

## Business services in Hungary

Editor and head of team:

Éva Palócz

This study was prepared by KOPINT-DATORG Ltd. in the spring of 2004 at the request of the Ministry of Economics and Transportation. It contains the assessments of the study entitled "*Measuring the current situation of business services in Hungary; advice regarding operational strategy, directions for development, with special attention paid to small and micro-firms*". Closed in May 2004.

**Serial Editor:**

Veronika Pásztori

ISSN 1216-0725  
ISBN 963 7260 03 X



KOPINT-DATORG  
Economic Research, Marketing  
and Computing Company Limited

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Budapest, March 2005

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**Project Manager:**

**Eva Palocz**

**Members of the working team:**

Éva Palócz  
Judit Hamar  
Lilla Jutkusz  
Ágnes Hárs  
Rozália Bogó

KOPINT-DATORG Economic Research, Marketing and Computing Co. Ltd.

H-1081 Budapest, Csokonai u. 3.  
Phone: (36-1) 459-4241 Fax: (36-1) 303-9588  
[www.kopint-datorg.hu](http://www.kopint-datorg.hu)

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## I. Hungarian and international trends in business services

### 1. Introduction

Economic thought has come a long way regarding theories on services. This journey was long not in terms of time, but rather, in terms of the merits earned along the way. For, a couple of decades ago, services were still considered a factor that slowed the rate of economic growth. In other words, this sector was deemed to have a low productivity which could be increased only at a slow pace; it was considered a sector whose mechanization, standardization – all that increases productivity in the manufacturing industry – could only be realized to a limited extent. Service theories held that the continuous growth in the weight of services in the economy was *a consequence of* economic development – instead of seeing it as one of the *causes*, i.e., an important element of economic growth.

This judgment is, on the whole, accurate when dealing with *household* and (state) *public services*. In line with the rise in incomes, **households** have more income to dispose of above what they spend to secure their livelihood; they then spend this remainder on different services<sup>1</sup>. Growth in the **public** services sphere is also a consequence of economic development, since it is connected to the broadening social services of the welfare state. However, if we turn to services provided to **businesses**, traditional development theories have only recognized the important economic role of *infrastructure* services (transportation, communication) and that of financial services, primarily their ca-

capacity to lessen transaction costs. *Business services*, however, were far from belonging to this group: in this area, the most that theories would acknowledge was that outsourcing business services increases the efficiency of the manufacturing industry.

The appearance of *information technology* dealt the first blow to this traditional theoretical approach, as it became obvious that the application of information technology to business services resulted in great gains in efficiency. Further, analysts were challenged by the fact that economic growth of the United States (regarded as the world's foremost *service economy*) did not lag behind that of European countries (where the share of services is far lower); actually, in the long run, the economic growth of the United States overtook that of Europe.

The increasingly broad scope of this industry steadily strengthened the realisation that business-related services represent the fundamental element of competitiveness in developed economies. The wide, thick network, as well as the quality of these services, is not only one of the central requirements for growth of both business productivity and efficiency, it is also the guarantee that the entire economy will function as a well-oiled machine.

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<sup>1</sup> It is true that the opposite trend is also discernible, in as much as increasingly sophisticated home appliances, to a certain extent substitute or “fill in” for services; in other words, decreased time at work makes for increased free time, enabling, or rather enticing, do-it-yourself tinkering at home (Gershuny 2001).

## 2. Services within the context of European economic strategy

The developed economies of Europe have always taken a more conservative approach to “service economies” than the United States. This assertion is bolstered by the fact that the share of services in the majority of Western European economies is lower than in the US economy.

Only during the second half of the nineties did the European Union realize that the improvement of both productivity and competitiveness, as well as economic growth, was hindered by the lack of business-related services. The Lisbon Strategy brought about a breakthrough, whereby it not only broke from the earlier view, which was slightly disdainful toward *service economies*, but it placed the development of business-professional services directly at the center of strategy. The goals of Lisbon, creating a knowledge-based society, increasing the capacity for competition and innovation, job-creation and supporting small businesses are all intimately related to the development of business services.

This development finally ushered in a new era in European economic policy, which had been previously influenced by the strong industrial lobby. The elaboration of the Lisbon strategy justified, to a certain extent, the realization that the Single Market, created in 1992, has not been functioning as expected: many administrative and practical obstacles remained, especially in services. The creation of the Single Market had raised the expectation that increasing competition among services, too, would equalise and push down prices. However, at the end of the decade already, it became apparent that

breaking down institutional barriers and overcoming boundaries, in themselves, were not sufficient to incite positive processes. Many studies and empirical analyses have shown that the level of penetration of service-providers is quite low among the EU member states.

One part of the problem are the challenges posed by different cultural traditions and customs, by the lack of language-knowledge and familiarity with the terrain; these difficulties cannot be treated by regulation and their easing is expected to happen at a very slow pace. The other part of the problem has a legal-regulative nature. Given the fact that important regulative differences do not exist any more, in general, this part of the problem does not relate to matters of great importance, but rather, to regulative trifles. However, these trifles can greatly constrict businesses’ free movement, as well as the possibilities for businesses to settle in other markets and to fare well once they are there (Commission DG Market, 2000a).

The partial strategy for the development of services according to the Lisbon strategy is laid down in a document completed by the European Commission in 2003, entitled “*The competitiveness of business services and their contribution to the performance of European businesses*”. Not only does this document relate a summary of the state of business services in EU member states, but it also recommends a strategy for European economic policy in order to improve the development of business services (Commission, 2003a).

The most important findings of the report can be summarized as follows:

- Market *integration and competition* in business-related services markets is not vigorous enough to ensure and strengthen their competitiveness;
- The *inputs*, being necessary for the production of business services (labour qualification, integration of info-communication technology and capital) are *limited* both in terms of quantity and in terms of quality;
- The outputs from business-related services are not transparent and standardized enough; both evaluation (interpreting intangible assets), and documentation (quality) pose problems;
- The possibility and application of business services is limited in less-developed regions, as well as in newly acceded countries; this is especially true for small businesses.

According to the above, the main requirements for a new, *active service strategy* for business services are the following:

- It should be **comprehensive and differentiated**: applying to all types of services as well as to all service providing means. Thus, the strategy breaks with the global branch approach;

- It should enable transactions between member states to be just as **simple** as those which are carried out within member states;
- It should be **transparent**: businesses and consumers must know the elements and the results of the strategy;
- It should be **dynamic**: because the service economy is in constant flux.
- It should be **in concert** with the other policies, mainly with EU competition policy, tax policy and trade policy.

.....

In the **first part** of the this study, *international* trends in services, foremost in the area of the production, trade and capital flows of business services are presented, with special attention to European Union countries. This is where the state of the *Hungarian* service industry in analysed and compared to 5 other Central-East-European countries, based on macroeconomic *statistical* figures. The **second part** reports *empirical* results, partly based on the questionnaire conducted with manufacturing firms in the April 2004 by KOPINT-DATORG and partly based on interviews with managers of business-related service firms.

### 3. The definition of business-related services

In spite of many experiments conducted and multiple volumes of literature written in recent decades, a general definition of services has not been successfully elaborated as of yet. This is why services are traditionally defined in a negative manner. They are defined in terms of what differentiates them from goods: they are **intangible**, **immaterial**, they **cannot** be stored, etc. However, these definitions do not grasp the essence of service activities, rather they latch onto certain characteristics of services; furthermore, these characteristics they latch onto are not entirely, nor are they exclusively valid for all services.

The line of demarcation between goods and services is further obstructed by the fact that goods and services continually “slide into each other” (this is what Bhagwati (1984) calls “splintering effect”). A good can become a service and a service can become a good, while remaining essentially the same (a good example of this phenomenon, is that the preparation of a unique software is considered a service, while a standard, consumable software program is rather considered a good). An important characteristic of the process of transformation from service to

good, is that the service, when turned into a good, loses its uniqueness, and that the direct relationship between producer and consumer ceases to exist.

The difficulty in defining a service is heightened by the fact that the service sector is extremely heterogeneous, regrouping activities which are very different from each other – from the simplest (for example, cleaning, which requires only low levels of training and capital) to the most complex (for example, research and development, which requires the highest levels of intellectual labour and capital).

Furthermore, service sector can be analysed from multiple angles: on the one hand, according to the *type of activity (branch)*, on the other, according to the *consumer sector* (household, business or state). Statistics use the former, i.e. the *branch* approach; this is why primary figures are only available when working with this approach. However, these figures provide us with no information concerning which sector utilizes a given service. Now, if we want to learn something about business-related services, we must only take into account the services, rendered to and used by the business sector.

**Table 1**

**The definition of business related services (BRS) and its categorisation according to EU statistical classifications of economic activities (NACE)**

<b>Business services</b> (NACE 70-74): 1. Knowledge-intensive business services: professional services, such as IT-consulting, management consulting, R&D services, advertising and professional training; 2. Operational services: such as industrial cleaning, security services and secretarial services.
<b>Distributive Trade</b> (NACE 50-52) distribution and delivering goods and services to other sectors of the economy and to final consumers.
<b>Network Services</b> (NACE 40-41, 60-64): supplying electricity, gas and water and communication services.
<b>Financial Services</b> (NACE 65-67): financial intermediate services such as banks and insurance companies.

Source: Commission (2003)

When translated into letter-coded National Accounts, business related services regroup the production of sectors G (commerce, repair), I (transportation, storage, postal services, communications), J (financial services) and K (real estate, business services).

By *Business Related Services* (BRS), economic literature means business, commercial, network (transportation, communication, energy, gas and water supply) as well as financial services (Table 1). Specifically, *that part of the services mentioned above which are enjoyed by businesses (and not by consumers)*, in other words the part which makes

up the input of *production*. However, there is little chance of elaborating such a categorization, for the only source would be the Input-Output Model (calculations pertaining to Hungary were executed utilizing this Model as well). This is why studies put out by the EU hold that all the above-mentioned branches are part of BRS, considering that the *majority* of these branches' production is used by business.

Concerning business services within this category (the first line of the Table 1), the following grouping is generally used:

**Table 2**

**The definition of business services according to the NACE Rev.1 classification**

NACE classification	Service	Main activities
72.1-6	Computer	Hardware maintenance Software maintenance Data processing Database maintenance
74.11, 74.12, 74.14	Professional	Legal services Accounting and tax counselling Management consulting
74.13, 74.4	Marketing	Market research Advertising, publicity
74.2, 74.3	Technical services	Architectural services Engineering consulting Technical testing and examination
71.1, 71.21-13, 71.31-33	Leasing and rental	Transportation and building equipment Office equipment rental
74.5	Workforce services	Workforce recruitment
74.6, 74.7	Operational services	Security services Industrial cleaning
74.81-84	Other	Secretarial and translating services Packing services Organisation of fairs and exhibitions

#### 4. The importance and effect of outsourcing services

Every product contains a big dose of services by the time it reaches the consumer. According to some estimates, the services content of certain products reaches 80%, in other words, only 20% of finished products can be connected with a narrowly interpreted manufacturing process, while the share of services accompanying effective output is 80% (Giarini 2000).

An important aspect of growth in the service sector is the outsourcing of service activities. Aside from benefits accruing from quality and cost, outsourcing makes it possible to concentrate more on core manufacturing activities. In order to take complete advantage of the benefits offered by outsourcing, the buyer of a service must acclimatise to the appropriate organisational and managerial changes. The outsourcing of services, being the most important for strategy-formation (for example, IT, professional training, sales and marketing, product innovation) is increasingly essential in order to improve competitiveness. Sometimes the service-provider (such as human resources or information technology) might monitor the entire business activity, which can result in the outsourcing of the whole business process (BPO: business process outsourcing). At the same time, outsourcing is not a risk-free enterprise: the consumer, to a certain extent might become dependent on the service-provider. However this risk remains smaller than the economic benefits, resulting from outsourcing.

One of the new, important characteristics of the outsourcing process is that businesses *outsource* certain service activities to *geographically removed countries* (off-shore outsourcing). At the beginning of this decade, all countries – even those who earlier had shun the idea of liberalizing the process

that enables foreign service providers to settle in their countries – have made it their goal to increase the import of foreign direct investment in their services sector. While, in the past, the Uruguay Round had been defeated precisely because a part of developing countries (foremost, India) rigidly opposed the liberalization of their services markets, nowadays, all countries strive to attract as much capital as possible, among others, into their business related services market.<sup>2</sup>

The outsourcing of call-centres, accounting, research and development and software production are at the forefront of this process. Once they have settled in a foreign country, they take advantage of economies of scale and practice mass production. The most important characteristic of these outsourced activities is that, in essence, they do not have any contact with the local economy, instead they are specialised in the production and export of one specific type of service product. To this extent, they behave exactly like manufacturing industry investments.

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<sup>2</sup> It would be unfair, not to mention, that differing types of services are referred hereto. In the Uruguay Round, developing countries primarily shunned the opening of infrastructure, financial-insurance, as well as retail markets; now, however, they are mainly trying to acquire foreign investments in offshore business services, whose characteristic is not market acquisition, but, to the contrary, the increase of export capacity. In any case, during the last decade, a general paradigm-change could be observed in developing countries, concerning foreign capital in the services branch.

## 5. The importance of business related services in EU economies

At the beginning of this decade, the service sector makes up, on average, 60-80% of the GDP in developed countries and employs 70% of the workforce. Thus, we are dealing with the most extensive sector of the developed countries' economies, the importance of

which rose by 5-15 percentage points during the last two decades. Although this expansion is also present in EU countries, the share of this branch in member states lags considerably behind the share it represents in the United States.

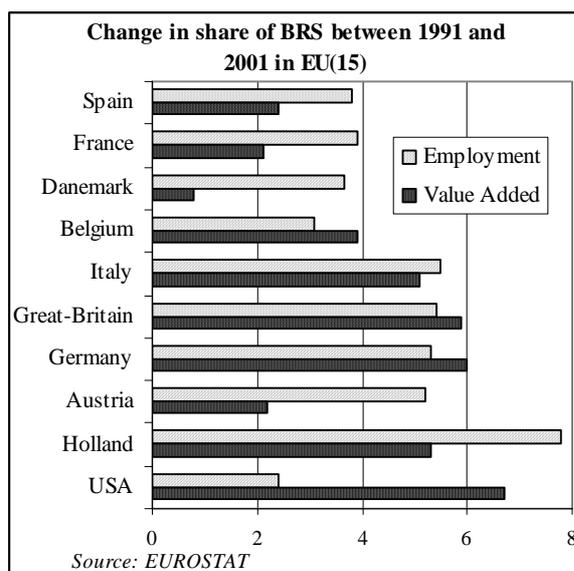
**Table 3**

**The share of services in terms of the GDP (in percentages)**

Country	1980	1990	2000	2001	2002
Belgium	68.3	68.5	69.4	69.8	69.7
Denmark	70.1	71.9	71.9	72.3	72.8
Germany			69.6	70.5	70.9
Greece	53.0	67.4	69.2	69.5	69.9
Spain	62.6	64.5	65.2	65.5	65.7
France	65.7	70.2	70.8	71.0	71.7
Italy	62.8	66.4	68.0	68.5	68.8
Luxembourg		75.3	80.1	80.2	80.1
Holland	65.4	67.6	71.1	71.3	71.8
Austria	64.0	66.7	65.9	66.0	66.1
Portugal	59.8	63.1	66.0	66.2	66.5
Finland	60.1	63.0	60.7	61.4	61.4
Sweden	67.4	67.8	65.0	65.3	65.1
Great Britain	64.7	65.3	70.0	70.7	71.2

Source: Eurostat/AMECO database

The **structure** of the services sector is also going through an important transformation.



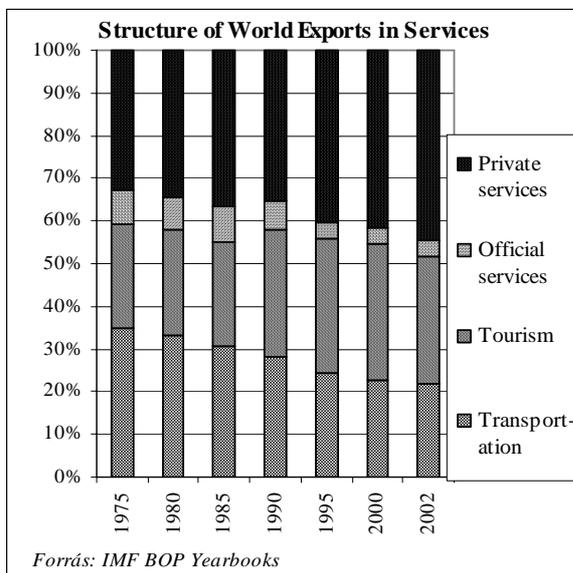
While the increase of per capita income is

accompanied by an increase in the volume of consumer services, the branch's engine of growth is made up of intermediary business related services.

In European Union countries in 2001, according to European Commission figures, 55% of those employed worked in business related services, as defined by Section 3. The share of this sector is especially high in Holland (65%) and Great Britain (61%). It is less important in Portugal (45%), Germany (46%) and Italy (48%). 46% of the sector's output is consumed by the sector itself, 11% is consumed by the public sphere, while 29% is consumed by the manufacturing industry. Thus, this sector's consumption of its own input is high, which carries the potential of autonomous growth.

## 6. The importance of business related services in International Trade

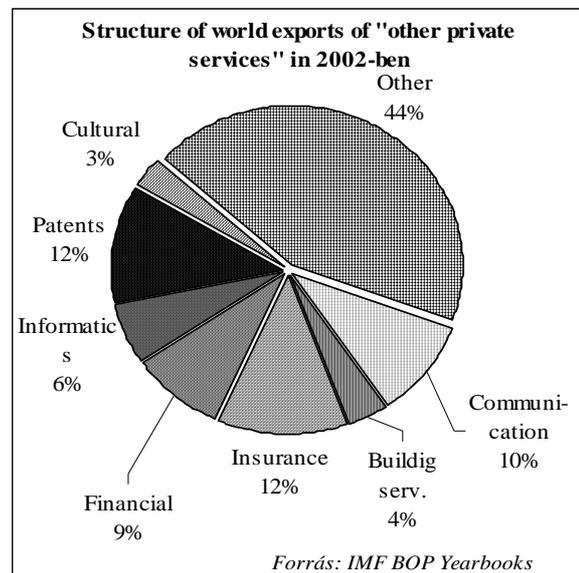
Services represent the stable part of **international trade**, which makes up approximately one fifth of the total world trade. Within this category, a strong structural shift may be observed, in favour of so-called “other services”, which are mainly comprised of business related services – the subject of our study.<sup>3</sup> The world export of “other services” doubled between 1990 and 2002, today its share is unquestionably pre-eminent, approaching 50%.



Within the category of “other services”, it is **business services**, which make up the biggest, and also the fastest growing, sub-branch. This encompasses diverse activities, be it commercial, market research, marketing, publicity, research, accounting, etc. *Insurance* services occupy the second place: only those services are placed in this category, which are not related to the transportation of goods, as these services are placed into the category of transport services.

*Patents, licenses* and *royalties* have continually represented over 10% of the global export of other services, while the share of *communication services* has been on a constant rise. They made up only 10% in 2002, but their share is expected to continue growing in the future.

The share of services explicitly linked to *information technology* is relatively low (6%), but estimating this share is very difficult, as information technology is built in almost all



services. Thus, only those information technology services are placed in this category, which are isolated from other services at the point of purchase.

The United States makes up 20% of the world export in “other services”, which, in 2002, represented a surplus of more than 4 bn dollars in information technology services, 25 bn in patents and 18 bn dollars in other business services. An important share of this surplus was generated when trading with EU countries: the majority of EU countries produce big deficits in most business services and those deficits accrue mainly in the trade with the US.

<sup>3</sup> Unfortunately, disparities between statistical categorizations hinder the comparison between domestic and foreign trade figures.

Table 4

**The import and export of business services in EU (15) countries in 2002**

(USD, million)

	Computer and information technology			Patents, royalties			Other business services		
	X	M	Balance	X	M	Balance	X	M	Balance
Austria	140	282	-142	111	1 053	-942	13 755	16 613	-2 858
Belg. Lux.	1 916	1 475	441	887	1 246	-359	11 207	10 494	713
Finland	502	374	128	559	604	-45	1 694	2 081	-387
France	1 190	1 150	40	3 240	1 960	1 280	20 860	19 110	1 750
Germany	5 180	6 120	-940	3 770	5 060	-1 290	27 910	37 110	-9 200
Greece	80	185	-105	13	288	-275	1 188	832	356
Ireland	10 426	543	9 883	249	10 347	-10 098	4 978	18 860	-13 882
Italy	390	1 060	-670	540	1 270	-730	17 040	10 370	6 670
Holland	1 422	1 586	-164	1 962	2 612	-650	20 074	21 038	-964
Portugal	76	183	-107	32	294	-262	1 000	762	238
Spain	2 487	1 572	915	370	1 810	-1 440	10 946	12 871	-1 925
Sweden	1 470	864	606	1 505	888	617	8 623	9 445	-822
GB	5 670	2 600	3 070	7 700	5 990	1 710	36 740	16 180	20 560

Source: IMF Balance of Payments Statistics 2003

Data in Table 4 shows that European countries are not competitive enough in the sphere of business services. The only significant exception is Great Britain, which has an impressive surplus both in total business related services and in the areas taken one by one. If we look only at so-called other business ser-

vices, they amassed over 20 billion dollars in surplus in 2002; moreover, their surplus grows from year to year. Ireland shows similar positive results in business related services, producing almost 10 million dollars in surplus for 2002 in information technology services.

## 7. The importance of business related services in the flow of international capital

Business related services also play a crucial role in **international capital flows**. Since services requires a stronger relationship between provider and consumer than commerce in goods does, often times, the only way a service provider can supply a market is by settling in that market. This situation has, however, started to change during the last couple of years. Lately, service providers have appeared in different countries which are not supplying the target market of the given country, instead, as part of an international corporation – similarly to foreign investments in the manufacturing industry – these entities produce mainly for export (research and development, accounting, call-centers, etc.).

This phenomenon implies a significant change in international capital flows. Concurrently, it brings about a conceptual change. In the past different characteristics and motivations had been attributed to foreign direct investment, depending on what branch was being outsourced: manufacturing industry or services. According to this paradigm, while the manufacturing industry's foreign investments by-and-large only make up a piece of the production chain – their corporations being characterized by a *vertical* expansion – the main motif of service providers is market acquisition. The latter produces primarily in order to cater to local needs, this is why services are characterized by *horizontal* expansion (they deliver the same service in every country). Although this distinction has kept a strong relevance, in certain extent has been changing: service providers, similarly to the manufacturing industry in their vertical division of labour, are gaining ground, producing exclusively or mainly for export.

Nevertheless, the majority of service providers continue to establish themselves on the local market they want to serve. This is why services represent twice the share of FDI (over 50%) than in the world trade. According to Eurostat figures, services already represented 55% of EU 15's capital exports (extra-EU 15) at the end of 2001, compared to 43% five years earlier (Passerini, 2004). During this period, manufacturing industry's share fell from 44% to 33%. Considering capital *inflow*, the share of services is even higher; it amounted to 64% at the end of 2001, whereas the share of manufacturing industry fell back from 36% to 31%.

In the framework of the FATS statistical system, at the end of the nineties Eurostat started to collect figures on foreign *owned* businesses. The first results of this survey are already available for certain countries (Schneider, 2004). According to this survey, service providers in most countries make up the highest number of businesses working with foreign capital, however they also make up a much smaller share of service trade (typically less than 50%).

It is worth noting that foreign businesses in EU countries are present at a higher-than-average rate in *high-tech* service branches. This draws our attention to the phenomenon of those services representing high-tech being particularly well-suited for foreign expansion, in part because of their physical endowments –the capacity to implement info-communications – and in part because these services hold competitive advantages that can be capitalized upon in foreign markets.

## 8. The service sector's role in newly acceded countries

At the beginning of the nineties, services made up a much smaller share of the economies of currently acceding countries than they did of old member states' economies. In 1993, the highest share of services was to be found in Hungary: services represented 61.4% in terms of the GDP; what's more,

57.1% of those employed worked in this sector. During the first half of the nineties, the share of services in production in the other countries remained well under 60%, and less than 50% of those employed worked in this sector.

**Table 5**

### Share of services in some currently acceding countries

According to level of employment and gross added value, by country

Services, G-O	Estonia		Poland		Czech Rep.		Slovakia		Hungary		Slovenia	
	1993	2000	1993	2000	1993	1999	1993	2000	1993	2000	1993	2000
Gross added value	57.9	66.2	54.0	61.3	55.2	56.8	58.2	61.3	61.4	62.7	56.8	59.3
Number employed	50.8	59.1	42.7	45.5	48.5	54.1	49.8	55.9	57.1	59.7	47.7	54.9
Total (A-O)	100	100	100	100	100	100	100	100	100	100	100	100

Note: Gross added value is summed up by branch, excluding taxes, funding and FISIM

Source: Based on national statistics, WIIW database and the computations of J. Stephan (2001), authors own calculations.

*Development in business services (K sector), with the exception of the Czech Republic, was at the forefront of growth everywhere. Among acceding countries – already at the beginning of the nineties – the economic weight of business services was much greater*

in more developed economies (Hungarian, Czech, Slovene) than in those of Estonia, Poland or Slovakia. The rate of development, however, was more modest in more developed countries (Table 6).

**Table 6**

### Development of service branches in some acceding countries, between 1993-1999

1993=100, gross added value, million EUR (PPP), measured at current prices

	Commercial branches	Estonia	Poland	Czech Rep	Slovakia	Hungary	Slovenia
G	Commerce, repair	161.5	148.8	146.4	116.2	134.0	152.1
H	Hotel services, restaurant business	187.3	223.4	99.1	44.3	121.4	151.0
I	Transportation, storage, post, telecommunications	232.8	150.8	130.1	200.5	154.8	153.6
J	Financial intermediaries	270.6	550.7	90.4	95.5	117.3	156.2
K	Business services	289.7	257.8	121.8	358.6	168.4	165.4
L-O	Public services	224.0	161.6	153.8	169.9	127.4	143.5
G-O	Services, total	217.3	173.2	130.8	158.0	140.4	151.9
(A-O)	Total	162.5	155.4	127.0	152.1	137.3	146.4

Source: see previous table

According to CANSTAT Statistics the role of services in acceding countries between 1999-2002 evolved in a very different man-

ner in comparison to the previous time period. In *Estonia*, the share of the service sector in terms of the GDP peaked in 1999 and

then, by 2002, its weight decreased, mainly due to the decrease in the relative weight of *public* services. The sector's share continued to grow in the other countries; the highest

rate of growth was reached in Poland, while the lowest could be observed in Hungary (Table 7).

Table 7

### Development of the economic role of services between 1999-2002

Gross added value =100%

	Estonia		Poland		Czech Rep.		Slovakia		Hungary		Slovenia	
	1999	2002	1999	2002	1999	2002	1999	2002	1999	2002	1999	2002
G	14.4	14.3	20.6	21.3	14.3	14.3	13.0	13.2	11.0	11.7	11.5	11.6
H	1.4	1.6	1.3	1.2	2.0	2.0	1.5	1.2	1.8	1.7	3.0	2.4
I	15.2	15.5	6.8	7.9	8.0	11.2	9.8	10.2	10.2	8.2	8.1	7.2
J	4.0	4.5	2.2	1.6	4.9	3.3	3.3	5.6	4.0	3.7	4.2	5.3
K	11.2	11.3	11.8	13.6	12.1	14.3	13.1	13.8	16.1	17.0	12.0	14.7
L-Q	20.0	18.1	17.5	20.8	15.5	15.2	14.2	14.4	19.8	23.4	20.1	20.6
G-Q	66.2	65.3	60.2	66.4	56.8	60.3	54.9	58.4	62.9	65.7	58.9	61.8

Source: HCSO, CANSAT, 2003/3

In *Hungary*, the development of the service sector during the last few years also differed from that in other countries in the fact that, while the weight of public services (sectors L-Q) decreased during the period 1999-2002 in most countries featured above (except in Poland), it was precisely this area that represented an engine of growth for Hungary. By 2002, the share of public services in the GDP was by far the greatest in Hungary (table 7). However, with the exception of business and commercial services, the share of all other service activities in terms of gross added value decreased. In spite of relatively slow growth, the share of business services (K sector) in the Hungarian GDP represented a particularly high level at 17%.

After 2000, the role of services in *employment* decreased in Poland and to a lesser extent, in Hungary; it hardly changed in the

Czech Republic and Slovenia, while in Slovakia, and particularly in Estonia, in continued to increase. However, the highest share (after Estonia) is still registered in Hungary (Table 8).

In Hungary, the fact that the share of services in employment has decreased somewhat can be explained, on the whole, by the relative decrease of those employed in financial activities (sector J); similarly to the changes recorded in Poland, and to a lesser extent, in the Czech Republic. During the two years in question, the role played by business services' (K) in employment was most significant, however, in Hungary (similarly to Estonia and Slovakia).

Table 8

**Development of the economic role of services between 2000-2002**  
Total employment = 100%; according to type of activity (NACE-classification, LFS)

	Estonia		Poland		Czech Rep.		Slovakia		Hungary		Slovenia	
	2000	2002	2000	2002	2000	2002	2000	2002	2000	2002	2000	2002
G	13.8	15.0	14.1	13.5	13.1	13.3	12.4	12.9	14.1	14.3	12.5	12.5
H	3.5	3.1	1.7	1.7	3.3	3.7	3.1	3.3	3.5	3.5	3.8	3.9
I	9.9	9.6	6.1	5.7	8.0	8.0	7.9	7.3	8.1	8.0	6.4	6.4
J	10.1	10.1	18.6	15.4	16.3	15.5	14.2	15.4	15.5	13.8	19.5	19.5
K	7.0	7.7	3.7	4.6	5.7	5.8	4.3	4.9	5.3	6.0	5.2	5.2
L-Q	23.9	26.4	22.2	21.6	22.6	23.3	26.6	25.7	26.4	26.0	21.0	21.4
G-Q	68.2	71.9	66.4	62.6	69.0	69.4	68.6	69.6	72.8	71.7	68.4	69.0

Source: HCSO, CANSTAT, 2003/3

### Foreign trade in business services

In East-Central-European countries, trade in services, among others trade in business services, is traditionally prone to producing deficits. In itself, this phenomenon is unsurprising, considering the fact that the situation is similar in most of the old EU member states (see Section 6). What is worth considering, however, is that the import of business services by this region is also particularly

low when compared with that of EU(15). Thus, a generally lower level of trade in services can be observed in these countries; this has a negative impact on the supply of business related services with domestic manufacturing firms. Although statistical anomalies might also contribute to this finding; the lower level of the imports of these services is indisputable.

Table 9

**Foreign trade of business related services in some newly acceding EU countries**  
(in 2002, millions, USD)

	Computer, informatics			Licenses, royalties			Other business services		
	X	M	Balance	X	M	Balance	X	M	Balance
Hungary	193	156	37	350	399	-49	2 232	2 678	-446
Czech Rep.	144	122	22	45	119	-74	1 489	2 244	-755
Slovakia*	52	57	-5	16	58	-42	501	693	-192
Poland	99	272	-173	34	557	-523	1 189	2 000	-811
Estonia	24	15	9	5	14	-9	196	204	-8

\* Figures for 2001

As is shown in Table 9, Hungary boasts by far the highest figures for both imports and exports in the areas analysed, namely information technology services, patent services

and other business services. These results could be related to the fact that it is also in Hungary that business-related services boast the highest share in the domestic economy.

## 9. The direct capital investment inflow in business services in Hungary

As was shown above, during the nineties in Hungary, business services, in congruence with international trends, represented the most dynamically growing sector of the economy. Between 1992-2002, the share of value added produced by business services (sector K) in terms of the GDP grew from 12.1% to 17%. More important is that, while the total number of employed decreased by 4% during this decade, the number of those employed in the service sector increased by 8%, of which sector K grew to one-and-a-half times its own size in terms of employment. In the same vein, the number of those employed in business related services as a share of total workforce rose from 3.5% in 1992 to 6% in 2002. This was the only economic branch in which – although starting from a very low share initially – the number of those employed rose extraordinarily quickly and continuously, especially during the second half of the decade. Thus, the fact that unemployment did not deteriorate to the extent that would have been warranted by the

loss of jobs in the manufacturing sector is in great part due to the expansion of business related services during the last decade.

When placing Hungarian business related services in an international comparison, it is also obvious that this is the area in which Hungary has the smallest gap to fill in order to catch up to the European Union average. The expansion of the sector approximates the EU average (according to estimates, the share of those employed in this sector is 45%, compared to the European 55%, while the share of gross added value produced by this sector is 43% in Hungary and 54% in the European average). The 48% average share of activities performed by business services for *corporations*, and the 26% performed for the *manufacturing* industry is only a little less than the 29% share recorded in the EU. As for productivity levels, Hungary hardly has a lag in this area at all (only 1% points), when compared with the serious lags Hungary has in the productivity of the industry (35%) and the public sector (32%).

**Table 10**

### Direct investment of non-residents in Hungary

		1998	1999	2000	2001	2002	2002/1998
A+B	Agriculture, Forestry	0.8	0.8	0.8	1.1	1.3	298.0
C	Mining	0.4	0.3	0.3	0.3	0.3	154.7
D	Manufacturing industry	37.3	36.3	39.4	43.8	45.8	238.1
E	Supply of electricity, gas, steam	10.3	8.1	6.4	5.3	4.6	87.4
F	Construction industry	1.5	1.2	1.3	1.3	1.1	146.1
G	Commerce, repair	8.3	8.2	9.5	11.4	11.1	260.1
H	Hotel services and restaurant business	1.0	1.1	1.3	1.1	1.1	205.3
I	Transport, storage, post, telecomm.	21.8	24.1	16.6	11.7	10.1	89.8
J	Financial activities	10.3	9.3	10.1	10.5	10.3	193.9
K	Real estate, business services	6.7	8.6	12.0	11.0	11.7	337.5
L-O	Other services	0.8	1.1	1.1	0.9	0.8	197.6
	Real estate purchase of non-residents	0.8	0.9	1.2	1.4	1.5	372.0
A-O	Total	100.0	100.0	100.0	100.0	100.0	193.7

Note: According to the new method of the Hungarian National Bank, the figures contain re-invested earnings, too.

Source: Hungarian National Bank

The large amount of foreign capital inflow into services, among them, into business services, played an important role in shaping this favourable situation. In the period between 2000-2002, 12% of total foreign investments were placed in sector K, making it the second most favoured sector by foreign investments after the manufacturing industry (table 10). But the share of foreign capital in commerce, transportation, as well as in financial activities is almost as large.

The typical trend regarding foreign direct investment inflow during the first half of the nineties, characterized by the priority of retail trade and manufacturing, turned in favour of financial and economic services. Already in

1992, the share of foreign direct investment (FDI) in capitalization (C) reached 21% in the manufacturing industry (sector D), while it amounted 15% in commerce (sector G); it continued growing at a fast pace, reaching 51% and 36%, respectively, by 1996. Since then, the rate of growth has slowed down: in 2000, the share of FDI/C only rose to 58% in the manufacturing industry and to 56% in commerce, while *business services, and particularly financial activities, became the most attractive sector for foreign investors*. Between 1996 and 2000, the share of FDI/C in business services (sector K) grew from 21% to 58%, while in financial services (J) from 44% to 89%.

Table 11

### The role of businesses working with foreign capital, by sector

Branch	Number of businesses working with foreign capital		Total number of businesses		Number of businesses working with foreign capital as percentage of total number of businesses		Invested foreign capital as a percentage of the branch's capitalisation	
	2000	2001	2000	2001	2000	2001	2000	2001
A	749	755	11 300	11 663	6.6	6.5	10.6	8.3
B	16	15	178	180	9.0	8.3	6.3	4.9
C	58	59	395	430	14.7	13.7	43.8	55.4
D	3 743	3 664	37 699	38 549	9.9	9.5	60.5	63.9
E	50	55	536	574	9.3	9.6	26.7	26.3
F	745	803	23 206	25 369	3.2	3.2	20.3	13.9
G	8 140	8 398	78 298	80 335	10.4	10.5	55.6	58.2
H	834	990	11 221	12 318	7.4	8.0	29.1	29.4
I	732	723	10 417	11 058	7.0	6.5	28.9	27.5
J	291	317	3 274	3 537	8.9	9.0	89.1	92.0
K	4 986	5 780	74 484	83 779	6.7	6.9	57.7	45.7
M	96	122	4 510	5 283	2.1	2.3	15.1	15.4
N	102	104	10 652	11 924	1.0	0.9	15.1	15.5
O	401	434	17 020	18 262	2.4	2.4	27.5	17.2
A-O	20943	22219	145043	176256	14.4	12.6	63.6	64.9

Source: State Tax Authority-Ministry of Economics and Transportation, based on the tax declaration of businesses using double-entry accounting, the author's own calculations; for the year 2001 the calculations are those of the Ministry of Economics and Transportation.

By the end of the nineties most big multinational service companies had settled down in Hungary. The next phase of direct investment flow into the services sector (which is still in

effect today) came in concert with the arrival of logistical, financial, research and development centres in Hungary; similarly to other central-east European countries.

## 10. The situation of business services in Hungary, based on empirical surveys

Two methodologies were used in the empirical part of the research. 1. The first part is based on a survey conducted among manufacturing firms who use business services as an input of production. 2. The second part

presents the results of interviews with the service providers. In addition, we made use of experiences drawn from KOPINT-DATORG questionnaires and interviews conducted on this topic during the last few years.

### 10.1. Questionnaire surveys conducted among manufacturing firms

Kopint-Datorg conducted a questionnaire survey in April of 2004 among manufacturing firms. The goal of the survey was to explore **to what extent** are **service activities outsourced by manufacturing firms** registered in Hungary, as well as to **determine, which businesses are the suppliers of these**

**outsourced tasks.** We received 184 usable answers to this survey. The branch and geographical structure of the sample was pretty much in line with the national average; however, when broken down by size, small businesses were underrepresented.

**Table 12**

**Outsourcing of service activities in the sample of businesses (%)**

	No such activity, or did not answer	Exclusively in-house produced	Mainly in-house produced	Mainly outsourced	Completely outsourced	Total
R&D	46.7	15.2	21.7	5.4	10.9	100
Product development	20.1	33.2	28.8	4.3	13.6	100
Machine repair, maintenance	2.2	10.9	54.3	24.5	8.2	100
Information technology services	10.3	6.0	33.7	28.3	21.7	100
Web-development	26.1	10.9	14.1	20.7	28.3	100
Web maintenance	12.5	27.7	21.7	14.7	23.4	100
Software development	16.3	3.8	11.4	33.7	34.8	100
Marketing and market research	17.9	23.9	37.0	9.8	11.4	100
Advertising	18.5	12.5	19.6	30.4	19.0	100
Printing services	12.5	2.7	3.8	17.4	63.6	100
Legal services	5.4	4.3	12.0	11.4	66.8	100
Accounting, auditing	3.3	33.2	38.6	8.7	16.3	100
Education, training	4.9	2.2	17.9	50.0	25.0	100
Workforce mediation	40.2	2.7	12.5	19.6	25.0	100
Real estate mediation	69.0	2.2	1.6	3.3	23.9	100
Cleaning, building maintenance	8.7	29.9	22.3	15.2	23.9	100
Transportation	3.3	6.5	25.5	31.5	33.2	100
Travel	47.8	3.3	15.8	11.4	21.7	100
Healthcare services	21.2	2.2	8.2	9.2	59.2	100
Customs administration	9.2	23.4	22.8	20.7	23.9	100
Foreign trade administration	13.0	34.2	26.6	12.0	14.1	100
Consulting on applications/tenders	37.5	2.7	15.2	19.0	25.5	100

A striking fact is that almost half (46.7%) of the businesses do not carry out or outsource R&D activities. However, this figure becomes less surprising when considering that the share of research and development in GDP is considerably low in Hungary, in comparison to the EU average. The government expects positive changes in this area, since the following three elements should contribute to reaching the EU level in funds allocated to research and development as a share of the GDP: first, the innovation law which came into effect in 2004, second, the creation of the Fund for Research and Technological Innovation and third, the establishment of National Research and Development Agency.

According to the results of the questionnaire, very few firms undertake *labour recruitment*, or use this service. This result is probably the outcome of a misunderstanding, as most businesses have a personnel (HR) department, or if they do not, they surely hire employees. Thus, surely the answers must mainly be reflecting the way of recruiting executive managers. Therefore, we can state with much self-assurance that “headhunting”, which in Western Europe is increasingly regarded as a specialized activity, has not quite yet taken root in Hungary.

Being industrial companies, almost all the businesses conduct (or outsource) *machine repair* (97.8%), half of them engage in the activity themselves and half of them outsource it. In addition, these businesses either conduct in-house or outsource information technology and legal consulting, accounting, auditing and they organize (or hire an external entity to organize) education, training, cleaning, transportation and customs administration).

*Bookkeeping* is mainly done in-house (71.8%), although businesses, required to

audit, did indicate that they are obliged to outsource this activity to an independent auditor. The share of businesses employing external services might probable reach 25% for this reason.

Businesses usually turn to the market to procure *legal services*: 66.8% of businesses acquire these services *exclusively* from external service-providers, while 11.4% acquires these services *mainly* from external providers.

Within the category of *information technology services*, web-development and software-development are typically purchased from external suppliers, while web maintenance activities are rather dealt with in-house.

*Printing services* are not dealt with in-house, either, according to respondents, partly due to the special nature of the task and partly due to the high capital costs they incur.

It is worth noting that, while businesses mainly, or rather, exclusively, outsource *advertising* (as it is not part of the scope of their activities), 50.9% of businesses do their own *marketing* and *market research* – two activities that are not branch-specific, either.

It is also striking that 35.7% of businesses do not apply on *tenders*, although they could represent important additional financial funds for business development (mainly in the form of the now-accessible European tenders). 44.5% of responding companies charge external companies with the task of completing applications.

Summing up the above, companies are most likely to have product development, marketing and market research, bookkeeping and auditing, as well as the administration of foreign trade done in-house, while they are most likely to outsource printing and legal services, trading real estate, health care services and tender consulting. They are more likely

to purchase information technology, advertising and transportation services and to do research and development, machine repair, maintenance, cleaning, building maintenance and the customs administration themselves. This result strengthens the perception that activities, **representing daily tasks**, are kept

by manufacturing companies mainly **in-house**. However, tasks, requiring **specialized knowledge** or **significant investment in fixed assets** – for example, tender consulting or printing activities – are preferably **purchased from service providers** who detain the necessary expertise and means.

### *Outsourcing servicing activities*

The service-providers of outsourced activities can be classified according to the following five groupings: 1) parent company, 2) a company created by the company, 3) other Hungarian service-provider, 4) other foreign service-provider with a subsidiary in Hungary, 5) other foreign company.

According to the results of the questionnaires, companies employ mainly domestic service-providers to perform outsourced tasks, with the exceptions of R&D and product development, where parent companies and domestic service providers hold close to equal shares. Here, the most relevant element is the price competitiveness of domestic service-providers; however, increasingly respondents feel that domestic service-providers do not fall short in terms of quality, either, when compared to their foreign competitors. We have to point out our suspicion that the respondents could not suitably discriminate between the domestic subsidiaries of foreign service-providers and the domestic service-providers themselves; nevertheless, the overrepresentation of Hungarian businesses remains a striking feature.

The parent company carries out product development in 52% of the cases, research and development in 44% of the cases, marketing

and market research in 30% of the cases and the foreign trade administration in 20% of the cases. It is not typical of the parent company to play a role in printing services, tender consulting, education and training, health care services, customs administration and in transportation.

We found a significant inverse relationship between the size of the company and its willingness to outsource. Smaller businesses are more likely to outsource service activities, due to the lack of capacity to perform activities that not intimately related to their core competence. Many respondents listed this as the “other” reason for outsourcing (i.e., not the need to increase efficiency or lower costs).

Foreign-owned companies are more likely to outsource their service activities, domestic businesses are, however, less likely to make use of the opportunities of outsourcing. Nevertheless, the majority of businesses have not changed their in-house activities during the last three years. The biggest difference regarding the outsourcing of activities is encountered in the areas of research and development, in product development, in marketing, in cleaning, in building maintenance and in transportation.

### *Reasons for outsourcing activities*

The answers lead us to conclude that businesses expect increased efficiency first and foremost from the outsourcing of R&D,

product development, marketing, advertising, training and consulting on tenders, while regarding machine repair, maintenance,

printing activities, legal services, cleaning and transportation, cost-reduction was the most important aspect. According to the differentiation above, it can be observed that aiming at improving efficiency, businesses outsourced activities requiring *special*

*knowledge*, i.e., having fairly high human resource costs. Businesses do not find it profitable to employ people with high qualifications (and high wages) whose type of work is not related to the company's daily activities.

*Results of the survey can be summarized, as follows:*

- Manufacturing firms have recognized the advantages of *specialization*, i.e. that outsourcing activities that do not fit their profile directly, increases efficiency and lower costs.
- Activities, requiring specialized *knowledge* and a great amount of fixed asset investments are preferably outsourced;
- Outsourced activities are primarily carried out by *domestic* service-providers;
- *Smaller* businesses, for lack of capacity, tend rather to buy these activities on the market;
- *Foreign-owned* companies, probably owing to their more-advanced corporate culture, outsource their activities to a greater extent;
- During the last three years, outsourcing has slowed down; however, the retrieval of outsourced activities is not typical at all.

## **10.2. The situation of business services in Hungary, based on interviews at service providers**

Thus far, we have tried to highlight the situation in the market of business services in Hungary, based on available international and domestic statistics, as well as on surveys with manufacturing businesses. In the following, we summarize the experiences learned from the in-depth interviews, concerning the characteristics and market size of the most important business service activities, the strengths and the weaknesses of given markets, the expectations of the company executives and the main impediments business development. We attempted to choose, from the narrowly defined areas, some companies belonging to big, international consortiums, as well as some in domestic hands and some small and medium sized companies (both domestic and foreign-owned). We also strove to reveal the characteristics of the market, based on information

from professional unions, trade chambers and web pages. In this analysis, we excluded real estate transactions (70) and the leasing of machines (71) from business services (K), in part because of the relatively small impact of the former activity on corporate competitiveness, and in part because of special character of the leasing activities. We only dealt briefly (conducting a couple of interviews) with info-communication technology and research and development (72-73), since a good deal of information pertaining to these activities is already available. We included a couple of companies dealing with transportation in our analysis, since this area recently went through some swift changes.

In the following we attempt to summarize the main characteristics of this heterogeneous group, and to touch upon the specific characteristics of the given professions.

### *10.2.1. A market with multiple actors*

All the businesses surveyed described their services market as highly competitive. Supposedly, this response cannot be entirely explained by the well-known psychological phenomenon that all market actors find their own market to be extremely competitive. The market for business services is indeed characterized by strong over-supply, which is caused by, among other factors, the relatively low level of investment needed to enter the market. For the same reason, the failure rate is also relatively high. Nevertheless, due to the low cost of entering the market, the losses incurred are generally significantly less than those afflicted by failure in the manufacturing industry. The market for and supply of business services is extraordinarily colorful, encompassing a multitude of actors; the entire corporate spectrum is represented in this branch: from 1-2 person companies to multinational corporations. Medium-sized enterprises are also found at a relatively high rate; however, these are generally companies with

networks, or companies, employing a great number of sub-contractors.

In certain markets, a healthy division of labour has developed between market-leader multinationals and smaller domestic companies. In this division of labour, the clientele of the multinational company is made up of multinational corporations similar to itself, while the domestic smaller companies mainly concentrate on domestic clientele. In addition, domestic companies have grown strong enough in many market segments to cater to multinationals.

In order to assess the market structure, it is important to mention that there are a good number of foreign-owned businesses among smaller companies too, which typically operate as part of a greater international network. However, independent companies, which are built on some sort of unique relationship with a foreign partner, also exist.

### *10.2.2. Multinational companies: market leaders in every sector*

Most markets for business services are characterized by the dominance of 3-5 big multinational firms. This is not only true of services requiring professional, high-level of specialized knowledge, but also of activities like cleaning, which does not necessitate a high level of preparatory training. However, reliability, brand-name and the application of high-tech, remain important factors for these services, too.

Foreign capital has a decisive role in large and medium-sized businesses: in the case of large companies, with few exceptions, foreign capital usually represents 100% of ownership, but its presence is significant also in the case of small enterprises. Although foreign capital appears in different forms in this

profession, the most typical is 100% ownership.

The over-representation of multinational service-providers is particularly severe among the clients of foreign-owned manufacturing companies. For, a significant part of multinationals in the manufacturing industry “bring along” their usual providers of business services when they settle in the Hungarian market. In the case of particularly sensitive services, i.e., services relying heavily on trust (as accounting, tax consulting), it is typical for the entire conglomerate that all members of the group use the same service-provider, wherever they may be situated in the world. As we learned from the questionnaire (point 10/1), the independence of sub-

subsidiary management, in choosing providers of strategic services, is very limited. Many multinational companies prefer to keep other types of strategic services, such as research and development and product development, in-house (at company headquarters); although in many recent instances, cost cutting seems to be more important than guarding production technology secrets.

### 10.2.3. *Diversification of activities*

Foreign-owned companies as well as domestically owned firms are both continually in the process of broadening their scope of activities. For multinational corporations, the intention to carry out differing services, even services that are substantially different from one another is a natural course of action. While, in the case of smaller service companies, this course of action acts as a must – or rather, an opportunity – which holds the possibility of increasing their likelihood of survival. In order to broaden their offer of services, R&D companies carry out education

### 10.2.4. *The role of image-building*

Almost all businesses surveyed stressed the importance of honesty, reliability, flexibility and precision in work. Small firms can stay afloat thanks to the best of all advertising, namely, that after a job well done, the client recommends the firm to other prospective clients. A good chunk of the interviews mentioned that the expansion of their clientele happened slowly, progressively, after having received good references. Small businesses

### 10.2.5. *The importance of human resources*

The role of competent and reliable employees is much higher in business services than in any other branches. The majority of busi-

In certain cases, the relationship between multinationals producing goods and those providing services is so strong that, not only Hungarian service-providers, but other Western service-providers could not come between them, either. There are, of course, exceptions to this rule and the interviews show that many Hungarian service-providers succeed in getting multinational clients; however, this is not the norm.

and training, cleaning firms also provide security services, quality-controllers offer environment management systems and work health inspection, while providers of logistical services offer complex marketing services. Thus, service-providers strive to offer their clients *complex service-packages*, making business-transactions with these providers more comfortable. By offering these complex systems service providers can improve their competitiveness and, at the same time, make use of their “image” offered by brand names.

have no other way to build their image, as they usually do not possess the means required for advertising campaigns.

The employees’ level of professionalism, as well as their reliability and know-how, play an important role in image building. These days, without an ISO-label, no service-provider will be entrusted with an important order.

ness services perform extraordinarily intense intellectual work; although, the importance attached to reliability and the respect for

work-standards is significant even for cleaning services. In general, wages make up 40%-60% of total costs – at times, even more.

The experience, fieldwork and professional past of employees are the main strengths of these companies. In this respect, smaller businesses are frequently at a disadvantage: bigger companies offering higher salaries oftentimes lure away young employees who were trained by smaller businesses. Not only do these big companies offer more money, they also provide better career opportunities. Generally, well-known companies look for employees with 2-3 years of experience, and this experience is often gained by young professionals when working for smaller busi-

nesses: “*we are a training base*” opined the head of a smaller R&D company.

An important characteristic of service-provider employees is that they have a *high rate of atypical employment and part-timers* (occasionally employed external experts). This is mainly due to the fitful character, the seasonal fluctuation, i.e., to the nature of the work itself. Translating firms are not the only companies, working with a few people employed (mainly tending to administrative tasks) and with a network of hundreds, sometimes thousands, of outside workers: almost all businesses in the services branch work in this manner. However, this tendency sometimes leads to chaotic situation on the given labour market.

#### 10.2.6. *Obscure market structure*

Since business services have high human resource expenditures but low investment costs, expenses incurred in order to enter the market are very low. The market’s biggest problem is that because of the low barriers to entry, numerous service-providers who operate today are not fit to survive in the long run, as they do not have the required skills and social capital. However, these service providers can depress prices even on the long-term, as those businesses that fail are constantly replaced on the market by new entrants.

Due to the lack of barriers to market entry, there is a high rate of less-competent businesses. This fact has a negative effect on small businesses in particular, since it creates

a feeling of distrust towards small businesses, shifting demand towards large companies with trusted brand names.

Competition on the market is further distorted by the high rate of companies practicing black market employment or some other dishonest activity (such as using illegal software). These practices enable firms to significantly decrease their prices to level where honest businesses cannot compete. In order to establish clean competition and a clean market environment, it would be important to strengthen professional associations, who would expel companies who deteriorate the reputation of the profession. These associations work well in certain professions, while in others, they remain weak.

#### 10.2.7. *Market deformation*

A significant share of the service-providers surveyed mentioned that state agencies making up a large part of commissions in many professions, discriminate against smaller service-providers by requiring large

capital endowment and own financial resources that smaller operations can not provide. Many respondents mentioned that that no transparent system of appraisal exists. State agencies often seem biased in favour of

some outcome, at times appearing politically motivated. In contrast to the public procurement of homogenous, standardized goods, in the case of services, the price of the service, as the only factor of decision, may be misleading. For, it is less than certain that the

quality of the service will turn out to be truly satisfactory. This is why other factors may play a part in the appraisal process, which, however, opens up the possibility of arbitrary decision-making.

#### *10.2.8. Regional concentration is strong*

The concentration of business services in Budapest is extraordinarily high: businesses with headquarters in Budapest dominate almost all branches. Most local service-providers cannot survive due to the small size of the regional market. If they do survive, however, they tend to vegetate and the rate of failure is high. This is very unfavourable for the supply of services to regions other than Budapest, causing inequalities between the markets to grow. While Budapest experiences a strong over-supply of services, the countryside often does not have a satisfactory array of services. Thus, precisely those areas where

there is the greatest need for the improvement of competitiveness through business services, the relevant services are often missing.

However, a distinct trend is emerging: businesses with headquarters in the capital are beginning to expand in the countryside and are striving to build nation-wide networks. Some do this in order to meet the need of expansion to further markets, but some build on the possibilities of cheaper labour force than that of Budapest. Teaming up and networking of regional service providers in the countryside cannot be observed, yet.

#### *10.2.9. Efforts to expand over the border*

The majority of service-providers produce for the local market. This is even true of multinational firms, since other countries are served by their other subsidiaries. However, this does not exclude cross-border co-operation: either between the different subsidiaries of a multinational firm (in the event that a lone subsidiary does not have the capacity to tackle a couple of bigger-sized commissions) or by capitalizing on other types of professional relationships (for example, if a tender is awarded to an international group).

Most of the service-providers surveyed, even the smaller ones, are positive about the new possibilities created by EU accession. They find that their best chances for expansion are in the markets of acceding countries. According to firms dealing with research and development, they will continue to have a

good chance at winning EU projects, mainly by entering tenders together with institutions from other countries. Firms dealing with market research hope that there will be increasingly more interest in the opportunities offered by the Hungarian market, which will have the effect of increasing the number of commissions from abroad.

Most other professions agree that their market possibilities have increased by having acceded to the EU, as they offer competitive services to foreigners at relatively *low prices*. However, the low capital intensity of small companies limits their possibilities, since above a certain firm-size or regional penetration, a high degree of technological equipment and information technology background are required, for which these small companies have no financial resources.

## II. Main elements of a possible strategy for services

The strategy of economic policy, concerning business services, as a matter of fact, is not essentially differing from the goals and tasks of the complex economic strategy, used in other branches of the economy. The weights and combination of these economic means, however, might be somewhat different. The most relevant economic policy areas toward a business related service strategy are:

- Improving the situation of SMEs;
- Intensifying the capacity to attract capital;
- Strengthening knowledge and innovation skills, as well as R&D and atypical employment;
- Supporting the expansion of information communication technology.

These are also, by and large, the main goals of the Lisbon Strategy, coupled with disassembling barriers to trade in services among member countries, resulting in increasing support for competitiveness and disassembling the barriers to Single Service Market.

The fact that the means to developing business services are essentially the same as the means used in industrial policy, does not imply that it is not worth elaborating an independent strategy for business services, either within industrial policy or separate from it. The points of emphasis differ and **the characteristics of business services necessitate a specific type of approach**. Moreover, highlighting the aims and means of the services strategy is also important because it is **currently in the centre of European Union interest**. A slew of studies and guiding principles are being written on this subject, to which Hungary can only contribute if it has a developed strategy.

As we have seen, Hungary finds itself in a particularly favourable situation concerning business services. This situation came about partly thanks to the relatively benign economic environment, already existing before the transition. The more liberal economic policy employed in Hungary even in the planning system, than in the neighbouring countries, was of crucial importance for possibilities of services development. Today, however, these inherited relative advantages have become inconsequential. This is why a new service strategy should be elaborated on the basis of the international and regional requirements. During the past few years, Hungary has again managed to improve its position: increasingly, multinational corporations – be it R&D, accounting or software development – are choosing Hungary as their services centre.

The **goal** therefore is to keep, and to strengthen, this position. Having said this, we did not mean a slogan without any content, such as: “Hungary should be the region’s (business) services center”, since this is – due to the varied and differentiated character of services – not a realistic goal. However, there is a possibility for Hungary to fill a central, or at least an important, position in the region, regarding *certain* services. This has already begun, partially. Branches such as the following could be successful in this respect:

- ⇒ research and development,
- ⇒ information technology industry,
- ⇒ logistics,
- ⇒ and certain professional services, such as accounting, legal consulting and marketing.

## 1. Supporting micro firms and small companies

Favouring small businesses is at the heart of the services strategy: micro firms and small companies make up the majority of this branch. While the contribution of SMEs to the production of GDP does not reach 20%, in production of business services, however, it surpasses 40%. It is striking that businesses without employees make up 5% of this category, while they only make up 1.2% in the GDP as a whole. Thus, the development of business services depends to a large extent on economic policy towards small businesses.

In Hungary, the legal background for funding small businesses is basically satisfactory for business services development. Moreover, it is an integral part of the Economic Competitiveness Operative Program, as well. *In practice, however, economic policy is still too industry-oriented and focuses less on services.*

In order to strengthen and develop the market position of small and medium-sized enterprises the following measures are necessary:

- ⇒ Increase the role of **venture capital**: they are already present in Hungary, but so far their activities have been mainly concentrated on manufacturing firms.
- ⇒ **Easing the access to credit**: aside from commercial bank lending to small and medium sized enterprises, different forms of subsidized financing would also be important. *State-founded institutions, non-profit organizations and foundations* can also play an essential role in the mediation of subsidized financing.

⇒ **Tax system, tax allowance**: although the *corporate tax rate in Hungary* is competitive in an international comparison, taxes on smaller businesses are high. Taxes make up, approximately, one half to one third of the net income of small businesses. Tax allowances are mostly in favour of large businesses. Typically, tax breaks and reductions in taxable income for small and medium enterprises are exploitable mainly by manufacturing companies – although they are made available to services companies, as well.

⇒ Aside from direct and indirect funding, small and medium-sized enterprises might be supported by **consulting activities**. Marketing, proposal writing and other business counselling can greatly improve the results of small businesses.

⇒ Persuading businesses to join **supplier networks** can also contribute to their long-term survival. These services can be made available to SMEs through *intermediary organizations*.

⇒ A particular problem is presented by the fact that small companies are routinely pushed into the background when competing for **state tenders**, due to capital requirements, or to expectations relating to previous levels commissioned or to foreign references. State requirements practically exclude small domestic companies, professional service-providers, designers and consultants from being awarded state commissions.

## 2. Stimulating foreign investment

During the second half of the last decade, the business services sector became the most attractive area for foreign direct investment. Meanwhile in 1998, only 6.7% of in-flowing capital went to sector K, by 2002 it increased to 11.7% (see table 10). It is not primarily the *value* of capital investments that shed light on the importance of foreign service-providers on the Hungarian business services market: since the end of the nineties, roughly all globally expanding business services have been present on this market. In the category of foreign-owned business services, the economic indicators per capita are twice or thrice as favourable as the average of the entire domestic economy. This shows that foreign-owned businesses contribute to the increase in labour productivity.

The share of foreign-owned firms, according to the number of companies, is low, at 9% on average. However, in 2000, close to one-fifth of the total number of those employed worked at companies operating with foreign capital. These companies produced 36% of revenues and 65% of exports. The average size of these companies was more than double that of domestically owned firms. Their supply of equipment was four times as large, capitalization was eight times, while their export intensity was seven and a half times that of domestically owned companies.

Despite this, the paradigm regarding foreign investment is still very much manufacturing-oriented. The stereotype that mainly foreign investments in manufacturing industry are contributing to economic development and employment still exists. Although it is true that exports are mainly due to foreign investments in the manufacturing industry, there is an increasing number of investments in services currently, whose scope exceeds Hungary's borders – what's more, in some instances, it exceeded the boundaries of Europe. These types of services centers,

aside from the fact that they produce exports (which do not appear in the foreign trade balance, but only in the Balance of Payments), also enable Hungary to fill a distinguished position among European services centers. Now, if Hungary wishes to be a regional services center, then attention has to be devoted to it, like the attention paid to investments in the manufacturing industry.

However, the system of requirements for funding is still tailored to the characteristics of the manufacturing industry: it does not contain *qualitative* requirements, only *quantitative* ones (size of capital invested, number of people employed, etc.). It is worth considering the idea that economic policy should support the establishment of a big services company in Hungary even when it does not have a big impact on employment – since it increases the exports of the Hungarian services economy, and has other indirect beneficial economic effects.

No doubt, there exists a certain fear of foreign service-providers. This fear stems from the belief that the strong domination of foreign service-providers decreases the legroom of smaller domestic services on the market. In practice, however, this type of squeezing off the market is very rare: foreign-owned companies offer services which domestic ones would not be able to provide – if for no other reason than the often-mentioned importance of brand name and image. The defences of small businesses should not be sought by discriminating against foreign service-providers; instead, it should be reached by supporting the small domestic businesses. During the last year, ITDH, the Hungarian state agency for attracting FDI, managed to draw a substantial amount of foreign capital in the service branches.

### 3. Employment, innovation and the funding of R&D

Business services are the agents of both **knowledge-based skills and innovation-skills**: business services in the U.S. carry out 34% of the entirety of R&D activities (value terms), however, this rate is only 13% in Europe. Moreover, business services enrich manufacturing activities with new innovative methods and processes, improving effectiveness and contributing to higher *quality*.

In order to improve the competitiveness of the Hungarian service economy vis-à-vis developed countries, both the private and the public sector must increase their R&D expenditures and the number of patents.

This strategy has the main elements, as follows:

- Reorganizing *higher education*: improving the relationship between educational institutions and the business world such as the partially funded teaching of business studies (broadly defined), as training for the unemployed. Introducing “*entrepreneurial university*”, which is already present in Western Europe. These are organizational units of a university, which work as a mediating body – or at times, as a venture capital fund to provide seed money – helping to put research results into practice, to get them out on the market and enabling the creation of spin-off enterprises.
- *Providing information*, for building economic and technological relationships through a relevant system of institutions (connected to international institutional networks).
- *Maintaining direct state funding* – of innovation, R&D, supply, cluster development and *incubator* development programs – as specified in the development plan.
- Supporting the *patenting* of the creations of those inventors and computer experts who do *not* have capital.
- Transforming the system of requirements for public procurements – the local and the central government’s *procurements* of goods and services – in a way that would enable *innovative* small and medium sized enterprises to participate.
- More favourable tax rates: similarly to German and British universities, research and development should be VAT-free, improving the possibility of publishing scientific works through the use of more favourable tax brackets, income tax rates, etc.)
- To have significant research tenders in the most important subjects (and not tailored to the needs of governmental daily measures) for the long term (and not in the framework of public procurements which are suitable only for goods procurements).
- Enabling labour force *mobility* by supporting the expansion of atypical forms of employment (long-distance work, part-time jobs), through tax measures.

#### 4. Info-communication

**Info-communication** technologies (ICT) are of special importance to business services, since they enable the development of indispensable network systems, and are often needed for communicating with clients. They greatly improve the chances of integration for small businesses; they also create a network that small businesses can use to co-operate with one-another. Although the so-called New Economy (which uses information technology) does not eliminate inequalities between smaller and bigger firms, it does mitigate these inequalities.

- Following the EU's example, it would be expedient to introduce a program in Hungary that would be similar to "Go Digital", by which SMEs would get a chance to integrate more intensively into the information society; also, such a program would significantly boost demand for activities offered by ICT service-providers.
- Regarding the digital future of Hungarian SMEs, it would be very important to publicize the *European e-Business Support Network* (eBSN), announced in the framework of e-Europe 2005. Furthermore, it would be important to create the Hungarian version of this portal, since Hungarian firms are increasingly dependent upon the economic, legal, market and other type of information, offered by the EU for SMEs.
- It would be expedient to create a specific *electronic marketplace*, where the IT needs of Hungarian SMEs, organized in categories, could be consulted free of

charge. What's more, the offers of service-providers could also be presented – if possible, in many languages – on this portal. By utilizing this dual approach, one can enable the "matching" of what ICT service-providers offer with what the SMEs (sometimes only latently) need, thereby improving the competitiveness of both sides.

- It would be important to introduce – following the British example – the institution of *certified ICT service-providers*; the essence of which is that those service-providers that wish to compete for government tenders must pass a test administered by a panel of independent experts and by a council made up of the representatives of potential users. If they pass this test, they get on the list of "royal suppliers" which is to be widely published, and from which both the public and the private sphere can readily choose their partners.
- Currently, the biggest procurer of ICT services is the public sphere. This is why it is very important for these firms that the transparency of public procurements be guaranteed, as well as the required ICT standards be determined. The most important prerequisite of the former is the introduction, without delay, of electronic public procurement, while the most important prerequisite of the latter, is the creation of an inter-operability framework for Hungarian e-government activities.

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