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The Hungarian SME Sector Development in Comparative Perspective

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INTRODUCTION

by
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The theme of this volume is most welcome. The benefits from an expanding SME sector are well known. Several long-standing OECD countries demonstrate that the SME sector is crucial for stability and growth. This sector facilitates innovation and provides comparatively larger room for labour redeployment and promotion. A sometimes neglected aspect of SME's development is that this is also a sector in which labour can make comparatively better use of their working environment to learn not only how to improve its skills and the quality of products, but also acquire managerial skills. In the Italian region of Veneto labour mobility to better jobs is extremely high, so much so that some entrepreneurs have a hard time in retaining workers who want to leave and create their own business. In this region 69 per cent of enterprises have been created by SME workers and employees. This is a region whose exports are about as high as those of Greece and Portugal together.

The development of the SME sector is one of the most important structural changes which occurred along the path of transformation to market in central and eastern Europe. In some countries, such as Hungary and Poland, this development started even before the large-scale transformation which was undertaken in the nineties. The problem is now how to promote further expansion of SME and their consolidation. There is a risk, as in any process of rapid economic restructuring, that, while the initial supply and demand factors which sustained the shift to individual and small scale business are fading away and competition is increasing, timely policies and institutions which should provide for continuity and growth are not paid sufficient attention.

I would like to draw attention to some crucial factors for, and obstacles to, the development of SME in the second stage of transition, which is that of sustainable growth, and offer a lively discussion of the necessary environment for the expansion of SME in this volume.

Firstly, the macroeconomic environment should be such as to stimulate the growth of SME, rather than delaying it. There are links between macroeconomic policy and institutional adjustments which need to be kept in mind. These have to do, primarily, with interest rate and tax policy. While at the start-up of small business, working capital was found in our resources and self-financing in business characterised by high turnover and the level of real interest rates did not much matter, at the present stage one should seriously take into account how to promote the conditions for access of SME to bank credit. A steady decrease in interest rates and reduction in the crowding-out of private lending by public borrowing cannot be attained if monetary and fiscal policies are not geared toward concomitant fiscal consolidation and price stability. Interest rates cannot be brought down if budget deficits and public debt are not brought under control. One must also keep in mind that high interest rates contribute to the appreciation of the real exchange rate which makes it more difficult for the SME to compete with foreign business.

While it is difficult to cut social expenditures at a time when social strains due to large-scale economic restructuring are still under way, *the temptation to tackle social problems by increasing tax on production should be resisted.* More thought should be given to rationalisation of expenditures and targeting of social benefits to the needy, while gearing taxation policy in such a way that production sectors and, particularly, labour intensive SME, find resources for growth.

Secondly, the remaining *institutional barriers to SME growth should be removed.* This policy pays more, from OECD experience, than muddling through forms of direct assistance. A proper institutional framework for SME needs better education and training, competition in the banking sector, functioning markets, including land, real estate and venture capital, opening to foreign direct investment and contract enforcement laws and institutions.

While transition countries had comparative advantages in education, the *matching of skills with demand for labour in SME should not be taken for granted.* Vocational training should be geared to new activities, including services where it is inadequate. Through competition in the banking sector, interest spreads can be brought down steadily, making room for access to credit also by SME. Through labour market mobility and collateral requirements, labour redeployment and *flexible pay-setting arrangements,* SME may find the labour needed for expanding business. By easing the real estate market, new business finds easier access to land and premises and a better environment for expansion. A functioning *real estate market* provides easier conditions for housing and labour redeployment, collateral for credits and room for new undertakings.

As the financial system matures, the steady development of a market for venture capital can provide a source of capital for entrepreneurs, and the mechanism for investors to diversify their financial participation in this inherently risky area. While at the beginning of transition, excessive focus was put on the need for keeping or attracting high technology, a more sober view of what are the comparative advantages of transition countries would suggest that the *most lively sectors are often found* in *subcontracting for foreign companies.* These are export-driving activities in which the presence and flexibility of SME is crucial. The need for *contract enforcement institutions* has often been overlooked. A market economy cannot work without a well functioning judiciary, which would guarantee contract enforcement. While the institutional framework should provide better room for entry, it should also provide *room for exit*: bankruptcy laws and procedures need to be rapidly adapted to these requirements.

A proper institutional framework also needs *better state administration.* This includes a simple and fast registration of new business, fair provision of public goods, disciplined tax authorities. By enhancing state administration and civil service, the spreading of bribes and corruption of public officials, which is often an effect of cumbersome access to basic state services and public goods, can be, if not halted, at least minimised.

Business often asks for state action and intervention. In market economies there is room for state action. But this should be directed to a better functioning of state administration and economic policy, rather than indulging in discriminatory policies (such as sector-specific policies). Tax policy, for instance, can best assist long-term planning by enterprises if the *policy rationale is clear and robust, and, if emphasis is placed on low, broadly based taxes.* Simplified taxation *procedures* and flexible regulations concerning depreciation are also of great help to small business. Another area of concern should be *social security* and its cost for employers. In some emerging market economies, including Hungary, the level of social contributions has remained too high (around 45-50 per cent of wage cost). This is a problem also for many long-standing OECD members of Europe. *If a steady growth of SME is looked for, this problem should be tackled seriously.* In many cases, high rates of social

...ontributions contribute to the expansion of the shadow economy. While this could be tolerated for a while, and one might even accept that the shadow economy offered a social and economic buffer during the early stages of transition, one should not neglect the fact that further SME growth is impeded by the shadow economy. There is no room in modern market economies for illegal medium-scale enterprises. When a small firm grows to medium size, it reaches a threshold beyond which it needs to become legal. One primary way to stimulate individual and small businesses working in the informal sector to make this leap is to erode the economic incentives to hide. In the area of social security, a number of more effective schemes can be developed which would shift the burden of financing from employers to workers, while opening to the latter the opportunity of voluntary insurance schemes and channelling their savings towards funded schemes rather than pay-as-you go schemes. Poland has moved this way, even with comparatively lower demographic constraints. Other central and eastern European countries with ageing population cannot endure further delay.

Part I.
EMPIRICAL EVIDENCE FROM HUNGARY

THE MACROECONOMICS OF SME DEVELOPMENT IN HUNGARY: A SUPPLY-SIDE APPROACH

by
László Csaba*

Introduction

This study is part of a project where empirical investigation of the taxation and market environment of SME in Hungary is conducted. Complementary studies include a survey of experiences in other central European countries, of competition policy, of venture capital, the room for a special banking agency to promote SME, as well as the retrospective view of what the market socialist heritage hase implied for the 90s. Being aware of the availability of a comprehensive overview of organisations and activities currently underway (*Kállay, L.* et al, 1997) we take a selective and normative view. *Selective* in so far as we address some issues that seem to be neglected in the respectable body of available literature/including the propositions of interest representations. *Normative* is our approach in the sense that we attempt to present some of the findings, based on the *international experience*, that could be relevant for the specific Hungarian environment. We shall examine some radical and less radical propositions under the point of view of *implementability* and *policy relevance*. Therefore we shall address some propositions which may well not reflect the highest available theoretical standards, but are being advanced by those shaping legislation currently in Hungary.

A theoretical framework for SME-supportive policies

Supply-side is to denote the theoretical approach taken in the course of our investigations. This line of thinking is not to be mixed up with its vulgarised form, stemming from the first *Reagan* presidency, and advocated also in the Hungarian public – rather than professional economic – debates, calling for generous tax and social security contribution cuts as the single and immediate way to economic recovery. As it can be formally demonstrated, tax cuts may or may not transform into more investment, depending on a large number of variables, including the state of financial intermediation, the expectations of agents on profitability, and the benefits to be reaped from alternative uses of the gains, from consumption to investing it abroad.

The supply-side approach here is meant to denote a concern that *public policy has the task to help adjust the forces that bring about non-inflationary growth.* Its task is to create a transparent regulatory frame, supply various sources of externalities, get the basics right, and last but not least, assist individuals to self-help

* Useful comments by *Kamilla Lányi* are appreciated.

... It attaches a high priority to *integrating people in societies in a productive fashion*, while avoiding paternalism, and leaving the elbow-room for them to find ways to capitalise on their decentral knowledge, and elaborate appropriate responses reflecting their own choice and tastes.

From this angle supporting the SME sector is of utmost importance, both as an element of generating new entries and innovative new firms (this is the purely economic component). A further – social – task is integrating people who were forced out of previously predominant large-scale socialist industry,[1] agriculture and public services, and currently earn a living from the irregular economy, from social transfers or – most frequently – a combination of both. *Competition*, as well as engaging people in *creating wealth* (rather than just caring about their subsistence) is seen as a value on its own right. It deserves public support as *a form of externality*. The latter accrues to society in the form of a wider choice of goods and services on the one hand, and less crime, less *éxclus*, more social cohesion, broader acceptance of the market economy and private enterprise, as well as of parliamentarism, on the other.

While understandable, it is still paradoxical that Hungarian SME studies focus on the EU experience. The latter group of countries achieved a different level of ocio-economic development. Corporatism and the pre-eminent role of chambers has long history in northern Europe and in the German speaking area, which is ertainly not the case in Hungary. Many of the countries in comparison usually have ong-established currency stability and the rule of law. Others have always had a ocio-economic structure dominated by SME, still others enjoy both. Thus the rrangements in the EU are normally based precisely on those premises which lungary has yet to create, and not in the distant future, but preferably before and uring its EU-accession. In this perspective it might be more relevant to look into ther comparable areas, where bringing about the institutional infrastructure, ivouring SME development, is equally in the making. From this perspective, the *atin American and Russian experiences* might be more illuminating, than omparisons to, say, Switzerland.

It is important to see, that while the EU bureaucracy does have a tendency to andardise everything, from cucumbers to birth control appliances and opening urs, the practice of EU member-states varies according to any quality one cares to ention. This holds for adopting statist versus decentral means of SME supports, the le of preferential financing etc. (*Román*, 1998, p. 75.) – and this despite enduring orts to elaborate the statute of the European Enterprise. Thus the range of options policymakers is relatively wide.

There are three customary ways of looking at the SME sector. The *political* proach sets out from the fact that two-thirds of Hungarian employment is in this a. In the particularly sensitive 1992-95 period no less than 80 per cent of those laid from the large scale sector found re-employment in the SME (*Kőhegyi*, 1998, p. . Therefore this view sees it primarily as a large part of the electorate, and makes ish, though vague and unoperational (or irresponsibly radical) promises to cut lic dues in order to gain public support. The second approach is that of the fiscal horities, who are hard-pressed to raise revenues at the time of *fiscal stringency*, ecially if current account adjustment is needed. This view sees the SME sector as a n of organised cheating, and acts – in the name of wage-earners, or of an

[1] In 1988-93 about 40 per cent of all jobs were lost in the Hungarian economy.

imagined social justice – as a counterbalancing force.[2] What entrepreneurs see as simple harassment is seen as a duty to enforce public dues from the other side of the counter. Finally actual or self-nominated *interest-representatives* of the SME sector often conduct an old-fashioned "more money to me" type of simplistic lobbying, calling for financial transfers or tax holidays, irrespective of vertical and horizontal equity considerations. In many cases the subject is about who should administer public money, preferably with little or no accountability.

In the more theoretical literature there are other, more serious ways of looking at the issue. One favours SME as a response to the crisis of the large corporation manifest ever since the oil price hikes. This view sees *flexibility* – from the industrial organisational point of view – as well as *employment generation* and market-led *structural adjustment* – from the macroeconomic point of view – as the major benefits in supporting the SME (*Tibor*, 1997, p. 19).

Much of the innovation literature also highlights the role of smaller firms, and not only in the Silicon Valley context. In many sectors, diseconomies of scale emerge, servicing specialised needs may turn more profitable than producing simply more. Flexible working hours face a large social and economic demand.[3] Besides outsourcing, subcontracting and the quest for self-employment, protests against being integrated in a large hierarchic organisation, all contribute to the boom of this sector (*Román*, 1997, p. 48). Thus, contrary to the traditional view, SME in an advanced economy need not be part of the backward sector. It is rather the standardised, low-skill-intensive activities that continue to be concentrated inevitably in the large-scale sector. In fact, the spread of personal computers have helped bridge deficiencies in physical infrastructure and foster the tendency towards decentralisation.

It is important to bear in mind that SME – the world over – constitute *a wide diversity of activities*, from highly skilled computer specialists and tax advisers to subsistence farmers. This also means that there is *no single* appropriate *or optimal way* of promoting the SME sector. Various elements in the long continuum require quite different care, if any. Therefore attempts to solve problems by passing a SME law or setting up a single agency – a quasi-ministry on the US SBA model – to administer all related public funds[4] seem to be ill-fitted, since these offer a formal-bureaucratic answer to the challenge only.

International experience (cf. e. g. *Cotter*, 1996, p.50) calls for distinguishing at least two basic types of activities: those aimed at supporting *survival-oriented poverty alleviation* programmes, and those helping small firms to *graduate into fully-fledged business ventures* with an improved *potential to grow into* normal or even *medium sized business*. Whereas the first is important basically for social goals and the success indicators are set accordingly – like empowering low-income women to find income and improve nutrition of children – the other requires facilitating mid-level business, with a view of their future wage-income generating abilities.

The first type of activity could be especially useful in Hungary as a means to *fight depression and the ongoing social deprivation especially of the gypsy minority* in the eastern and northern areas of the country. Social policy up until now was

[2] The tax authority's withholding legally granted tax exemptions on equity grounds e.g. in 1995 was a clear sign of self-interpretation of this executive organ as a custodian of equity.

[3] This is the core idea of the *Jospin* government's employment promoting policies; more work does not imply more of the same e.g. between 8.00 and 16.00 for everyone.

[4] It is interesting that the suggestion came recently from a high fiscal official (*Székács*, 1998, p. 42) and the Budapest Chamber of Trade and Industry (as reported in: *Népszava*, 20 Apr. 1998).

... retraining courses. With the very high costs of commuting – as against the minimum wage levels – retraining and other active labour market policy measures were mostly a waste, as retrained people had no *better access to local employment*[5] *possibilities*.

In the second set of activities an important change could be observed in the 1990s. Hand in hand with the ongoing policy reforms the tendency was to *help small enterprises* graduate, i.e. grow out of their self-employment level, and turn them into normal business ventures, while helping those parts of their activities which are particularly vulnerable. In so doing both Asian and Latin American experience point to the paramount importance of *getting the basics* right (*Torecko – Kolshorn*, 1996, p.44). Without a stable currency, low public deficit and positive real rates of interest, further a transparent regulatory frame no amount of special programmes or incentives will be of assistance.

Then comes the so-called *meso-climate: opportunities* (like that of importing), *competition* (like contestability of markets, low entry barriers), *resources* (reliable supply, business networks) and *supporting institutions* (esp. at the regional level). This would support the call for a decentralised support scheme in Hungary, where local municipalities should develop their co-financing facilities (*Dóczy*, 1998) as a major means to operationalise their pro-business statements.

The above sketched international experience is instructive on several plains. First, while previously SME development was seen as a sectoral programme, *now it qualifies as a macro-task*. Second, if previous emphasis was laid on special incentives and support schemes, now it is on the *overall regulatory environment*. Third, while previously SME policy focused on cheap money and low interest credit, currently the emphasis is on *crediting viable self-sustaining units*, thus the focus is on the intermediaries rather than on the recipients.

The state of art of SME in Hungary

Tables 1-5 present an overview of the quantitative aspects of development in the Hungarian enterprise sector over the last few years. It is interesting to note that individual ventures started to stagnate in 1995 and contracted in 1996-97. The other major form of typical micro-enterprises, the non-incorporated firm, has also been registering diminishing growth rates ever since 1993. Table 3 also is indicative of the stagnation of the classical start-ups, whereas the statistical term "functioning enterprise" refers to the fact close to a third of registered firms are dormant.

Román (1998, p. 73.) is even more cautious noting that about a third of individual ventures are only auxiliary, others perform services – like letting flats – which do not usually register as entrepreneurship, furthermore act as a defence against fiscal arbitrariness real entrepreneurs diversify their activity. Thus they have more than one firm to hedge against unforeseen bureaucratic intervention and cover actual costs/profits. In this respect the SME sector is less than well developed in Hungary, although 96.7. per cent of employees are working with micro and 1.8. per cent at small firms (cf. *table 2.)*

The fragility of the small business sector is well reflected in table 5, with the minuscule share of small firms in crediting and the contraction of net crediting to this sector. The lot of the firms seem to follow the overall macroeconomic pattern in terms

[5] As the study of *Tóth* on market relations highlight labour supply constraints on expanding business in western Hungary, the mobility and the skill aspects come to the fore.

of geography as well (*table 4*), with Budapest booming and the depressive Borsod contracting the most.

The fragility of the SME sector is relativity easy to explain. As the policies of the 1990-97 period were dominated by current account concerns, the domestic market contracted or stagnated. As a recent quantitative analysis (*Borszéki*, 1998) demonstrated, this has implied a fundamental rearrangement, basically to the detriment of middle classes. While both conspicuous consumption and subsistence activities – together with the irregular economy – expanded, traditional middle classes have struggled with eroding incomes up until 1997. In other words, the *major constituent of final demand for the output of SME sector was in a very poor shape, which put a severe limit on its possibility to expand.* As SME is not the typical exporter in most countries[6], only the regeneration of domestic demand may create a more promising perspective from the macro-demand perspective – and it is likely to come.

Another explanation for the fragility of the SME sector is offered in tables 6-9. While large firms were paying only 31.6 per cent of total taxes (against 45 per cent in 1992), they were enjoying 71.7 per cent of all tax reliefs (against 26 per cent in 1992) and received 43.5 per cent of all subsidies. This is indicative of anything but a neutral tax policy stance, reflecting the *overgenerous tax holidays* granted to multinationals in a period *when the initial uncertainly phase was already well over.* In the period between 1992-95 58 per cent of all investment sources were generated at large firms, 26 per cent at medium sized, 15 with small and only 1 per cent at microfirms (*Kőhegyi*, 1998, p. 52.). The latter is an indirect proof of the widespread assertion that many, if not most, of the microfirms are unsophisticated ways of avoiding public dues, especially the crippling social security contribution. This happens by nominating wage-earners to entrepreneurs, while the latter continue to perform employee functions under a more favourable arrangement, without becoming much more Schumpeterian than before.

Independent business surveys have also supported the validity of the traditional division between profit oriented entrepreneurs and small business, where major sources of subsistence and the major activity is running the family shop. According to *Bencze* (1998, p. 170) more than half of the small firms do not set up a formal business plan, even for themselves, or if so, they are valid mostly for 6 months only. Lack of strategic thinking, insufficient knowledge of the regulatory and market environment are seen as major weaknesses and obvious areas where the setting up of consulting centres, preferably on a co-financing base, could be of help. This, of course, has nothing to do with the aspiration of some chambers to accumulate even more public policy competencies than some of them require (*Vereczkey*, 1998). Instead, it recalls recently successful Latin American experiments of the IADB to set up units *that gradually become self-financing* while supporting the SME firms in their graduation process.

Similar findings were arrived at the analysis of the medium-sized firms. These often suffer from the lack of access to proper sales channels as well as their weak decision-making capacities, antiquated assets, and underfunding. *Benedek* (1997, p. 58.) sees a combination of these factors as the major reason for the suffocation of this enterprise category. They did manage to find the market segments which are still willing to buy their products, but the profit margins are too low for them to allow for

[6] Even if many small firms engage in sales abroad, as documented in the market relations study of *Tóth, I. J.* in the present volume, the bulk of Hungarian exports originates with MNCs.

... marketing channels. Here various forms of *collective marketing* and even temporary reliance on *outward processing traffic* might be a solution. This might justify public investment into collective marketing and training programmes as well as *partial* co-financing of the related consultancy fees.

Knowing the basics of Hungarian macroeconomics we can already establish a few points where the basics are not right. First, the unilateral support of larger firms is not justified in general.[7] The possible exception could be the early transition period, when psychological barriers to entry and inflated risk-expectations need to be overcome. This did apply for the 1988-92, *not however for the post-1994 period.* Second, as several analyses demonstrated (e.g. *Voszka*, 1995), large firms tended to enjoy – mostly covert – *preferences through individual bargains,* like debt rescheduling, tax holidays, guarantees extended in the privatisation deals, environmental clean-up costs taken over by the state property agency, and the like. Third, the level of consolidated public dues in Hungary is next only to Sweden. This goes hand in hand with a lax administration – a textbook case of how *not* to collect public dues. Thus the incentive to cheat is great, the cost of dodging is low, actual burden-sharing is unfair.[8]

Under a weak administrative capacity, economic theory (*McLaren*, 1998) suggests a cash-cow approach, in which basically one sector is bearing the whole tax burden (pp. 675-6). More or less the opposite is taking place in Hungary, where the fiscal authority is trying, with sometimes questionable methods, to collect from the SME sector all the revenue lost through lavish tax grants extended to the large corporate sector[9] as well as the even laxer control of the social security directorates, a major component of fiscal outlays (and a notorious overspender). The *standard maxim,* in which poor countries should tax less in order to foster growth, *is also not heeded.*

Transparency and coherence are hard to interpret in a system where 40 various tax titles and 183 social security items are officially registered. This is a clear indication of the tax system's being captured by special interest lobbying, as well as by the heritage of situative legislation, where items are levied on one-time policy consideration, not on macro grounds. Efficiency of the tax administration is regretfully a non-issue. Regulations abound, whose administration may, and indeed do, cost more than the revenue they raise, especially if costs incurred by others than the tax authority are also included in the consolidated bill (*Gergely*, 1998, p. 350). Administrating the Ft 2100 health contribution per employee, or checking the misuses of family allowances did cost more than the revenue raised by the enhanced compliance. Administering public procurement did cost about the same as the saving generated by this procedure. Savings gained by the Treasury Office are also commensurate to the costs of introducing this institutional innovation.

In sum, as we shall demonstrate in some detail, the *getting the basics right plus deregulate* approach has an obviously large potential for improving both the equity

[7] Regulation in general, and tax policy in particular, should be neutral according to standard economics.

[8] See the chapter of *A. Semjén* for detailed quantitative evidence supporting this claim.

[9] To my knowledge, neither the fiscal authority nor the privatisation agency posess with a consolidated record of the costs and benefits of preferences, granted by individual bargains, for the nation (the community of taxpayers) as a whole. In theory, such balance should be kept up to date and presented as part of the budget to the legislation.

and efficiency aspects of Hungarian regulation. By the same token it could create a *favourable environment to SME*, where transaction costs – including fees for tax-consultants against costs of compliance with formal rules – are disproportionately higher than in the large-scale corporate sector. Should no improvement in this macro-frame be forthcoming, sectoral and special incentives programmes including regional support schemes are bound to fail, as subordinate to the overall macroeconomic environment. An obvious example for this is that of Ukraine (*Kaufmann*, 1997), where no amount of special incentives could make up for the inadequate macro framework in generating growth.

Hungary has done pioneering work in introducing a market-based taxation system back in 1987. These reforms have implied a qualitative improvement in so far as rules of the game tended to be fixed at the level of a law, not – as previously – in various orders, circulars and other obscure official documents. In theory these rules should have been fixed for at least a year – a maxim which has still a long way to go. Last but not least, having refocussed revenue raising from corporate taxes to final consumption Hungary – unlike many other transition economies – did not suffer the fallout of revenues that plague the early transition phase.

In analysing the Hungarian tax arrangements it is worth *delineating the system* on the one hand, from the *degrees* and *magnitudes,* built into its operation on the other. Whereas the system *per se* was quite akin to those in the EU countries in terms of its philosophy and techniques alike, early analyses (*Koltay*, 1993) have already highlighted a basic compromising element: i.e. that quantitative coefficients in the system were calibrated so as to avoid offsetting major – inherited – income distributional patterns of the day.

It is worth noting that other external analyses (*Jarvis – Pudney*, 1996) also highlighted the very strong redistributional elements in the Hungarian taxation system, basically to the detriment of families with small children, and to the favour of the numerous – and politically very active – stratum of pensioners. Also lack of targeting figures among the overall characteristics of the Hungarian taxation system. Meanwhile the strong presence of special interests, like the Ft 4m tax-free intakes granted for small-scale farmers (in an environment, where someone receiving 12 months of minimum wage, or even unemployment benefit is liable to personal income tax), or the above discussed lavish tax holidays granted to foreign direct investors, are clear points in case. In sum, *the calibration of the Hungarian tax system takes little account of considerations of wealth and growth creation, whereas the redistributive elements are overwhelming.*

On the favourable side, quantitative analyses (*Tóth – Ábrahám*, 1996) emphasise two strong points in the Hungarian tax system. One is its relative strength in generating governmental revenue, even in periods of recession or stagnation. This point has been reinforced in the years 1996 and 1997 and preliminary data for 1998, when Ft 50-80bn unplanned deficits of the social security directorates could be easily made up by the unplanned additional tax revenues, stemming from acceleration of economic activities, combined with improved collection discipline.

Another favourable element of the tax system, demonstrated in detail by the above analyses, is its ensuring vertical equity. Accordingly, if indirect taxes are taken into account, no less than 37 per cent of the total tax burden is born by the upper 10 per cent of the population. The fact that a fair degree of PIT is dodged is more than *overcompensated* by the use of various indirect taxes, as VAT, luxury tax and customs duties. If anybody buys a Porsche for Ft 51m today, about 35m of it is indirect taxes; in the price of gasoline the tax content is 70 per cent.

... populist statements, voiced by some tax administrators and policymakers, Hungarian tax legislation already *does perform the function of ensuring fair burden-sharing, and the administration should not be entrusted with additional disciplinary and educationary exercises*. The latter point is particularly valid for SME sector, where complexity of the regulation, and also arbitrary implementation, figure high among the currently deterring elements. The tendency of the tax administration, particularly following the severing of the cost-accounting rules in 1996-98, *hit particularly* that half of the SME where *involuntary entrepreneurship* and enforced self-employment dominate. In a number of those "ventures" costs of living and costs of running the business *do overlap*. Attempts by the tax legislator to draw a line between the two looks artificial and cost-inefficient.

The decline in the number of individual entrepreneurships as well as the over 30 per cent dormant firms (cf. *table 1*) is a clear indication of many self-employed being pushed out from this sector – most probably to various forms of social transfer schemes and the irregular economy. This is certainly a more costly and socially more disintegrating phenomenon than the previous practices of having included private phone bills among the running costs of microfirms. The imposition of minimum taxable income limits for various trades and services obviously introduces a fair degree of arbitrariness on the side of the fiscal authority. Start-up ventures may often have high introduction and establishment costs – a fact clearly demonstrated in the 1997 loss-making of one the star banks in the country, ABN-AMBRO/Hungary – due to enhanced costs for developing customer services. Other entrepreneurships face seasonal demand only, as much of tourist services at Lake Balaton, or the small accountancy businesses, serving similar clients before the annual and semi-annual tax declarations are due. Also the regional differences, that may create a 1:4 difference of average per capita income, say, between Budapest and country Békés, caution against reliance on a national average.

Allowing the authority to estimate incomes, without carrying the burden of proof and without cost-efficient ways of appeal, is also an element of institutionalised arbitrariness, which is *not warranted by macroeconomic considerations or facts*. The overall quest for discipline, or the self-proclaimed priority to serve justice to wage-earners are, indeed, plausible considerations behind these practices. These however, do not qualify as *macro* or *economic* in their nature. Instead, a historic continuity with the socialist past, having seen entrepreneurship and profiteering as fundamentally sinful activities, seem to have shaped current practices. On the other hand, as *Gábor* (1994) correctly observed, the legacy of the second economy, of a very large grey zone between semi-legal and semi-illegal activities, the "virtue" of fighting public authorities, will be among the heaviest legacies of the period of overripe socialism, where mentalities and practices, not accepted in civilised market economies, abound.

Sociological analyses of the tax awareness in Hungary (*Kornai–Csontos–Tóth*, 1998) have highlighted a very *low level of consciousness* of the liaison between the *payment of public dues and receipt of public services*. This finding is based on the fact that much of public dues in this country are paid by employers. Thus employees are simply not aware of it, as they never see it on their wage bill, since the deduction takes place at the corporate level. Whereas some analysts strongly questioned the validity of the above quoted analysis, a recent survey conducted by the authority (as reported in *Nagy, G.*, 1998) established that 75 per cent of the citizens *reject taxation* on principal grounds, while in the Netherlands two thirds considers it as normal. Citizens in Hungary see taxation as a *unilateral* and *arbitrary* action of the state with no correlation to the level of public services.

The attempt to introduce a local tax – *teho* – generally in 1988 proved to be a grandiose failure. Local taxes – except for the 1.3 per cent tradesman-tax (*iparűzési adó*) – remained of limited importance. Analyses by a former minister of finance on the practicality of introducing property tax or wealth tax, well established in mature market economies, were inconclusive (*Hetényi*, 1995), especially if costs of administering the process are properly accounted for.

All in all, two fundamental misperceptions of the current Hungarian tax administration have become manifest. First, contrary to the normative considerations voiced in the preceding section, there is a *tendency to treat the SME sector uniformly*. This disregards the inherent diversity of the sector in general, and the fragility of SME in Hungary in particular. A second obvious flaw of tax policies is the heavy emphasis on the immediate redistributory aspects, measured against wage earners in the state sector. However, 1.5 million people lost their jobs in the public sector during transition, and the level of employment has not grown over 3.3 mn in 1997. In other words, many of those in the SME are not voluntary entrepreneurs. From the social policy perspective the real trade-off is not between wage earning employment in the public sector or self-employment, but between keeping people on various social transfer schemes, or helping them to self-help. Lost tax revenue is regained by the very fact that these people mind their own businesses rather than queuing up for various social transfers or diving down in the irregular economy.

A third, additional flaw of tax administration is *its disregard for the inherent fragility of SME*. This also is a heritage of the socialist period, when leaving the public sector for SME often meant to capitalise on obvious situation rents or monopoly profits. But sociological analyses of the 1990s have amply demonstrated that it is not the corner shop owner who leads the income ladder of Hungary any longer. Half of all new SME close down in five years even in the EU. Thus it is absolutely wrong to treat start-up businesses, or a firm after a single successful year, as a source of major wealth accumulation. *Risk premia* are also *insufficiently accounted for*. Moreover, PIT rules[10] do not even account for valorisation of asset value in an inflationary environment: all nominal gains are liable to PIT. As interest income is tax free – which is justified for macroeconomic considerations – a disproportionate overtaxation of investment in the real sector is created by the regulatory environment, not reckoning with the inherent risks in enterprising behaviour and the need to compensate for these. The cash-cow approach advocated above would require precisely the opposite from fiscal authorities. While in the 80s SME was a source of capital accumulation, in the 90s it should be taken as a *source of generating employment and social cohesion*, rather then the cash-cow element. Fiscal equilibrium – and lowering public dues – would call for *action on the expenditure side*, i. e. streamlining and targeting what remains, while *narrowing all other items where the creation of externalities is not demonstrable*.

SME policies and the room for improvement of taxation

What has been sketched above is supportive of the overall view that in Hungary the "get the basics right and deregulate" approach has still a long way to go before specific policies could also bite. In fact, quite a lot of the techniques and procedures,

[10] These apply to microfirms up to a certain value limit.

…, are already available or
will soon emerge (as will be presented below). However, as long the first things first approach is not heeded, specific policies may have little overall impact on the macro-development of the entire sector. This does not preclude that certain agents or regions may benefit from the specific policies, but for our macro-subject the implications will be meagre, if any. As empirical surveys conducted in the framework of the present project also highlighted, it is overregulation coupled with the very high level of public dues, primarily social security contributions, which inhibit the growth of SME. The regulatory failure unfolded in the preceding section aggravates this state of affairs.

The basic question is of course whether one sees a realistic possibility of lowering public dues.[11] This is not an innocent question, since it is redistribution which moulds Hungarian taxation. Cutting back public dues while expanding public services is hardly more than election rhetoric, and even for that, less than serious. As experiences with the *Bokros* adjustment package of 1995 have amply demonstrated, the Hungarian public is allergic to cuts in the already achieved level of services, even if these are marginal, or merely turn previously covert practices open (as was the case of making the services of dentists payable). Thus the room for US-style cuts is not given, since the public expectations against public services have stuck at a high level. The uproar introducing fees for highways, an established practice in most of western Europe, is indicative of the sensitivities and social strains. Without getting into the details of these examples, the latter show the clear social limits to ideas of simply rolling back state redsitributory practices.

Detailed and mostly unpublished calculations made in the course of public finance reform committee activities in 1995-96 have clearly indicated the practical and quantitative limits to the oft-argued option of offering more for less via better organisation. These may well be virtuous steps in their own right, not however conducive to major fiscal savings or efficiency improvements . The latter is particularly trivial in the area of *health care*, where both improved medical technologies and better medicines cost significantly more. A population leading a particularly unhealthy way of life, plus ageing, by and large preclude any suggestion that saving in the health sector could be forthcoming. Dampening the cost-explosion already requires heroic efforts and conflicts in the established pattern of managing health care.

The other major item is *pensions*. Here the problem goes as follows. In the 1988-93 period about 1.4 million people have been transferred from (covert) unemployment to the pension scheme, through various disability schemes, early retirement options and the like. Whatever one thinks about the merit of this option, it is already given for present policies, as these entitlements are irrevocable. Should reforms in the future preclude any misuses of these options, the stock problem still remains. 3 million pensioners against 3.3 million employed today, with a worsening proportion and poor payment discipline in social security contributions set the elbow room for fiscal cuts narrow in this area.

Analyses of the now unfolding pension reforms in Central Europe (*Müller*, 1998) as well as those in Latin America over the last two decades (*Nitsch*, 1996) are equally stating the limits of introducing reformed, partly privatised pension schemes. Problems of the new generations joining these may well be solved. Problems of the older generation, especially those not qualifying for the private schemes, or actually hurt by the investment failure of these funds, must be kept on the public funding, in massive orders of magnitude. While pension reforms do help broadening the scope of capital markets, which is a plus in macro-terms, they *do not*, as originally visualised, *contribute to alleviating the public financing burden* on the pension outlays.

These macro-constraints act as hard budget constraints, i.e. put severe limits on any easy-go solutions to cuts in social security contribution. The latter would be a must for the SME sector, especially for enhancing its ability of job-creation. From this it follows that *expenditure cuts will remain top priority* for fiscal policies. This has two immediate repercussions for Hungary.

1, The state should *refrain from taking up new implicit commitments*, especially ones that have lasting, legally binding repercussions for later periods. Lavishness in the already overcommitted public pension scheme is inadmissible. Offering new services free of charge and abolishing currently payable items by making them free of charge looks irresponsible.

2, The *externality* consideration needs to be much *more seriously implemented* (not only preached) *than before*. It is hard to see e. g. what externality direct export subsidies on farm products create. It is hard to see what externality the free flight of pensioners on Hungarian carriers generate. It is hard to see what externality is created by bailing out private banks. Thus the room for manoeuvre in this area is given and making use of it should become a top priority. The more public the misuses of preferences become, the greather is the probability that the median voter and the median MP (or journalist) would support "fiscal cold-heartedness" rather than – as usually – blaming it.

One of the traditional bottomless barrels of the Hungarian general government has been social security spending. The semi-autonomous directorates are postulated as self-governing agencies by the Constitution. Management of these has been a carrot given by the *Antall* government to the union bosses in early 1993 to accommodate them amidst transformational recession. The construction worked, as was to be expected, with no checks and balances – a notorious overspending has emerged.

The need to regularise the spending practices of these funds hase been highlighted by the ongoing scandals as well as their regular lack of observance of limits set by legislation. The recurring of these is a clear sign that not occasional mishaps, or individual causal factors, are to blame. Therefore the socialist-led government in July 1997 passed an amendment basically putting the directorates under the control of the fiscal authority. This, however, fell short of preventing a similar 70 to 80 bn overspending to reoccur in 1998.[12]

Therefore projects elaborated under the socialist-led government called for more rigorous collection of social security contribution and the administration of these by the single tax authority (as reported in *Tinnyei*, 1998). The argumentation is based on the fact that social security authorities are partly run by employers, who are directly disinterested in severing collection. The problem with this proposition is that it *precedes* the constitutional amendment that would re-nationalise the funds (as proposed by the new centre-right government). Lacking this amendment the

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[11] This is particularly important, given the strong (empirically tested) correlation between …s and potential employment creation, established in the study of *Mária Lackó* in the present volume.

[12] Ft 48bn for the first five months of 1998.

... is bound to outlaw the planned stipulation, as it has no jurisdiction over changing the wording of the current Constitution.

In fact, as long as the pay-as-you-go schemes operate, de-statisation of the social security system is a mere formality, thus there is a logic in the attempt to recentralise. Another important item is the severing of disability schemes (cf. *Sóvári – Tinnyei*, 1998 reporting the document of the Ministry of Public Welfare). Outlays for this scheme were Ft 44bn in 1992, 79bn in 1996, 98bn in 1997, and 125bn in 1998. Even allowing for inflation, the trend is seriously off the mark and requires mending. In one proposition regular reviews were introduced, disabilities set only for limited periods of time, and incentives to make use of remaining working abilities enhanced.

Yet another area of reducing public spending would be to subordinate the property holding/privatisation agency to the Treasury Office, so that consolidated and controlled spending activities – including taking up environmental, reorganisation and employment guarantees in privatisation deals – could be recorded, consolidated and publicly controlled. Extending the competence's of the TO to social security directorates would be an obvious technique to forestall regular overspending of public money by public authorities without fiscal control.

Another area where public spending could be curtailed would be to regularise the practices of *public procurement*. The ongoing propositions, elaborated by the public procurement council (and reported by *D. N.*, 1998) call for more publicity and less bilateral "invitation" that, by definition, discriminate against SME.

Chopping up orders in order to avoid the validity of public procurement should be penalised. Signing the contract could first take place 8 days after promulgating the verdict, thus discontinuing present practices, where appeals can attain partial damage repairment at best, since contracted deals can not be withheld or undone by later court rulings. These measures would effectively support SME and a very important chunk of the domestic market could be opened for them.

On the revenue side of the budget better administration of available rules, coupled with sustaining recovery can (create) miracles. This was documented by the implementation of the rules on excise tax(*jövedéki adó*), which has resulted in the enhanced registered sales of petrol by 12 per cent. and of gasoline by 17 per cent in the first quarter of 1998, i.e. a year with a very mild winter (*Miklós*, 1998). As 48 per cent of fiscal intake originate from excise tax, consumption tax and the related VAT, less lavish practices can generate much more intake than the invention of new forms of tax, let alone the harassment of tens of thousands of "small fishes".

This rudimentary overview presents both the limits and the possibilities for improvement of overall tax policies, and sets the pace for SME-related arrangements. While room for quick fixes is not given at all, more discipline in the administration of general government finances, based on some of the available pieces of legislation, as well as other pieces in the phase of elaboration *may create the* currently non-existent *elbow room for improving the lot of SME*.

This presupposes a very consequent conduct of fiscal stringency on both the revenue and the expenditure sides. It further requires a strong deliberation on the side of decisionmakers *not to use available savings for other purposes than tax reliefs*, like social transfers or public investments not generating externalities, or income support schemes of various sorts. This is easier said than done. In 1997, for instance, savings on servicing domestic public debt were spent on increases in pensions, which has, of course, precluded any possibility of decreasing the consolidated tax burden. In other words, *the gradual but constant decrease of consolidated tax burden is to become a top priority for overall fiscal policies*. Under this condition small but steady improvements can be realistic, which over a couple of years may well add up to a *sizeable relief* from the present burdens of SME.

It is important to see that in this approach the priority to SME is justified by the self-help effort of those involved, by the consideration of enhancing social cohesion, as well as by the priority of creating new employment in a decentral form against the conspicuously failed "active labour market instruments" including public works programmes of the recent years. Public dues are going to be cut not only for SME, thus the truly *public nature of the benefit* is trivial. On the other hand, as SME starts from a dispreferred state, they are *likely to benefit significantly more* than other agents.

Deregulation and SME development

Deregulation is a tremendously unpopular task within the state administration, whose job is to control, and whose standing is enhanced by a large number of rules and discretionary powers, even if no corruption were to be spotted. From the point of the individual bureaucrat the more detailed regulations are, the smaller is his individual responsibility for obviously bizarre outcomes. Thus the tendency to overregulate is natural, especially with the Austro-Soviet legal heritage and under conditions of democratic uncertainty. This natural inclination must be countervailed by deliberate policies by the overseeing authorities. Such attempts as to ensure all entrepreneurs report monthly on computer diskettes is reported as a deterring example from Brazil (*Holden*, 1996, pp. 31-32). Of similar effect are the rigid and toughly enforced national labour standards, disregarding the marginal productivity considerations for the individual worker (who may simply be by crowded out of the job market by this seemingly socially-minded practice). In the case of Hungary, the setting up of labour market police and its regular uncovering of illegal employment, or the attempt to require computerised reporting from all entrepreneurs, were clear examples where the natural deliberations of bureaucracy have been dominating the more general pro-business arrangements.

Deregulation should be on the banner of the government, and *regular bi-annual deregulation drives* on the 1989 model (when all regulations lost force that were not positively required by writing by somebody interested) could *enhance the rule of law in the economy*. Standardisation of record keeping, observing already existing laws on informational sovereignty, the limitation of the number and the nature of data that can be required by various authorities, are all ideas originating in the second half of the 1980s. Still, they have a long way to go before shaping Hungarian practices.

According to both our surveys and the propositions of the chambers of trade and industry it is *overregulation* which hampers employment and expansion in the SME sector most. Looking form the other perspective, introducing *compulsory cost-benefit accounting before new legislation is passed* may be a way of forestalling the recreation of unnecessary and inefficient pieces of legislation. Internal (non-public) limits in Forint terms under which trespassers will *not* be prosecuted could help avoid most of the harassment currently deterring individual entrepreneurs.

Abolishing several formal rules may be a most efficient way of SME support. Coping with these constitute – also according to Latin American experience – the most significant items of search and entry costs, as well as overheads, which smaller firms are unlikely to pass over with such an ease as larger firms can or may (cf. also *Holden*, 1996, p. 29.). The simpler and more transparent the rules, the easier it is to enforce them, and the easier it is to internalise them – thus smaller the lure of using a parallel informal arrangement of the irregular economy.

... important to bear in mind, that macro-improvements proposed above are *lasting, sustaining solutions to some of the traditional headaches of the SME sector in Hungary*, which could never have been remedied as yet. The sustaining nature of the proposed options render these superior to specific programmes, tailored to individual segments of entrepreneurs, or to individual situations. For instance the current *supplier* or *subcontracting programme* is likely to be captured by larger firms, as it is easier for them to bear the overhead costs needed to search and ensure quality control. Likewise only larger firms can benefit from *innovation programmes* – like those of OMFB in Hungary – as smaller firms can hardly advance the capital needed to produce a prototype product. Finally, cheap money tends to induce *rent-seeking* behaviour and *accommodativeness* rather than robustness, also adjusting behavioural responses within microlevel.

Additionally, the EU has just rejected a proposal that would have supported labour-intensive services, through *tax cuts*, in order to support employment. This is bad news for most of the SME research in Hungary, having advocated similar types of solutions. Our analysis is in line with the philosophy of the EU ruling on public welfare and distributional neutrality grounds.

One of the strongest arguments favouring the supplier programmes is the widespread belief, most recently voiced by *Diczházi* (1998, p. 26) that *exclusively large firms/multinationals create growth in the Hungarian economy*. Meanwhile, domestic firms, especially SME stagnate or even contract. This, however seems to be a somewhat mechanistic and extremely one-side macro-view. First, the SME sector – similar to western Europe and developing countries – should not be seen in a romantic Schumacherian way as the basic engine of macroeconomic growth. Rather, it is a part of social intangibles with important possible spillover effects for the economy. Thus, it is not realistic to measure actual processes against an abstract model of SME-led growth, but against the very real threat of structural underemployment.

Second, recent business surveys of Kopint as well as the market relations study conducted within the present project are indicative of *growing interlinkeages between the SME and the large corporate sector*, even in terms of exports. Yet another alternative studies (*Balázs*, 1998, p. 101) have shown sales to the domestic market to be of lower profitability than are exports.

This was due primarily to the nature of current account adjustment policies, having redistributed GNP in favour of external uses. As long as the domestic market started to recover, as indicated by the study quoted above, and reinforced by the surveys of ours conducted later, profitability of SME supplying more for domestic end- or processing users also started to recover. These are indications of a *more organic interrelationship* between the MNC and the SME.

The future of SME and options for promotion policies

As long as we do not cherish the irrealistic hope for a small business economy, there would be nothing wrong in the dominant role a of MNC in qualitative and macro terms in so far as this is not a sign of a pre-reform Latin dual economy, where local and multinational businesses hardly overlap. Our own survey, the ones quoted above, the business surveys of Kopint as well as alternative analyses of the SME sector (*Laki*, 1998) highlight the plurality of SME. This implicates the corresponding variety of options, with some obviously developing a useful symbiosis with the exporting sectors domestic activities of MNC, whereas others loosing out.

It might well be too early to hypothesise over the future pattern of co-existence between the MNC and SME in Hungary. What we have experience in the decade of transformation was that *theories postulating the reproduction of inherited structures*,[13] the predominance of inherited networks, or other static equilibria proved to be empirically poorly founded in so far as these were relevant only for peculiar – transitory – periods of time or for certain stages of development. This could be demonstrated with cross-ownership, with the problem of payment arrears, the lack of bankruptcy, or the tendency to buy markets rather than localities for further expansion in the context of FDI.

Generalising this experience may allow a more optimistic view of the future of SME, which, of course, is yet to be tested by future empirical investigations. In the latter view, following the transitory phase, the Hungarian capitalism will be just like any other European brand on the similar level of development. This means a coexistence of a basically export-oriented MNC and related sector on the one hand, and a basically local-market-oriented SME sector, whose certain segments subcontract or live in symbiosis with the large scale sector.

Should the latter view hold, which is at least plausible, and also follows one possible reading of the empirical surveys of this project, supplier programs and centralised institutions and promotion programmes would look *misplaced* at best. All these are liable to falling hostage to groups and individuals with far more barraging power than a median entrepreneur in the SME sector. In this view if public money is made available for the purpose of support schemes for SME, this *should be spent decentrally for one or more of the following options*.

1. Organised *poverty alleviation programmes*, adopted from the IADB, and targeted for ethnic minorities, in our case the gypsies, to involve them in socially useful activities. These ventures may well not graduate for a long time, but keep people away from the socially destructive doing nothing, and create a stakeholder stratum at the bottom of society.

2. Training programmes for *new start-up business in the depression areas*. This would include a fair degree of free or subsidised consultancy on matters of taxation, management, simple record keeping and the like.

3. Building up or expanding *tax consultancy services* as extended parts of the tax authority. This is a costly proposition in terms of space, personnel and informatics, however it may improve tax compliance, if for no other reason, better than the tax officials better peeping in the cards of the entrepreneur.

4. *Standardisation of the information base* of the tax, social security, statistical and municipal *administrations*. As long as this is not performed, any deregulation is likely to be reverted very soon. For instance, the simplified registration procedure effective from 1 July 1998 is already undermined by the fact that all authorities require additional pieces of information on additional forms. This is likely to render the entire procedure actually more costly and time-consuming than before, although it is called the single window procedure (cf. *Magyar Hírlap*, 9 June 1998).

5. Elaborate *simpler*, more *transparent* and *unambigous rules*[14] *of taxation*, even at the cost of allowing for minor injustices or inconsistencies. If half of the PIT

[13] For a recent powerful exposition of this theory cf. *Burszt – Stark* (1998).

[14] The very fact that deabtes over the interpretation of the 1995 PIT rules required a precedental decision of the Supreme Court in April 1998(!) is an indication of the room for improvement. The ruling followed a dozen of mutually contradictory verdicts of other courts at the lower level.

around, due to obvious chaos, there must be something wrong with the way tax rules are operationalised.

While much of the SME research and interest representation call for centralised solutions, one of the broadest-based corporate surveys (*Chikán*, 1997, p. 30.) highlight the active and elaborate *roles and instruments of the local municipalities* in Hungary. These already posses with own strategies and priorities, employ many people, order large quantities of production and are fully aware of the need to conduct *diversified strategies vis-á-vis diversified categories of SME.*

One of the paradoxes of the centre-left government's tenure of 1994-98 was its overall pro-business approach coupled with a unilateral bias favouring big business. Elements of this conduct of affairs were manifest in the above mentioned spread of covered – ant therefore *by definition non-generalisable* – subsidies and supports of various sorts. This was followed by a series of measures squeezing the SME sector. An EU-sponsored project of the Small Business Development Institute has listed the restrictions in a structured fashion in their call for deregulation (*Kállay – Kissné – Vörös*, 1997).[15]

Besides the already mentioned restrictions on cost-accounting and the arbitrary revenue-estimates employed by the tax authority, the restrictions on cash-payments, and the right of the tax authority to reject due refunding in case of irregularities in other – social security – obligations is mentioned. Quality certification is still in force in areas and degrees where public interest is hardly demonstrable, as with chinaware. A large number of fiscal regulations is still retroactive, the incongruence among various stipulations is significant, which limits the scope of law-abiding behaviour. The administrative burden, as well as public dues, continue to grow year by year. Especially the legislation of PIT requires overdocumentation, including 7 various detailed sets of record-keeping. While big business receives VIP treatment, smaller investors may find it hard and time-consuming before they can obtain regular residence permits. These examples clearly fit to our earlier described theory of the socialist heritage, in which authorities see small business by definition as a sinful activity, where a punitive approach is the only legitimate one.

Needless to say, that *competition from the widespread informal sector,* added to the restrictive practices of authorities, put many ventures out of the legal business. One argument in favour of lower, but more transparent, taxes and rules is the diminishing incentive to switch to the irregular economy. This may be heightened by occasional though stances on obvious cases of trespassing, like it happened in the construction of the headquarters of the police in Budapest.

It might be equally important to *assist the spread of non-profit organisations* especially in the services sector. The literature is split over whether these will mature, in due time, into quite normal profit-oriented activities or not. Whereas in developing countries the tendency towards "graduating" is manifest, in the welfare societies of Europe the post-materialist mentality is spreading. The latter allows for a much wider scope of charitable, leisure, sociable, and generally non-profit-motivated activities in many walks of like. For instance sports clubs or neigbourhood-alliences overseeing kids and the elderly need a positive subsidy. Associations taking care of public security, for instance, do not need – in theory – to follow elaborate fiscal regulations. Especially home care services may be significantly more cost-efficient – and also more humane – than the standardised large-factory hospital care, currently priorised

[15] The issues of agricultural SME is a special subject, not treated in this project. On recent developments cf. *Éder* et al, 1997.

punitive stance of the authorities against SME were discontinued.

Strengthening the position of *creditors* in collecting collateral and enhancing the efficiency of *courts* in economic affairs is a prime interest of the SME sector, as its members are the ones who can not sit out years for a court settlement.

Another much discussed issue in the literature is the need to support the growth of *market infrastructure by public funds*. While this might seem trivial, on the other hand information equals to money. Thus *relevant information is unlikely to be transmitted free of charge*, on charitable grounds, rather than by trade. Thus setting up a large number of contact points, where not much more than the location of the capital city or the name of the current prime minister could be easily checked, does not seem to be a particularly efficient way of improving the market entry of small firms. Tougher enforcement *competition laws* and *disclosure requirements,* on the other hand, do help a lot.

From this perspective the Russian case seems to be particularly illuminating. Following IBRD advice, Russia has established the full set of instruments, by which western countries support small business. However, field evidence (as reported in *Golikova – Avilova*, 1997) reflects a major *split between from and contents*. For instance the prescription that 15 per cent of all public procurements should go to SME, is simply not known, either by firms or by the authorities themselves. New private start-ups tend to avoid any contact to the authorities, while the latter find the larger half of proposals submitted by SME as "raw", i.e. not meeting formal requirements, not to speak of substance. Among the private entrepreneurs the approval rate for such forms as support for training, innovation, or assistance to special groups is about 5 per cent. The overall feeling is that decisions are arbitrary, with no appeal or even deadlines. In sum, if distrust rather than co-operation is the name of the game, *transparency* of procedures and *publicity* may matter more, than the specific schemes. And this obviously holds also for Hungary, if for no other reason, because of the ongoing punitive stance of the authorities.

Concluding remarks

Our overview of various aspects of SME-supportive policies attempted to contrast normative with descriptive approaches. Without pretending to sum up findings of the analytical and other policy-oriented studies in this project, our first run concludes with a fairly inconspicuous finding. *There are no quick fixes.* There is not much room for the oft-required sector-specific target-programmes or support schemes, as the efficiency of these is not demonstrable at best, and is sheer special interest policy at worst. The latter can not be substantiated on accepted economic terms and grounds. The best advice is to avoid irrealistic fiscal projects, like the recurring tendency to decentralise taxation including PIT, allowing for additional levying of PIT by municipalities, or attempting again the failed idea of wealth and property tax, as currently contemplated by the ministry of finance in the context of reforming the finances of municipalities (as reported in: *Népszava*, 30 May, 1998).

There are some *simple but hard-to-implement findings*. Once search, administration and other overhead costs fall disproportionately on SME, the more the government deregulates, the *lower will be the entry barriers*. The more seriously the fundamentals of the market order, like competition, transparency, simple rules, accountable authorities, intervention based on externalities and efficiency controls of governmental measures hold, the easier is the life of SME sector.

these constituting principles, has become manifest over the last few years. The unilateral favouring of large corporations, accepting monopoly positions in some cases, while imposing disproportionate administrative and consolidated tax burdens on the SME sector, are prime cases of *regulatory failure which should be remedied.*

Deregulation would require a Copernican *turn against the socialist legacy*, still seeing the SME sector as a basically sinful activity to be controlled to the utmost. New, simpler rules would allow for less bureaucratic discretion, which is unlikely to be a hit with regulators.

Major rate cuts are implausible under *ceteris paribus* assumptions. In the longer run, however, if streamlining of the expenditure side of general government materialises, while collection discipline improves, step by step cuts, *that add up to a sizeable relief in 3-5 years are fully within reach*. This technical feasibility, however, requires tough and consequent measures to implement already unfolding *public finance reform projects*.

The lot of SME could significantly be improved by simply *observing the spirit, not only the letter, of currently available*, but mostly dormant *pieces of legislation* on public procurement, public information, public finance, competition, registration, reporting and informational sovereignty.

The empirical parts of our project allow for a relatively *optimistic* interpretation of the *growth potential of SME*, including their co-existence and co-operation with the dominant MNC sector. This view is supported by other analyses highlighting the beneficial role of ongoing disinflation and the recovery of domestic market, as well as the favourable role already played by local municipalities in much of the country.

Our analysis underlines the role of SME in its capacity as a social intangible in two crucial points of the Hungarian society. At the bottom, this might be a most efficient way of poverty alleviation and fighting crime. In the middle income strata support schemes could help graduate microfirms to medium-sized ventures. Furthermore these may assist the spread of NGOs and various non-profit organisations that *may take over many, currently publicly extended, services in a cost-efficient and decentral, humane way.*

We are sceptical against the standard propositions of the chambers of trade and industry that go beyond deregulation and calls for transparency and simplicity. Their ideas (*Varga*, 1998) that quality improvement programmes, subcontracting programmes, soft loans, ministerially elaborated offering-lists for MNC, or prescribing local contents are either at odds with international agreements (esp. WTO/TRIP), or represent thinly veiled attempts to conduct traditional special interest policies for handouts. If the latter deserves support, which I personally doubt, then this *support should be direct, public and limited in time, with a pre-announced scale of digression*, to be monitored by outside auditing agencies, publishing progress reports all the time long.

The major difficulty in the implementability of our propositions is in the *incremental* nature of *improvement*, which could be delivered only by a sustainingly *stable policy line* which is not always easy to comprehend by the public (including legislators). But from this perspective, as well, it is in line with other, more standard findings of modern policy-relevant economic theory.

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Table 1

Registered entrepreneurships in Hungary

Previous year =100 per cent

	1991	1992	1993	1994	1995	1996	1997	1990-1997 1990=100%
Incorporated companies	179	132	123	118	115	117	116	538
Non-incorporated companies	153	135	139	124	120	116	107	528
Corporatised altogether	165	133	131	121	118	116	111	533
Individual ventures	130	119	114	113	102	94	89	168
Altogether	135	121	117	115	105	100	95	218

Source: Ipari Szemle, 1998/2. p. 4.

Table 2

The size structure of Hungarian enterprises according to number of employees

	micro 1-10	small 11-20	medium 21-50	large 51-300	300-	altogether
1991.XII		97.62	1.09	0.89	0.39	100.00
1992.XII		97.92	1.02	0.79	0.26	100.00
1993.XII	95.10	3.20	0.88	0.65	0.17	100.00
1994.XII	95.54	2.81	0.89	0.63	0.13	100.00
1995.XII	96.89	1.57	0.88	0.55	0.11	100.00
1996.XII	96.86	1.65	0.89	0.50	0.10	100.00
1997.XII	96.74	1.74	0.94	0.49	0.09	100.00

Source: as in table 1.

Table 3

Functioning firms according to their legal form

(December 1997)

	micro	small	medium	large	altogether
Ltd.	14.81	1.70	0.37	0.04	16.91
JSC	0.20	0.10	11.07	0.07	0.49
Public Ltd	0.47	0.01	0.00	0.00	0.49
Joint Share Co.	15.92	0.20	0.011	0.00	16.13
Co-operations	0.33	0.19	0.15	0.01	0.68
Other joint forms	1.01	0.02	0.00	0.00	1:04
Partnerships altogether	33.59	2.29	0.65	0.13	36.66
Individual ventures	63.14	0.20	0.01	0.00	63.34
Firms altogether	96.72	2.50	0.66	0.13	100.00

Source: as in table 1.

Table 4.

Territorial pattern of entrepreneurships in Hungary

(year-end)

County	1995.		1997.		share
	number	share	number	share	97/95.
Budapest	170687	28.18	215164	29.30	1.13
Bács-Kiskun	30566	5.05	35301	4.81	-0.24
Baranya	23860	3.94	29083	3.96	0.02
Békés	20223	3.34	22470	3.06	-0.28
Borsod	2908	14.80	22969	3.13	-1.67
Csongrád	26792	4.42	32467	4.42	0.00
Fejér	22224	3.67	26708	3.64	-0.03
Győr	26464	4.37	30831	4.20	-0.17
Hajdú-Bihar	26516	4.3 8	31966	4.35	-0.02
Heves	15501	2.56	17950	2.44	-0.11
Jász-Nagykun	18842	3.11	21701	2.96	-0.15
Komárom	17316	2.86	30820	2.84	-0.02
Nógrád	9235	1.52	10260	1.40	-0.13
Pest	57863	9.55	73247	9.98	0.42
Somogy	19378	3.20	23497	3.20	0.00
Szabolcs	25319	4.18	29257	3.98	-0.19
Tolna	13170	2.17	15323	2.09	-0.09
Vas	13329	2.20	15852	2.16	-0.04
Veszprém	21093	3.48	24881	3.39	-0.09
Zala	18335	3.03	23178	3.16	0.13
Altogether	605794	100.00	734236	100.00	0.00

Source: Ipari Szemle, 1998/2. p. 49.

Table 5

The stock of credit granted to enterprises

	Dec. 1994.		Oct. 1997.		in p.c.
	bn Ft	share of SME	bn Ft	share of SME	1997 per 1994
SE credit	89	10.17	64	3.79	71.91
Total credit	875		1690		193.14
SE deposit	31	5.59	65	7.08	209.68
Total deposit	555		918		165.41
Net credit to SE	58	18.13	-0.5	-0.06	
Total credit	320		772		241.25

Source: as in table 4.

Table 6

Taxes paid by entrepreneurships in Hungary

	tax (bn Ft)			share (in per cent)		
	1992	1994	1995	1992	1992	1995
Micro	15	28	26	23.4	24.6	26
Small	9	20	18	14.7	17.7	18.1
Medium	11	19	24	16.9	16.4	24.3
Large	29	47	32	45.0	41.3	31.6
Altogether	63	115	100	100.0	100.0	100.0

Source: Külgazdaság, 1998/1. p. 54 based on data of the tax authority

Table 7

Tax holiday for entrepreneurships

	sum (bn Ft)			share (in per cent)		
	1992	1994	1995	1992	1994	1995
Micro	12.3	2	0.6	36.4	5	3.1
Small	5.5	3.6	1.4	16.3	9.3	7.1
Medium	7.1	10.8	3.5	21.2	27.5	18.1
Large	8.8	22.8	13.9	26	58.2	71.7
Altogether	33.7	39.2	19.4	100.0	100.0	100.0

Source: as in Table 6.

Table 8

Subsides to entrepreneurships

	sum (bn Ft)			share (in per cent)		
	1992	1994	1995	1992	1994	1995
Micro	5.8	13.3	19.4	16.9	19.1	21.2
Small	2.7	8.2	10.3	7.9	11.7	11.3
Medium	8.5	19.9	21.9	24.8	28.5	23.9
Large	17.3	28.4	39.8	50.4	40.7	43.5
Altogether	34.4	69.8	91.5	100.0	100.0	100.0

Source: Külgazdaság, 1998/1. p. 55.

Table 9

Average tax burden of entrepreneurships*

	1992	1994	1995
Micro	–0.30	0.67	0.23
Small	0.10	0.55	0.30
Medium	–0.43	–0.57	–0.04
Large	0.10	–0.08	–0.37
Altogether	–0.09	0.09	–0.05

Note: * Tax burden = tax minus subsides minus tax reliefs per net intakes
Source: as at Table 6.

MARKET LINKS AND GROWTH CAPABILITY OF ENTERPRISES IN A TRANSFORMING ECONOMY: THE CASE OF HUNGARY

by
István János Tóth

Introduction[1]

In the following study we examine various aspects of the relationships between Hungarian enterprises on the basis of a survey of approximately 300 firms (CIPE98A)[2]. The reorganisation of enterprise relationships during the transformational recession (*Kornai*, 1994) is crucial because since mid-93 growth in the Hungarian economy started to recover. The sustainability and robustness of this growth depends significantly on the extent to which the small and medium-size enterprises forming the majority of the Hungarian entrepreneurial sector can participate in it. This, however, is influenced by the extent of business relationships formed between the various segments of Hungarian enterprises. Thus we need to examine, on the one hand, the quality and frequency of business relationships between the various groups of Hungarian enterprises, and, on the other hand, the extent to which the existence and characteristics of these relationships influence the growth capacity of the companies.

Our inquiry into the nature of economic growth of companies can be divided into three questions. Is the growth *real* or *virtual* ? Is the growth *widespread* or *isolated* ? Is the growth *equalised* or *polarised* ?

In our opinion the answers to these questions are interrelated. In the first inquiry we have to examine whether the growth measured in 1997 is the result of the actual economic performance of the enterprises, or is it merely due to the fact that several dozen foreign companies relocate their production or profits to Hungary because of favourable taxation or other economic conditions? In the latter case growth is generated by simple bookkeeping procedures or by transferring some activities to Hungary which, should economic conditions change, can be transferred to another country within a short time. The second query is related to the number of companies effected by economic conditions. It is possible, that macroeconomic revorey effects all types of companies in the same way and to the same extent. But it is also possible that the improvement only concerns one group of firms, that stand out like an isle from the majority of the companies, and are considered to be the locomotive of economic growth. The third question is related to the rate of growth. How similar are the expectations of the enterprises? Will the economic expansion increase differences between various groups of firms?

[1] This study is the short version of a longer research report, published simultaneously in Hungarian. I should like to thank *Kamilla Lányi* for her remarks and criticism related to the first, Hungarian version, and *Lawrence P. King* for his enormous help by proofreading the English version of this study.

[2] A more detailed description of the CIPE98A survey can be found in Appendix 1.