approximately 17 per cent of the local industrial labour force).

3. Regional Differentiation and GDP

The levels of regional inequality in SR during the late 1990's continued at relatively high levels. The capital region of Bratislava (144 per cent of the average GDP) and the industrialized region of Košice in the east (78 per cent of the same), lie above the threshold, but the distribution of regional per capita GDP is significantly more polarized than in Hungary. If we compare Slovak Republic with 44.7 per cent of the average GDP with Hungary with 51.5 per cent of the average GDP and Czech Republic with 60.6 per cent of the average GDP, or Estonia with 38.5 per cent of the average GDP, or Cyprus with 77.8 per cent of the average GDP, we see that Bratislava and Košice regions are not so bad. The relative strength of these regions is in part due to the concentration of comparatively high value-added industrial activity, with Bratislava and Košice alone accounting for 35 per cent of SR's industrial output.

The capital city of Bratislava recorded 2.1 times the level of the second NUTS II region of western Slovakia and 2.4 times the level of the poorest NUTS II region of eastern Slovakia. The relative dominance of the greater Bratislava region, which includes Trnava as a commuting hinterland for the capital city as well as a significant economic region in its own right, is underlined by strong, although similarly slightly diminishing relative improvement in regional per capita GDP. Another factor contributing to the high per capita wealth of Bratislava and other city regions is the fact that there is significant commuting network, so that large numbers of people who contribute to the output do not reside in the area.

Elsewhere, the Košice region in the east has seen a relative improvement in regional per capita and lies just below the national average, largely because of its relatively strong and strategic steel sector. Four of the five remaining regions lie between 80 per cent and 90 per cent of the national average per capita GDP, while Prešov in the east shows a very low level of comparative development (65 per cent of the national average in 1999) and little relative improvement over the four year period for which data is available (Smith, 2000). The slight fall in inequality in Slovakia, when all regions saw an improvement in performance, was due to the relatively higher growth recorded in central and eastern Slovakia. For example, relative to the EU average, per capita GDP grew by 12 per cent between 1995 and 1999 in the poorest Slovak region of eastern Slovakia, while in Bratislava the growth was just under 9 per cent (Smith, 2000).

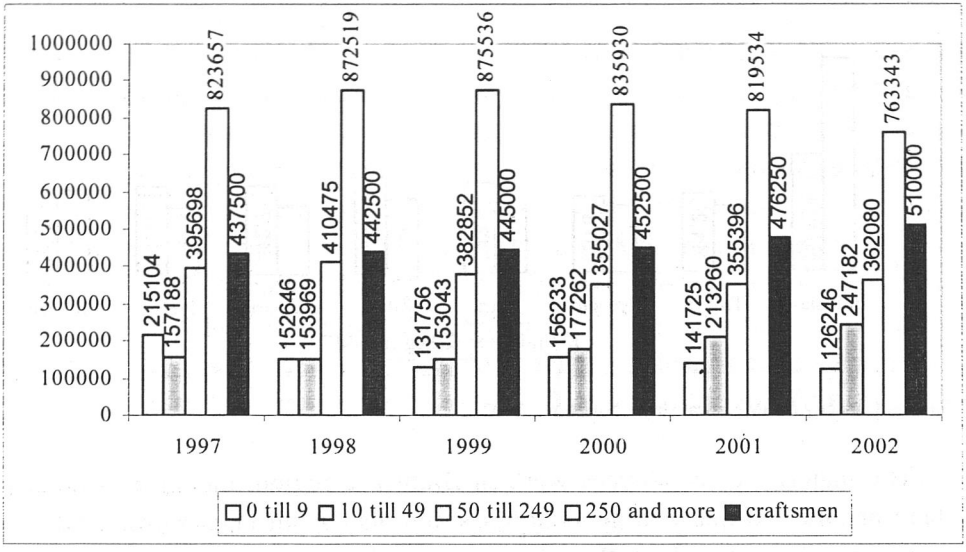
Modelling work undertaken at the World Bank has estimated a convergence to 75 of the EU per capita income (the threshold for which areas are eligible for objective status under current EU. Structural Funds rules) will take 15 years in the Czech case. Under this growth scenario, Poland will never converge and Hungary and SR will take 41 years each. If the average growth rates of these five economies are used, convergence rates will take from 28 years (in the Czech case) to 50 years (in the Polish case). The difference between the highest and lowest regional GDP per capita is 77 per cent in the Czech Republic, 43 per cent in Hungary and 56 per cent in SR Production and employment in less developed regions in SR is approximately at 30 to 36 per cent and, in better-developed regions, 38 to 42 per cent.

4. Analysis of Development of Small and Medium Enterprises

Small and medium enterprises represent a substantial part of the economy in developed countries. In OECD countries small and medium enterprises represent more than 95 per cent of the total number of enterprises, though their share of employment varies between 60 and 70 per cent. As of 31 January 2003, there was a total of 356 306 SMEs in SR and 85 per cent were physical entities. They constituted 60 per cent of the total employment. One of the conditions, which had to be fulfilled in connection to EU accession in the area of SMEs was the compatibility of the statistical register for SMEs. For this reason, a census of SMEs was carried out from March to September 2002. From this point of view it is possible to summarize that the quantitative share of small and medium enterprises in the Slovak economy is comparable with that of other OECD countries. Approximately 98 per cent of all enterprises are small and medium enterprises – and their share of employment amounted to 57.7 per cent as of the end of 2003.

Graph 3

Number of Employees According Size of Enterprises



Source: Capacity of SMEs, 2002. Bratislava: NADSME 2003.

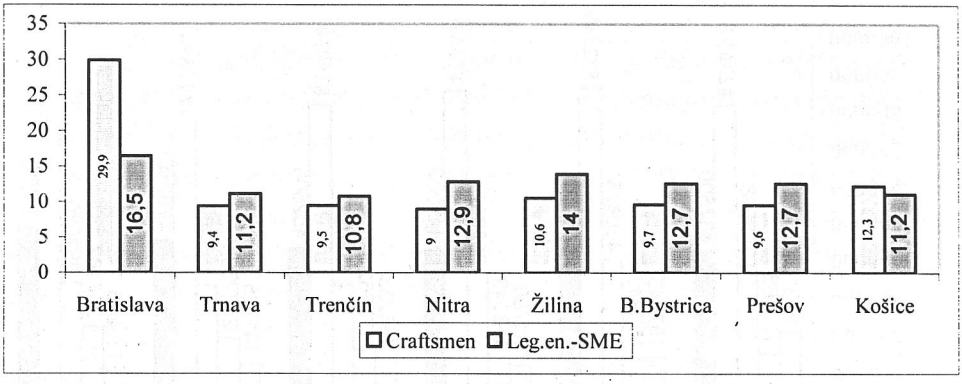
5. Regional Differentiation and the Situation in Enterprises

Current regional differentiation and the positioning of SMEs depend on individual regions and also on situations influenced by the previous socialist period. As we have mentioned before, industrial enterprises with low added value and a low rate of finalization were established in different regions. The differences in the economic situation in different regions were influenced by the fact that, particularly in those regions with relatively new large industrial enterprises constructed during the socialist era, industrial production was supported by a traffic infrastructure. In those regions small and medium enterprises founded after 1989 also enjoyed a better position (especially in the Trenčín, Žilina and Košice regions) than in SMEs in regions in the southern part of Slovakia and the Prešov region.

The dislocation of entrepreneurial units in different regions is relatively regular with only one exception – the Bratislava region. In other regions, the share of legal entities varies from around 10.8 per cent in the Trenčín region to up to 14 per cent in the Žilina region. The percentage of craftsmen is, from this point of view, much more unproportional, because the Bratislava region produces 29.9 per cent and Nitra region at nine per cent produces the lowest percentage (see Graph 4).

Graph 4

Entrepreneurial Units in Different Regions in 2002



Source: Capacity of SME. Bratislava: NADSME 2003.

The majority of employees work in Bratislava region, though in Bratislava there are located many large enterprises and also small enterprises. And from this point of view we think Bratislava is a very good example of a region where are all conditions for networking among large and small and medium enterprises This networking will also promote efficient entrepreneurial atmosphere for small and medium enterprises (Zajac, 1996).

6. Consequencies of Regional Differentiation for Enterprises in Slovak Republic – Conclusions

Especially after entering EU those small and medium enterprises, which are active in the area of foreign trade will be confronted with much stronger pressure of competitiveness. There is a certain danger the unemployment will increase. The Slovak Republic must face new challenges linked with this situation- to create new jobs not only for recent unemployed people, but also for those who will be threatened by this expected development in near future. New institutional reforms and harmonization with *aquis communautaire* should permanently support the foundation of new enterprises especially in the field of services. Especially small firms are influenced by institutional and legal measures helping them to find new sources for new technologies and finances in comparison to large enterprises and multinational firms. These small and medium firms are much more vulnerable to abuses of law and corruption. Some important reforms passed in 2003 and realized in 2004 will have probably very important influence on growth.

If we want to find some consequencies for the impact of different kind of policies on regional development and SMEs we see there is a real challenge through

the help of all described policies and especially after coming to EU those policies will increase their impact on real economic development in SR especially due regional and structural policies.

The relative loss of industry's weight within the national economy should not necessarily mean its weakening role. Slovak industry itself can manage some of new challenges, but the public authorities and the adopted form of economic and industrial policy will be needed to develop a favourable business environment. Formulation of a coherent industrial policy is a very difficult task. The industrial policy concept, its rules and goals has changed significantly as the global economy has become a reality. The recent development, trends and changes of Slovak industrial policy have reflected those of EU industrial policy. To foster and to increase the competitiveness of Slovak industry on domestic and international markets has also been the main goal of Slovak industrial policy. At present, the Ministry of Economy of the SR is elaborating a new draft of industrial policy. Only the consistent elaboration and application of horizontal oriented concept will guarantee the continuous improvement of the competitiveness and quality of products and services with which Slovak industry – competing on European market – is looking to win.

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