RECOMMENDATIONS FOR SME-SUPPORTIVE POLICIES IN HUNGARY

by

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The main purpose of the present CIPE/USAID sponsored project was to offer an up-to-date *description* of the state of art of SME development and related policies in Hungary. The related international experience puts these findings in a *comparative perspective*. Empirical investigation proved to be useful in so far as substantially new developments and changes in previous trends could be established, and theoretically relevant statements could be formulated. The international conference, co-organised with EACES, helped produce a feedback and quality control. Also in formulating our policy recommendations we draw on the lively exchange of views provided by this forum.

SME development is generally seen as a weak point in the overall success story of Hungarian transformations. While most analysts do call for more support for SME, to better integrate start-up ventures in the overall economic development, very little is offered in terms other than pious intentions or open vested interest policies. The latter, while fully legitimate in a pluralistic democracy, can by no means accepted as macro or economic considerations, thus should not be treated in this sense. Therefore the present project has come to a somewhat *sceptical view* over the majority of currently fashionable policy propositions, like *sectoral programmes*, soft loans, enhancing the public policy role of interest representation, or supporting the regularisation of bookkeeping through special incentives/an idea contrary to the practices of the EU/.

SME account for 85 per cent of enterprises and 65 per cent of employment in the OECD region. This defines SME as a major element of social intangibles both in economic and political terms. With the new trends in industrial organisation, enhanced by the spread of PCs, as well as the social disinclination against rigid giant organisations, SME turned into a most promising form. Much of innovation, as well as 70 per cent of new entrepreneurs and managers e.g. in Italy originate from among former employees in this sector. *Managerial and entrepreneurial skills are thus often produced* by and through this sector. As this feature is relatively weak in Hungary as yet, one of the major tasks of second generational transformation policy in Hungary is precisely in *consolidating the SME sector*, promoting the ongoing process of microfirms graduating into small and later medium sized ventures.

Hungarian and international experience commonly point towards the overwhelming relevance of the *macroframework*. When inflation is high, regulation intransparent, interest rates skyrocket or conversely, they are negative, public dues are collected from production and trade rather than from consumption-related items, further when the tax system is non-neutral and/or is captured by vested interest, no amount of targeted SME programmes are likely to overcome the obstacles posed by the inappropriate macroframe.

In Hungary - like in most of OECD-Europe - *high public dues*, primarily high social security contribution, *discourage* self-employment and even more *the use of legally hired workforce*. The only feasible way these contributions could be lowered is

[1] Comments by *Kamilla Lányi* are appreciated, with the usual caveats.

through a gradual, but thorough, reform of overall government spending in general and social security spending in particular. In this area no conspicuous breakthrough seems possible. However strenuous efforts at expenditure reduction *may* result in the *gradual decrease* of these dues, should the savings accruing from better targeting, rationalising and of cost-efficient ways of spending practices not be misused for competing claims, especially for those not creating any externality.

A third area where SME promotion could be relevant is lowering the current *institutional barriers to new start-ups*. Overarching regulation of labour market is a severe problem all across the EU, except Britain and Holland. In Hungary much of the regulatory frame is around, however it is, as yet, mostly or often disregarded. Deregulation in this area may create more employment in the legal sector and discourage employment in the irregular or the grey economy. The use of buildings as a collateral should become easier; legislation pertaining to this and enabling better access to collateral is underway. However much of the seemingly unrelated regulations, protecting e.g. tenants must be eased in order to make the new legislation relevant. While maintaining an open trade regime proved to be an important plus in creating entrepreneur-friendly mesoclimate, setting up a new law on venture capital seems to have missed the point. Under continental conditions, it seems, venture capital is to promote innovative high-tech establishments, rather than the typical Hungarian microfirm, which is to graduate into small business into the legal sector. Moreover actual regulation adopted in Hungary allows for public money to compete for very risky businesses, while financable investment projects in this area are not very numerous.

A fourth area where SME promotion could be relevant is *training*. While Hungary used to have an edge in secondary and higher education, it is hard to oversee that all Hungarian Nobel-winners, including *Oláh* and *Harsányi*, were basically products of the interwar training system. These edges can easily be lost. Enterprise-relevant knowledge need to be produced and transmitted; special training programmes, especially in the depressed areas and particularly for new or lagging behind entrepreneurs, like those of the gypsy minority, should be organised and offered at subsidised prices, by the municipalities in a decentralised order.

Fifth, *competition in the financial* services sphere is only in the making as yet. While the techniques of most advanced forms of services are already available and for the wealthiest segment they are already in oversupply (*Ursprung, J.* et al, 1997) most of the large banks have only recently been crowded in to retail banking, and in offering services, rather than making money on T-bills. Especially in provinces most banking, including the financing of municipalities, is dominated by two dinosaurs, the National Savings Bank and Post Bank. Thus access to a most important element of competitiveness is severely limited as yet for many SME. The attitude of banks is well reflected by their angry reaction over the Constitutional Court's outruling the compulsory upper limits on cash payments (*Lázin*, 1998). The former ruling - as well as the obligatory bank transfer for public sector employees - has, in fact, reinforced monopolies over a captive *clientele*, which otherwise should have been won, in competition, via better services.

A sixth area where SME promotion could be crucial is *efficient* and transparent public *administration*. This is by no means a theoretically new finding, however its relevance has been re-stated by our own surveys, as well as concurring analyses conducted parallel to ours. What entrepreneurs find most deterring is not so much the level of public dues, as much as the intransparent way these are being administered. Retroactive legislation as well as the very high priority allotted to the personal(ised) relationship to the tax administration[2] against open procedures and norms is a clear indication of the *long way* to be gone *before rule of law* in this area could be empirically established. Given that search costs, overheads administration fall disproportionately on SME, helping these problem could be a *cost-efficient* and *externality-warranted way of assistance* against soft money programmes of various sorts. The latter will probably foster misallocation and enhance competing claims on the grounds of a precedence.

Seventh, the role of *physical infrastructure* should be re-emphasised. Not necessarily building new motorways, but also modernisation of railways and generally improving physical availability through user-friendly tariffs and timetables can, and as west European experience suggest, does create miracles also in terms of regional development. The externality for the SME sector is thus by definition greater.

An eighth important finding is quite in line with developing country experience. Instead of a large centralised financial institution specialising in SME support, the present project has found, quite in line with the predominant view in the financial sector, that *networking* among the *savings co-operatives*, rather then a centrally nominated special agency which is to cope with the problem of SME financing in a cost efficient and flexible manner.[3] Much of the informational asymmetry burdening SME finance and making it unattractive for a classical large financial institution can be overcome by decentral arrangements. Local bankers are better entrenched in local social networks, thus can gain, through informal and social contacts, much of the relevant information otherwise missing over micro and small entrepreneurs. This includes the conduct of their business and the soundness of their family finances. In so doing both *risk and risk-assessment is decentralised*, its conduct is not confined to processing files and hardly operational indications therein.

As the specialised collateral and farming bank (FHB) is already available, the idea to nominate a politically burdened and financially weakened Post Bank with this task seems to be misplaced. By contrast, supporting more networking among the local savings' co-operatives and encouraging the elaboration of *debtors' lists*[4] and *track records* may be a much cheaper and more efficacious way of addressing the same task.

One of the most controversial issues in the project has been the *ability* and willingness of the *microfirms to graduate* into SME. The socialist legacy has turned most entrepreneurs of this size extremely cautious, not venturing to expand over a safely overseeable size. However, as Hungarian and international evidence suggests, growing over a certain size means not only a clear commitment in terms of money advanced, and wealth frozen, into a given activity. It also acts as an incentive to leave the irregular economy and graduate into normal business. A corner shop run by employees rather than by the owner might be the first place where selling under the counter might cease. But for this process *availability or lack of the above listed institutions, costs of securing property rights, as well as of enforcing contracts might be of crucial importance.*

Also this is the phase where financial services and bearable credit costs may come in. Consolidation of the Hungarian banking sector, followed by its privatisation,

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[2] Cf. the related tables of the joint *Semjén-Tóth* paper in the present volume.

[3] Contrary to this deliberation all non-farming SME has been under the authority of MITT, re-baptised to Ministry of the Economy in June 1998.

[4] The first such databank - GIRODAT - of banks, blacklisting major private persons not

as well as disinflation and the growing competition in financial services, also supported by the OECD-inspired liberalisation[5] together may bring about the previously non-existent conditions in the years to come. With a series of rulings enforcing proprietary rights, and with the threat of nationalisations vanishing, with experience and also due to OECD/EU/NATO membership, *the inherited behaviour of microfirms may gradually change and their ability and wish to graduate may well improve*.

Last but not least - as tenth - the favourable impact of the EU *single market arrangements* should be mentioned. The currently somewhat intransparent public procurement procedures may well open up a sizeable segment of domestic market for SME. Better enforced competition policy directives will also protect SME.

One of the indirect benefits from single market, inducing more transparency and more competition might be the decrease in corruption, informalism and intertwinigs between business and politics, normally by definition *privileging big business and disfavouring SME*. These lasting factors may turn out to be *more relevant than the specialised SME programmes of the EU*, where the informational requirements, paperwork and the related search costs may pose next to insurmountable *entry barriers* to most Hungarian SME.

Against this background recent proposals elaborated by the ministry of finance[6] (as summarised in: *Várkonyi*, 1998) are restrained to a mere rehash of earlier programmes (and the new governmental programme is understandably a general policy document, being rather abstract by nature). The *ministerial concept* foresees a decrease in administrative burdens, allow for wider use of average-based taxes (*átalányadózás*) and re-states the idea of granting unspecified tax benefits to those submitting their reports on diskettes. PHARE money is running out for microfirm crediting, which is to be replaced by an unspecified non-profit agency, who is to take bank credits, to be counter-insured by the Credit Guarantee Inc. Also in public procurements SME are to be priorised, and supplier programmes extended. The concept itself tackles some of the unresolved problems not having left much room for SME to graduate into subcontractors, but - as it states as an abstract normative - these are to be overcome...

The ministerial concept re-calls venture capital funds as promising sources for SME development, and theorises about the need for a public fund extending long term soft loans to SME. It also stipulates contractual agreements between chambers of trade, fulfilling public functions, and the authorities proper, including the setting up of meeting points where those looking for investments and those looking for funds could meet. The distance between our findings and the above described official deliberations is so great that is does not require further elaboration.

Involving representatives of major international agencies - such as the OECD and IBRD - at our final conference served to test whether our suggestions qualify as unrealistic or contrary to international experience, but this did not prove to be the case. Thus we see *both the philosophy* and the *arsenal* of the ministerial project as *inadequate*, for the reasons elaborated in detail above. This might also explain why much of the state administration and the chambers, stuck in outdated approaches to SME, see the challenge of the single market more in terms of a threat than as an opportunity.

One of the most widespread *myths* of Hungarian SME research could be dispelled by involving the parallel experience of eastern Germany. This area looks like paradise in terms of overall transformation theory: a well-tested and clear-cut legal framework was taken over, a functioning public administration, availability of managerial skills, and last but not at all least stable currency and seemingly unlimited amounts of financing has been provided by the reunification process. Eight years of experience in eastern Germany, as documented in the chapter of *Brezinski*, is indicative that these may not define the heart of the problem properly. Despite an unprecedented scale of transfers, reaching up still to 35 per cent of the GDP of the eastern *Ländern*, the self-sustaining type of growth could not take off. Following an initial stage and having overcome trivial business bottlenecks, especially in the services sector, the macro-growth of eastern and western German provinces have been conspicuously converging, even prior to the equalisation of productivity levels. While the east German experience is subject to a variety of interpretations, one thing seems certain. *Availability of money* and appropriate financing *plus managerial skills together are necessary, but by no means sufficient, conditions for a self-sustaining robust growth* of the SME sector. Therefore in the Hungarian studies, the recurring and usual claims about underfunding and lack of money as the single cause of all evils, must be seen as of relative importance at best.

In terms of making use of *tax allowances* the German experience also casts doubts about their uses. While over 800 items of various entitlements of these are known in German tax law, empirical investigations highlight the pre-eminent role of larger firms making use of these for obvious reasons. Therefore tax reliefs do not seem to be the appropriate means to foster the particular SME objective. In Germany, concentration on the local markets, on non-tradables and on the consumer goods demand created by transfers, together have brought about an SME sector which is quite unlike that modelled on the Silicon Valley. Also the very *large number of incentives must be seen as problematic*. First, coherence and efficiency considerations can obviously hardly be heeded. Second, the more complex a system is, the higher are the search costs and the lower is the probability of the benefits actually accruing to the SME sector, and even less for the new start-ups and microfilms. Socially seen, the latter are the target group, where the externality argument for public spending applies.

Interestingly, the Czech experience is also supportive of the above findings. While much of the instruments advocated by most of analysts, like the special bank for financing SME and the tax relief schemes are in place, *the efficiency of this could not be proved by empirical research*. In the majority of cases not even those operating the special incentive schemes produce /self-justifying/ efficiency calculations; credits of the SME bank for instance are granted on a first come first served base, without measuring competing claims against one another, and without ex post control of the efficiency of using these funds. In another interesting finding, the small size of the Czech Republic, like of Hungary, is not a reason of avoiding regionally very different patterns of unemployment. This is due to a low mobility, brought about by a stagnant housing market and high costs of commuting, relative to minimum and close-to-minimum wages.

Also quite similarly to Hungary, corruption, informalism, frequently and retroactively changing rules figure high among the factors discouraging entrepreneurship in the Czech Republic. Field evidence by *Rohatá* and *Mládek* in this

[5] As *Várhegyi* and *Gáspár* (1997) demonstrate, this required more liberalisation in the financial legislation than Hungary's future EU accession will.

[6] From the present project's perspective, focusing on tax affairs, this seems to be decisive against the rather general programme of the Ministry of Economy, calling for deregulation.

enforcing these as well as of contracts, among major factors hindering entrepreneurship and small business. The high share of dormant firms - about the half of all those registered - as well as inflated collateral claims of banks /a derivate of the previous ills/ make the Czech case quite similar to the Hungarian one. The somewhat unexpected similarity is one of the important findings of the comparative element in the project.

The empirical analyses of the interrelationship between high *public dues and high involvement in the irregular economy* has established an econometrically tested link between the two. This finding of *Lackó* is important as it implies a rather strong correlation between spending cuts and the rollback of the irregular economy. This link is policy relevant at least in two dimensions: 1. expenditure cuts do create employment ; 2. the way to eliminate unfair competition for SME is not through enhanced reliance on police methods and regulations,[7] but via smaller, simpler and thus better enforceable burdens. While this finding, *per se*, says nothing about the size and timing of desirable rate cuts, it does provide a strong argument for those who believe that all possible savings from the tightened fiscal expenditure *should be used for this purpose*, rather than spent for other, competing claims. Regular overspending in general government thus can not be seen as an innocent mishap, worthy of tolerating for societal reasons.

Analysis of the Hungarian tax system has shown it to be *captive to vested interest while lacking clear conceptualised priorities*. Taxation seems to follow improvisations and allow very little for the considerations of *wealth creation or neutrality*, two fundamentals in any textbook view on the subject. Non-neutrality is particularly striking when comparing small and large firms, when comparing tax reliefs to the two, or actual tax burdens born by these. If we compare this with the enhanced reporting obligations of small firms, the insufficient data protection of theirs, as well as the natural competitive disadvantages of these, the finding is fairly obvious.

The non-neutrality of the tax system renders the attempts by the tax authority to act as guardian of social justice and representative of wage earners as ironic at best. Accounting rules, disregarding not only inflation, but not allowing for capital revalorisation, and *disregarding any element of risk premia are simply unfounded* and need to be quickly remedied as an obvious case of *regulatory failure*. The growing share of PIT as against excise taxes, for instance, is an example of policy decision without anybody having made a public choice, or without any respect for any principle of taxation. When 83.5 per cent of all tax reliefs actually accrues to MNC, this is *per se* a call for abolishing these on both social and economic grounds.

One of the important findings, having included historic and sociological aspects of SME development[8], has been the devaluation of both knowledge and networks originating in the reform socialist period. The star entrepreneurs of the transition period are bankrupt, marginalised or sit in jail. One of the fundamental differences which is particularly hard to cope with, is the *closure of the traditional way of the entrepreneur back to the public sector*, should a worst case scenario materialise. Therefore both in terms of tax policy and in terms of assistance programmes SME actors should not be treated as those having gone astray from secure and orderly paid public sector jobs. On the contrary, *they deserve help to self-help*, and poverty alleviation programmes, capitalising on developing country experience could do a lot to create stekeholders *en masse* also at the bottom of Hungarian society, and particularly among the gypsy minority and those living in depressed areas. Micro ventures are, also in the west, mostly non-bankable due to their size and short history. But the real Rubicon is crossed only when family wealth and business wealth are formally delineated, orderly bookkeeping is introduced, costs and benefits are accounted (unlike in the traditional peasant household).

One of the obstacles hindering this organic graduation process in Hungary is the notoriously *unresolved issue of protecting minority shareholding rights*. This is a very severe setback in so far as this deters most attempts to pool resources and set up network based outside personal/family circles. As punishment of non-compliance is ineffective and trust is understandably low, *a fundamental element of enterprise graduation is missing in Hungary*. Court procedures lasting for years, unavailability of simple and cost-efficient ways of enforcing private contracts and rights, corruption and the spread of private enforcement techniques together are warning signals for what the lack of formal and informal institutions for policy imply.

The bright side of the picture is the *improving financial discipline* uncovered by the market relations analyses, which also had a favourable spillover effect on tax paying morale. The civilising and disciplining effects of foreign ownership proved demonstrable, as was the diminishing role of cross-ownership against foreign and Hungarian private firms. Financial discipline of publicly owned firms proved to be significantly poorer than that of their private counterparts.

The relatively underdeveloped state of *competition policy* was shown by the little use of the opportunities, provided by the related legal framework, by SME against dominant positions and misuses of market power. It has been typical that MNC were the ones making use of this tool - mostly against other MNC - whereas public policy nurturing SME, as well as representatives of the sector or the chambers of commerce have been making little, if any use of its stipulations. This is in sharp contrast with the elaborate legal superstructure (on this cf. *Bara*, 1998).

One of the most interesting findings is the one having emerged from the debates evolving around the role of venture capital. It seems that contrary to much of the theoretical literature generalising Anglo-American experience, in Hungary the *SME sector has not developed as yet into a nucleus of R+D development*, into a vanguard of technological development. This state of affairs, which is partly attributable to certain peculiarities of business culture, is unforthcoming to attempts reflected in the new law on venture capital, fostering the sector in this capacity. This might well be premature on average, whereas more *down-to-earth tasks*, related to nurture microfilms as alternatives to living on social transfers, or graduation to small enterprise thereby leaving the irregular economy, *remain unattended*. Thus in this specific area, a well-known feature of the Hungarian regulatory frame, the parallel existence of over- and underregulation could be spotted.

This is not the place to re-iterate the policy recommendations summed up in the concluding five pages of the macrostudy. The findings presented here and our recommendations also underline, in the same vein, that *SME promotion ceased to be a sector-specific task*. Meaningful measures actually relieving the burden currently falling disproportionately on those trying to help themselves out of trouble, can not be formalised into a governmental programme, and *should certainly not be entrusted with any centralised agency*. Attempts to enhance the role of tripartite co-ordination of interests, or to delegate more public functions to chambers of trade and industry,

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[7] For a contemporary assessment and warning c.f. (*Bóc* and *Klauber*, 1996) highlighting the role of irregular economy as a social safety belt.

[8] In detail in the book of *Laki* (1998).

with factors actually shaping the elbow room of micro and SME firms, their growth potential, or their possibilities to create wage earning employment, or simply alleviate poverty. Decentralisation should be the superb maxim, if for no other reason, because of the *inherent diversity* of the SME sector. Tax consultants require something else than subsistence farmers, though both are active in the SME sector.

Measures improving the lot of those employing the majority of citizens require inconspicuous, but hard to implement, policy measures to be taken. The drive to deregulate[9] is inherently at odds with vital interests of the civil service to ward off individual responsibility, while retaining discretionary rights and power. Likewise the pressure for more public spending is always there, and the number of purposes that may be supported is infinite. Thus the proposal to resist these and use all savings for financing cuts in public dues does require a *sustainingly stable and committed policy stance*. This is much advocated in theory, but is hard to implement in practice, especially if implicit fiscal overcommittments are sizeable and attempts to roll these back are timid.

There is a lot more that may be inferred from reading the individual papers thoroughly. However, a major purpose of our research project was to present new findings. *Quantities* and *interrelationships* that were previously not known, *changes in trends*, empirical *testing* of otherwise plausible but unproved *propositions* were all figuring high on our agenda. The findings, e.g. that the Hungarian economy is not network-dominated, but it is the weakness of networks which impede SME, is an important finding for sociology and economics alike. The changes indicating the overcoming of the dual character of the Hungarian economy is also relevant for transformation studies and classifications. Last but not least, some of our *negative findings,* i.e. the identification of ways of how *not* to promote SME may also be *policy relevant* for decisionmakers and analysts alike. The fact that our findings are in line with other elements of the mainstream of policy relevant theoretical literature looks reassuring anyway.

Improving the overall business environment is not an easy task and covers many areas including legal reform and social security. The more serious a government is about SME support, the more it is going to implement the related considerations in seemingly unrelated areas as well.

[9] For the theory behind it cf. the survey article of *Lányi* (1995).

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