

**Small and  
Medium  
Enterprises in  
Transitional  
Economies**

**Edited by  
Robert J. McIntyre  
and Bruno Dallago**

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# Small and Medium Enterprises in Transitional Economies

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## The Role of Financing in the Growth of the SME Sector: The Case of Hungary

László Csaba

This chapter addresses the hypothesis as to whether a lack of institutional infrastructure is the major component explaining sluggish progress in transition countries. Furthermore, it tests the normative question of whether general principles for SME support are valid in transition countries, and if so, to what degree. Hungary, as one of the frontrunner countries with a long reform heritage is addressed and the concrete forms of SME programmes are reviewed in order to provide an answer to the two theoretical questions. The empirical findings of the first decade of the transition indicate that, although institutions for SME support abound, their efficacy is limited. Money is an important, though not exclusive, constraint on SME graduation (from microfirms to small, from small to medium-sized ventures).

### Introduction

With the decline of traditional vertically-integrated large firms and the emergence of 'learning firms', new forms of industrial organization like outsourcing and other innovations crossing the boundaries of the traditional firm (Szabó and Kocsis, 1999) have developed, and the relevance of smaller firms has been significantly appreciating. The literature on endogenous growth argues that the long-term well-being of nations is contingent upon innovation emerging from within an enabling environment (Romer, 1994); and this requires a set of socioeconomic conditions that reward innovative and punish purely imitative or self-reproducing behaviour. One component of such an environment, which plays a growing role in determining competitiveness, is the availability of finance for expanding businesses, as part of a set of services offered by the system of financial intermediation.

Financing small business is important in all market economies, but in the context of systemic change is probably even more important. Command economies had overcentralized organizational structures of monopoly producers operating under price controls, so the need for decentralization was

evidence. This happened both by chipping up large firms (in part through spontaneous privatization) and by setting up *de novo* private firms. Like OECD countries, up to 97–8 per cent of all firms in transforming countries fall into the SME category, but, unlike OECD countries, this is a new situation which developed out of the conditions of the 'transformational recession' (Kornai, 1994). Many new firms have been established not by Schumpeterian entrepreneurs, but by individuals seeking self-fulfilment in less-bureaucratic structures than state bureaucracies or other vertically-integrated large organizations like banks or multinational corporations.

Sociological surveys and empirical studies (Gábor, 1994; Laky, 1998) highlight that the vast majority of those in the small-business sector are 'forced entrepreneurs', who did not have alternative employment in the wage-earning sector despite willingness to accept considerably less money. Just as in the West, these family businesses do not think about expansion and modernization, let alone innovation, during crisis times. They are basically subsistence/survival arrangements which may or may not change with the passage of time – and this important empirical question needs to be examined on a country-by-country basis.

Although the original expectations of a Schumacher-type 'small is beautiful' economy proved obviously wrong, in those countries where overall macroeconomic conditions significantly improved over time, conditions for small business also turned out to be better than before. *Thus the conventional wisdom seems to require reversal: it is not small business which drives macro-level growth, but the other way around.* This is not necessarily a call for a negativistic approach to SMEs, since in both the theoretical and industrial organization literatures the developmental significance of the small-business sector is not limited to its contribution to GDP and does not require a steadily growing measured contribution to wealth creation; indirect spillover effects and social considerations weigh equally heavily.

In societies where decades of artificial full employment plus a related legitimating ideology had shaped public perceptions of social order in general, and social justice in particular, the contribution of the small-scale sector to employment-creation, to money-earning activities and social cohesion can hardly be played down. All the less so if even quickly growing economies, like Poland or Slovakia, face lasting double-digit unemployment rates.

Last but not least, in the post-socialist context the usual argument in favour of the SME sector as being the most important producer and generator of new entrepreneurs gains significantly in importance. Likewise the role of the sector as a model shaping the career aspirations of the younger generations, in a period where old values are being lost and new values are lacking, can hardly be underestimated.

This chapter surveys the role of finance in supporting SME as part of an enabling environment. We do not assume that all that matters is finance. OECD experience (as reported, for example, in Fazey, 1997: 151) also reveals

a kind of cognitive dissonance in this area. While entrepreneurs keep on complaining about the lack of finance in general terms, surveys indicate that weaknesses in marketing and management, and insufficient consumer-orientation, are most often weightier hindrances to their growth.

Similarly, empirical microeconomic analyses have shown various other factors to be more frequent causes of business failures than unavailability of external finance (Papanek, 1999: 29). Among these are the lack of market-specific pricing, poor liquidity management, insufficient surveillance of the solvency of business partners, or simply playing down inherent, abstractly foreseeable business risk in the drive for markets, influence and profits. These factors often derive from poor managerial qualifications, and empirical surveys show this to be among the reasons for business failure (Benedek, 1997). This is exactly what is termed the 'midlife crisis' of the firm in the industrial organization literature. Qualities which are well-suited to running a small venture may turn into their opposite, becoming disadvantages when the owner loses oversight of the growing entity – usually when it exceeds 40 or 50 employees in size – that is, when it turns into a truly medium-sized firm.

Still, money does matter. We survey its role in promoting SME development, often drawing examples from Hungarian practice which has a longer history of marketization and active banking than other countries. For this reason the country may offer some insights into the efficiency of certain schemes. Since the Hungarian economy has been recovering since 1993, our findings are unlikely to be overdetermined by sustained macroeconomic depression. Finally, the role and extent of corruption is not comparable to the newly-independent states or the third world, thus the 'pure' working of some schemes can better be studied.

In the present chapter we first survey reasons why small business should be supported from the public purse, then look at how this support should be implemented – addressing the longstanding debate of sectoral versus regional approaches. Against this background a short description of Hungarian SME financing schemes is provided, as an example of how more general points are, or are not, reflected in the regulatory practice of the country the author knows best. Finally, a normative non-country-specific approach is suggested as to how SMEs could best and most efficiently be promoted.

### What is a SME and why should it be supported?

Because of methodological considerations, there is an international consensus among statisticians that the data on the number of employees is the only reliable basis for measurement of firm size. Also, it is conventional to treat firms employing fewer than 10 people as *microfirms* where survival/subsistence is most likely to prevail and which in theory should be subtracted from

proprietorships. However, microfirms are usually included in the SME numbers for good reason. Self-employment does constitute an alternative to being a wage-earner or receiving transfer payments (early retirement or unemployment benefit). Of these alternatives, self-employment is certainly a behavioural norm.

Any government facing serious unemployment and problems of social cohesion has both social and financial reasons to find this choice worthy of support. In Hungary in mid-1999 no fewer than 96 per cent of all registered businesses employed fewer than 10 people, and only 1 per cent more than 50. In addition, about 20 per cent of registered firms are dormant according to Hungarian Central Statistical Office (CSO) data, although their number and share is declining. The number of 'one-man-shows' skyrocketed in 1989-95, but has been declining ever since (Schmuck, 1999: 132-3); only 70 per cent of individual proprietorships are functioning. This form is particularly favoured by freelance workers who constitute 37 per cent of this group. Only 40 per cent of them are functioning, suggesting use of registration for other purposes (such as one-time tax evasion, or securing 'just in case' a legal form offering tax-saving ways of wage earning). Meanwhile, limited liability companies grew 25-fold in 1989-97, joint-stock companies 10-fold (in both cases over 90 per cent are actually functioning). These are clear signs of consolidation of the SME sector - with the initial euphoria gone survival firms are also declining.

CSO data on SMEs show that they are primarily a non-industrial activity, where R&D-intensive activities are by definition a friction. Thus the emphasis of many international organizations on promoting this segment does not seem to be warranted. Not much more than one-eighth of actually functioning Hungarian ventures operate in industry. Trade and economic services employ twice as many, justified by the overarching need to rebalance the industrial structure and by the emergence of a postindustrial service society. The large number of truly small (fewer than ten) joint proprietorships in healthcare and education, as well as in construction, the wood and printing industries, and other public and personal services is indicative of the underlying heterogeneity of these activities. The representative sectors in our sample do not include 'flea-market' and other survival activities, typical of third-world societies.

What we find here is the wide variety of activities that fall under the category of SME, whereby the economics of choice replaces the outmoded economics of scale. Should these activities be supported for these or other reasons? Considerations of equity, transparency and competition - seen as public goods - do not call for, or even allow, differentiation among economic entities according to their size. All registered activities (those not prohibited by law) should be entitled to equal treatment. Also, 'smallness' may be relative, as in stockbrokerage firms that employ few people but are able to mobilize enormous financial flows through leverage. Unless we find very

convincing arguments against the social usefulness of trade, economic services, and even finance and telecommunications as being 'parasite' activities, it is hard to justify restricting supportive public policies to the high-technology branches and manufacturing (this is what is normally meant by 'productive' services).

If heterogeneity is the overwhelming feature of SMEs (disregarding for the moment 'survival' ventures, which are obvious cases for public concern), this suggests the dangers inherent in centralized across-the-board schemes of various sorts that dominate the practice of EU countries. As Sweeney notes (1997: 157), there are more than 250 SME programmes in the EU. These are mostly poorly coordinated projects, reflecting the preoccupations and perceptions of bureaucrats, reaching very limited segments of those allegedly targeted. In a recent survey monitoring the efficiency of these programmes, EU officials found that despite the large numbers of policy measures there was very limited practical effect. This seems also to be the case with much-heralded pilot projects such as Europartneriat and enterprise matching (as reported by Román, 1999: 52).

Thus it is not the number of measures (input side), but the way they are targeted which is important for the outcomes. Since these targets can be numerous, let us list a few of them without aspiring to be exhaustive. Upgrading of firms obviously deserves support, implying both quantitative growth and qualitative changes since a larger firm must be organized and managed in a critically different way than a small one. Expansion - from individual to micro, from micro to small, from small to medium-size ventures - should certainly be promoted irrespective of the sector of activity, if it is justified by market conditions.

New entrepreneurs should also be encouraged. Public works programmes and other so-called active labour-market measures in Hungary have seldom succeeded in creating new employment for people (other than those administering the schemes and controlling how public money is spent). In these cases inclusive strategies should be encouraged, including the promotion of female entrepreneurs since transition societies are mostly *macho* societies where economic roles for women are often assigned to the household or the public sector. Ethnic minorities, primarily gypsies, suffer disproportionately from the losses of jobs and should therefore be positively supported in setting up self-help schemes involving training, consulting services or financial support. All are likely to require public money in light of the easily emerging externalities.

Young people also deserve support because they tend to suffer disproportionately from unemployment, and their unemployment has important social implications. The positive role model of self-employment discussed above should be contrasted with the danger of social disintegration in the form of the emergence of an underclass in which many rely on lifetime social support. Also, those who tried and failed in self-employment may more readily accept the hardships of having to work in a large organization.

In these and other possible schemes, the aim of poverty alleviation and promotion of the entrepreneurial attitudes needed for the smooth functioning of a modern market economy are the obvious externalities that deserve public intervention and spending. R&D-intensive firms also deserve support, in particular if one is concerned with Europe lagging behind in technology-intensive branches. Since a growing number of registered innovations come from small firms, promoting them – on a non-exclusive basis – may be cheaper and more productive than the traditional state-run technology programmes. Last but not at all least, survival ventures should be supported as an alternative to direct transfer payments or social entitlements unrelated to any improvement in performance.

Similar to mature market economies, the profitability of small firms in Hungary lags behind larger ones (Ecostat, in *Napi Gazdaság*, 26 August 1999). Unless we disregard the economic and social/externality considerations advanced above, it is this end of the enterprise sector, rather than large corporations, which deserves public attention and support. Since large firms are more often technology-intensive and labour-saving, regional development and employment-creation considerations as well as the need to foster constant competition from below further justify public intervention in favour of small business. Another important reason for public intervention consists of increasing the number of market players to increase competition – in particular if large firms decay in a lifecycle perspective – also in order to innovate and change the economic system.

In sum, public financial support for SMEs does not need to be based on political or special-interest-group argumentation. The considerations listed above make this proposition easy to square with standard economics in general, and the case is even stronger for transition countries. In previously overcentralized and 'market-averse' states, Hayekian decentralized knowledge may be more tacit and the Schumpeterian character less frequent than in established market economies. The need to foster self-help approaches is also underlined by the ageing of these European societies, and is already developing into a promising and profitable business providing services needed by elderly people. The situation is compounded by the obvious failures of governmental policies to generate a sufficient level of employment and accelerate endogenous sources of innovation in the first decade of systemic change.

### How to promote the financing of small business?

There is a near-consensus view in the literature that small business is normally *non-bankable*. The lack of a performance record, collateral and a credible business plan normally make these ventures unattractive to commercial banks. They often 'redline' these clients (Király and Várhegyi, 1998), formally excluding them as possible clients. The fundamental source of funds for micro and small business is their own savings and family loans. Empirical analyses

support this view, showing that two-thirds of Hungarian SMEs receive no loans whatsoever (Vajda, 1999: 540). In agriculture, reliance on external sources is seen as an absolutely last resort, not least because of the monitoring involved in formal credit contracts and high bank collateral requirement of 120 to 300 per cent (Alvincz, 1998: 181). This finding, however, may hold true more for the survival and micro firms that constitute the numerical majority of registered entities. It is interesting to note that especially at the medium-sized end of the SME scale, foreign direct investment plays a substantial role.

A recent multicountry survey (Szanyi, 1998) analysed 300 SMEs in five transforming countries, using an explicitly comparative approach and distinguishing between domestic and foreign firms. The highly relevant findings are summarized in Table 12.1. Domestic firms tend to rely basically on 'own-savings', while in foreign firms 'other' sources (meaning mostly parent-company finance) dominated. This is understandable knowing the high real rates of interest and sluggish banking services in transition countries. It is also in line with the 'gradualist' strategy of conquering markets by external investors described above. The negligible role played by the much heralded (and analysed) special incentive schemes is striking. This might be seen as a plus, if we compare it to the Russian experience (Åslund, 1997: 201–3) where discretionary support for SMEs led to rent-seeking and bureaucratic arbitrariness. Bank loans played a relatively significant role in the Czech Republic and Albania in 1997, countries where lack of transparency and not always prudent lending practices led to crises in financial intermediation in that particular year.

In financing working capital we see the relatively important role of foreign-supplier credit in Poland and Hungary, where foreign penetration had become sizeable by the time of the survey. Retained profits and personal savings, however, continued to dominate. Foreign bank loans play an insignificant role everywhere except Lithuania, but there the sample is too small to allow for broad generalizations (Szanyi, 1998).

In financing investment it is again striking to see the minimal role of foreign banks. Domestic banks tended to extend more loans to foreign-owned companies than to domestic companies. Domestic bank-lending was used relatively extensively in the Czech Republic and Poland, where bank consolidation and privatization was delayed. In the course of privatization and restructuring in both countries in 1998–99, many of these credits were found to be non-performing. In investment finance, self-reliance is basically the name of the game. It is interesting that those who finally have obtained loans complained most about the cost and collateral requirements. This is quite in line with overall OECD experience, where financing small business is seen as a problem – from both the borrower and creditor sides – for exactly the same reasons. What is even more surprising is the lack of major differences between foreign and domestic small and medium firms in this respect, suggesting that financing behaviour is size-specific.



Table 12.1 Sources of small business financing in five countries

Ownership	Poland		Czech Republic		Hungary		Lithuania		Albania	
	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic
Average size of initial capital (US\$000s)	186	260	1081	210	190	162	439	61	215	54
Sources of initial capital (%)										
restitution	0.0	0.6	0.0	3.4	0.0	0.0	0.0	0.0	0.0	3.0
own savings	46.0	74.2	25.0	61.1	79.4	84.7	44.4	72.0	47.9	29.9
family loan	2.7	7.4	12.5	8.0	5.9	3.5	5.6	7.9	7.9	10.2
bank loan	0.0	3.8	0.0	11.6	0.0	1.9	5.6	4.6	0.0	14.1
loan from special support scheme	0.0	0.0	0.0	0.0	0.6	0.6	0.0	0.0	0.0	0.0
informal capital	0.0	1.6	0.0	0.0	0.0	0.0	0.0	2.4	0.0	11.4
market	51.3	12.3	62.5	15.7	14.1	9.2	44.4	13.2	44.3	31.3
other										

Source: Szanyi (1998): 24.

Last but not least, it is surprising that lack of finance does not figure at the top of the list of barriers to growth, in particular in the Central European countries and for foreign firms. More general business considerations, like the lack of effective demand, high social insurance contributions, shortages of appropriately qualified labour, and unpredictability of the regulatory environment are as high or often higher on the complaint list of entrepreneurs. This finding was supported by another survey covering 281 companies, 72 per cent employing fewer than 50 people (Bratkowski *et al.*, 1998). This analysis focused on companies that received credit, and tried to test two widely held theses. First, does adverse selection of banks among clients persists? Second, is lack of finance the major impediment to business growth in transition economies?

While the question of politically motivated adverse selection was a problem in the early transition years, this recent survey did not find any current evidence of this in the three Central European countries. On the contrary, and quite in line with sources quoted earlier on Hungary, self-selection of those who perceive themselves as unfit to receive credit seems to be the dominate explanation. In a most interesting result, Bratkowski *et al.* (1998: 9) found that only 28 per cent of managers cited insufficiently available finance or lack of investment as their major headache. These results match our earlier findings that own-capital and parent-company financing dominate in covering investment needs in all countries, own-savings predominating in start-ups. Bank credit is subordinate in financing working capital in Poland and Hungary, but not in the Czech Republic (Table 12.2).

Support for our earlier claim comes from comparison of Czech 'deviations' from Polish-Hungarian 'standards'. It may seem that a more active role of banks is a sign of a more forthcoming, pro-business approach, but with the benefit of hindsight we see that the latter can be just a sign of insufficiently

Table 12.2 Structure of financing of investment, working capital and start-up capital in the Czech Republic (C), Hungary (H) and Poland (P) (%)

	Investment			Working capital			Start-up capital		
	C	H	P	C	H	P	C	H	P
Own capital	23.8	31.4	41.3	49.3	69.9	49.7	53.7	84.8	79.8
Bank credit	36.0	18.0	19.8	37.1	9.5	14.9	20.7	4.2	4.4
Trade credit	1.7	4.2	7.0	6.0	15.5	23.7			
Leasing	3.4	5.3	10.3						
Others	35.1	41.1	21.6	7.6	5.1	11.7	25.6	11.0	15.8

Source: Bratkowski *et al.* (1998): 19.

prudent behaviour, hardly surprising in an underregulated environment. Serious regulation of the Czech financial sector took place only following the Tosovsky and Zeman governments measures in 1997-99, when it was necessary to recapitalize all large Czech banks with public funds.

SME growth is unlikely to lead to the recovery of aggregate demand, since like in OECD economies, GDP in transition countries derives mainly from large business. On the contrary, recovering domestic demand resulting from successful adjustment and reform policy is in the longer run likely to widen the elbow-room for SMEs in transition countries as well. The macro approach to SME growth does not call for a hands-off strategy of public policy, but it dispels some of the myths diligently cultivated in the SME literature. It disproves the idea (Árva, 1999), that lack of interest-representation is the main reason for underfinancing this sector. It disproves the widespread calls for more soft money, as if this would hold the key to a blossoming small-business sector. It means that the immaturity of the banking system, rather than its inherent features, led to the problem of adverse selection in the early transition period. And it also means that financial services, broadly understood, are more likely to hold the key to the market success of SME, than the availability of money *per se*.

This is an important finding, suggesting that it is investment in the financial infrastructure, undertaken by the banks themselves over several years, which is likely to have more spillover to SME than any targeted scheme, especially those administered by central authorities. Furthermore, it is the expansion of financial services, from tax advising to home banking facilities, which is likely to secure the lasting competitiveness of this sector, not the artificial prioritization of certain activities (like manufacturing), or certain side-elements of entrepreneurial activity (use of computers, or exporting). The growth of these services takes considerable time and money. Since no financial institution will advance more capital than it is likely to recoup in a certain market segment, there is no way for public policy of any type to produce a conspicuous breakthrough. It can, however, foster organic evolution by creating a transparent and calculable environment, simple and transparent rules, fighting corruption, lowering taxes and creating what is usually termed an enabling environment for small business. Many elements of this require conditions that are theoretically fairly trivial, but in reality often non-existent.

### **Channels and mechanisms of financial assistance to SMEs: the example of Hungary**

It is sometimes suggested that transformation has led to an institutional vacuum, where SMEs are more vulnerable than large corporations and cannot find their way. Reference to the experiences of the Commonwealth of Independent States (CIS) and Southeast Europe adds the problem of a weak

and corrupt state with resultant inefficient and non-transparent regulation to the picture. It is often alleged (most recently in Stiglitz 1999a) that neoliberal excess has led to a neglect of institution-building.

In the case of Hungary, the long reform history resulted in an elaborate set of institutions and financing schemes meant to support SME. In the following we describe the institutional system and financing facilities, then provide an assessment. Since our focus is finance, we do not address all institutions and measures in detail, but focus on the related issues only.<sup>1</sup> Although small business is officially 'under' the Ministry of Economy (ME), practically it is the tax authority (APEH) and its superior organ the Ministry of Finance (MF) which are the most important regulators of its environment. Interestingly, the Department for Business was abolished in the Finance Ministry in 1998. This was meant to strengthen the ME (which cut social security contributions paid by employers by 2 per cent and exempted reinvested profits up to Fts4 million from any taxes, both valid from 2001), a representative of down-to-earth considerations, but the outcome is likely to be the opposite. Fiscal plans, including tax reform projects, do not seem to take more account of small business promotion than before, rather the opposite is the case.

The fiscal authority tends to emphasize considerations of tax discipline and has also attempted to devolve, as much as possible, financial burdens to the business sector. One recently aborted project called for employers to pay up to 45 days of sickness benefit to their employees. Another measure allows 45 instead of 30 days for VAT reimbursement to enable the authorities to control misuses. These two moves exemplify the nature of the problem highlighted above. If the planned rise in the lower limit for VAT reimbursement from Fts2 to 4 million is carried out, the loss of this most important source of cash flow will cause serious liquidity problems for about half of the SMEs (Szabó, 1999).

One of the traditional and justified criticisms levelled at the Hungarian SME support system was its lack of transparency. Individual entrepreneurs have been required to navigate among an impressive array of local, sectoral and national schemes offered by various agencies. The old call for a structured and easily accessible overview of these measures has recently been heeded by the issuance of the *Resources Map* (GM, 1999a), a book which covers all relevant information and is being continuously updated with availability in electronic form. A brief overview of this volume follows.

SME support can be divided into three categories, the first financed from the central budget, the second consisting of preferential credits and guarantees of various sorts, and the third consisting of various programmes and organizations that support SMEs. The latter includes the Council for Business Development (a coordinative and consultative body that initiates changes in legislation and makes recommendations) and local Chambers of Trade and Industry (coordinated by the Hungarian Chamber of Trade and Industry). Several official functions have been delegated to these local chambers (in particular, issuing all business licences), after a period from 1994 to

2000 in which membership in them was compulsory. Regional chambers interact with municipalities that finance and organize many public services.

Local business development councils (HVK) are integrated in the Hungarian Business Promotion Fund (MVA), which is meant to provide a nationwide network and a transparent organization for various financial support and training schemes for SMEs. It administers the Phare SME programme, the microcredit programme, the energy-saving programme, the START credit-guarantee programme, the incubators, and so on. To illustrate their scope: in 1992-97 altogether 1000 projects were approved in the Phare SME programme, with credit of Fts3.7 billion (15.3 million euro) actually extended. Roughly 9400 microcredit projects were supported in the lump sum of Fts5.8 billion (23 million euro). From among the 369 credit guarantees approved, 39 actually had to be paid at a cost of Fts96.2 million. The small overall size of these programmes is clear. The programmes from the third category, such as employment promotion, agricultural marketing and productivity improvement, are similarly small in terms of actual spending, and the macroeconomic spillover is smaller than the ones already listed.

Centrally-funded programmes cover seven major areas: overall economic development, tourism, technological development, employment and training, environmental protection, rural development, and farming. With the exception of the last item these are truly cross-sectoral projects not targeted either to special interest groups or to special production lines. Applicants must employ not more than 250 people and must be independent (no other external corporation may own more than 25 per cent of them).

Credit subsidies are aimed at technological and marketing improvements and may be granted by the ME through open tender. Credits cannot be more than Fts400 million (c.1.5 million euro) with bank interest charges limited to 3 percentage points over the prime rate. Credit subsidies can last for four years and cover 50 to 20 per cent of the interest burden (decreasing by year). Supplier programmes also entitle participants to such a credit subsidy, with the 'integrator' firm qualifying for as much as 70 to 40 per cent of total interest outlay (decreasing by year). More traditional targets, such as trade promotion and EU-conformity quality-control systems, as well as registration fees for Hungarian innovations, figure on the list.

Microcredit programmes aim at supporting SMEs which do not as yet qualify as bankable. However the programme also lists among its aims job-creation and the fight against depression in regions. Applying ventures must not employ more than ten people and assets must not be over Fts2.5 million (c.10,000 euro). The upper limit on this kind of credit was Fts1 million in 1992-99, rising to 3 million in January 2000. Credits can be granted no more than three times, and a minimum of 10 per cent of the investment must be the entrepreneurs' own contribution.

Table 12.3 shows that microcredits started slowly, but with the slow, steady recovery of domestic demand from 1996 on the dormant

Table 12.3 Size and scope of microcredits in Hungary, 1992-99

Year	Funding of local enterprise support centres (Ft000s)	Applications		Approved applications		Credit distributed		Average credit (Ft000s)
		number	value (Ft000s)	number	value (Ft000s)	number	value (Ft000s)	
1992	136,101	730	210,564	280	75,928	204	54,546	267
1993	298,500	1990	676,286	961	323,459	688	208,137	303
1994	719,000	3204	1,399,067	1617	649,250	1540	594,480	306
1995	833,000	4426	2,361,669	2608	1,307,034	2238	1,025,318	458
1996	773,928	4962	3,596,034	2762	1,980,794	2281	1,759,829	772
1997	730,000	3730	3,292,408	2693	2,267,776	2456	2,207,479	899
1998	0	2912	2,573,433	2075	1,854,012	1734	1,732,926	990
1999 (May)	0	828	729,336	568	490,597	490	453,573	926

Source: Újlet (2000) 7, 4, no. 36.

'entrepreneurial spirit' awakened and the size of average credits also increased steadily. It is interesting to note that the number of applications positively evaluated by the enterprise promotion agencies has been declining. This is in line with the overall trend observed in the preceding section of the diminishing role of 'one-man-shows' and the increasing role of medium-sized enterprises – that is, the consolidation of the firm size pattern of the Hungarian economy. Also remarkable is the relatively small number of firms receiving credits: less than 5000 of the 100,000 potential applicants estimated by the ME (*Világgazdaság*, 1 September 1999).

A special support scheme provides interest subsidies for exports, and another supports those SMEs that buy assets of other organizations under liquidation. Hungary takes part in the EU SME programme, following an agreement reached in the EU-Hungary Association Council in November 1998. Most important among these are: Europartneriat (organizing fairs and meetings twice a year), Interprice (matching small firms), EIC (promoting SME preparation for the single market), IBEX (promoting international supplier relations including subcontracting), Distributive Trade (assisting retailers in adopting best practices), and Craft Small Enterprise (supporting traditional handicrafts, and also young and women entrepreneurs in these sectors, by supplying catalogues and start-up assistance).

In the field of tourism, there are training programmes (including languages), support for gastronomic activities, horse-riding and bio-tourism. There is also attention to 'product-improvement', meaning support for tourism-related investments of various sorts including a large variety of activities related to the promotion of rural tourism. The latter is defined very loosely in order to promote local employment in areas other than the traditional fashionable tourist centres.

The National Committee for Technological Development offers financial support to high-technology SMEs through the Tech-Start programme, where up to 70 per cent of project costs can be obtained as non-reimbursable subsidies. Technological development resulting in internationally competitive products may also apply if their value-added increases as a result.

Since unemployment is a major social problem, a variety of job-creating programmes target SMEs. Besides these nationwide programmes, regional and local governments and NGOs also launch similar initiatives. Among the most important items are support for SME inclusion in public works programmes, involving retraining the unemployed as entrepreneurs, subsidies for retaining jobs and employing disabled people, direct wage subsidies to those employing registered unemployed persons (up to 70 per cent of wage cost) and school-leavers, and subsidies for regular commuting to more distant work areas.

Environmental protection support schemes are not specifically tailored to SME needs, but are made available to this group of companies as well. As non-reimbursable subsidies, interest-free credits, credit guarantees and

interest subsidies can be added up, their combined effect may make it extremely lucrative to invest. While a minimum 30 per cent own contribution is required, supports of various sorts may run up to 60 per cent of the total costs of development.

Regional development funds are administered by the Ministry of Agriculture and Regional Development, who mostly support projects in areas where GDP is below 75 per cent of the national average; where it can be carried out in 24–36 months; and offer at least 12 per cent nominal profitability. The maximum non-refundable subsidies are Fts500,000 to 1 million for job-creation projects. These funds are not very attractive to SMEs, since they are normally administered by the Treasury Office (TO) which has slow and bureaucratic procedures.

Last but not least are a large number of special programmes in agriculture. No fewer than 76 priorities are explicitly listed in the sectoral programme, if priority still has a meaning with such a vast number of specific projects! These are cases where the concerns of the regulators rather than specific needs of entrepreneurs seem to have gained the upper hand.

The other major source of SME finance is preferential credits and guarantees, but these are fewer in number than the schemes promoting various preferences of the state administration. The financial sector global loan of the European Investment Bank aims at SME promotion in general, excluding certain activities (the nonprofit sphere, farming, public administration, tobacco and armaments industry). Credits of between 20,000 to 12.5 million euro run for 5–11 years and are tailored to medium-sized rather than small firms and are administered, except for two cases, by foreign-owned banks and their affiliates in Hungary.

The EBRD has an agricultural restructuring programme, where private ownership is the sole explicit criterion. Returns should be over 12 per cent, own-funds should cover at least 30 per cent of the investment, and the maximum credit is 50,000 euro. Buying arable land or dwellings and paying overdue taxes or fees are excluded, with interest at 3–8 per cent above LIBOR based on individual rating of the entrepreneur.

The E-loan is meant to promote the creation of a domestic entrepreneurial class by supporting up to 50 per cent of the price of items of formerly state-owned property. The upper limit of this credit is Fts50 million (c.205,000 euro), the maximum interest rate is 7 per cent and the repayment period is 15 years. Understandably this used to be a most popular form of privatization credit in the period when many items were on offer and nominal interest rates skyrocketed. After 2000 the decline in the rate of interest as well as the lack of small-item privatization – except for liquidation – is likely to constrain the use of this form of financial support.

Three energy-saving loans support heating-system modernization. The one focusing on family dwellings and on local municipalities is likely to attract the interest of small businesses working in this particular area.

A Japanese loan promotes SME efficiency, productivity gains and related investments, categorized according to the normal micro, small and medium ratings. A minimum of 30 per cent own-contribution is required, interest is 75 per cent of the prime rate, plus 25 per cent margin for commercial banks and a one-time 1 per cent processing fee. Loans can extend from 2–7 years with creditworthiness checked by the commercial banks operating this scheme.

Export deals up to 75 per cent of their sales value can be financed from the SME credit line of the Exim Bank for sales of Hungarian products with a maximum of Fts200 million (c.767,000 euro), but it can revolve several times during the year. In the first six months of maturity only half of the interest due must be paid; interest is a maximum of 2 per cent above LIBOR with a maximum maturity of 12–18 months.

A special SME investment scheme is operated by the Ministry of Economy (though credit rating is done by the commercial banks). The scheme aims at helping the purchase of fixed assets especially during privatization where support can go up to 25 per cent. The foreign ownership cannot exceed 49 per cent, the state share cannot exceed 25 per cent, the establishment cannot employ more than 500 persons (even after having successfully completed the deal), and activities like mining, metallurgy or debt-conversion are excluded. A maximum of c.2.04 million euro is offered with interest equal to the prime rate plus a maximum margin of 2 per cent and a maturity period of 10 years (with a maximum grace period of 2 years).

Three further arrangements should be mentioned that can be particularly relevant for smaller firms. An ESOP loan up to 50 per cent of the purchasing price bearing a low 3 per cent interest and a margin of 4 per cent for a maximum maturity of 15 years is available if up to 25 per cent of the employees set up an ESOP organization to buy their company. Second, a START-loan is meant for companies composed of Hungarian residents. It aims at upgrading individual and micro ventures into joint and real proprietorships, mostly in the areas of production and trade. A maximum of c.128,000 euro can be acquired, with 10 per cent of own-resources to be deposited at the commercial bank; another 20 per cent can be from external sources, and 70 per cent from the START. The rate of interest is only 75 per cent of the prime rate plus 1 per cent for the part guaranteed by START Credit Guarantee Fund. Maturity is 15 years for construction, 10 years for machinery and equipment investment and 8 years for start-up inventory, with a maximum grace period of 2 years. Third, the Credit Guarantee Ltd. (CG) may take on cash-payment guarantee for SMEs with insufficient collateral for raising credit under normal conditions. This is offered to resident individuals and joint forms of entrepreneurship including coops and ESOPs not employing more than 300 people. The sum guaranteed cannot exceed Fts400 million (1.5 million euro) and does not normally exceed 80 per cent of the obligations of the company. For very small amounts below Fts10 million, as much as 90 per cent can be covered.

Maturity can run from 3 months to 15 years, with 1 per cent required as a processing fee. Over 25 different banks, 41 savings coops and two credit unions qualify as partners to CG Ltd.; thus the service covers practically the entire country. However, the efficiency of the arrangement is questioned by bankers (Csányi, 1998).

### Some controversial points and normative considerations on SME finance

This relatively extensive overview of the basics of SME financing schemes serves as a base for some overall conclusions, restricted by limits of space to Hungary. One feature that comes to mind is the relatively rich variety of institutional arrangements and target schemes, but a number of other points seem problematic. First, it is not always clear how relevant a concrete project is in practice at the macro-level. We have called attention to the fact that in several cases the scope of these programmes is quite small measured against the total number of entrepreneurs.

Second, it is not clear how the efficiency of specific projects or schemes is measured. This is the inverse to the problem raised recently in the literature (Bateman, 1999) criticizing the overemphasis on self-financing as a success indicator for support schemes. While this may be a valid criticism for World Bank-supported schemes in some Latin American countries, in transition countries this is not a serious consideration because there is no regular reporting and cost-benefit analyses of SME schemes. I certainly am unaware of any such attempt at measurements, even *ex post*, in Hungary. Neither is this considered in the preparation of small-business legislation, nor in the already-cited SME promotion programme of the government, let alone in the calls for more support by the Trade Chambers (or other interest representation groups) working on this issue.

Third, similar to criticisms made within the EU of SME support schemes, it is hard to see a coherent and well-coordinated public-policy perspective that could provide a basis for targeting these public monies. Instead, a mosaic-like sectoral approach seems to prevail where initiatives, uncoordinated in space and time, add up to what is *ex post* the backbone of public policy. From the resource map presented above it is clear that departmental segmentation of financing remained dominant and the coordinating role of the Ministry of Economy is subordinate or nominal at best, while the Finance Ministry and Ministry of Justice are totally untouched by the concerns of entrepreneurial development.

As a fourth point this is problematic in so far as not only our previous research but also that of other institutes (GKI, 1999) point to weaknesses in the rule of law as the main impediment to SME growth. This relates to enforcement of property rights, availability of collateral, or the cost of legal action in terms of time. These all provide incentives for semi- or non-legal

ways of contract enforcement. Also the sums of money earmarked for SMEs and the repeated calls for simplifying procedures are regularly reversed by decisions of the fiscal authority, who aim to enhance controls and make tax collection more strict while fighting misuses and the irregular economy. This is a major problem for microfirms.

A fifth point of criticism may be levelled at the relatively unimportant role played by local municipalities and non-governmental organizations, insufficient both in terms of poverty alleviation and in terms of providing incentives for microfirms to expand.

Two further issues involving SME finance may be raised: calls for establishment of an SME bank; and the possible role of venture-capital funds as sources for financing the expansion of *de novo* firms, particularly in the high-technology sector. The idea of setting up an SME bank has a long history in Hungary and can be documented at least since 1993. The idea is simple: once normal commercial banks redline SMEs, a semi-state institution, caring more about public purpose than profitability, could and should finance small business, particularly start-up ventures. While the size of the use of the public purse always remains open, the idea itself seems clear. However, it does not withstand closer scrutiny.

A recent analysis by the Hungarian Chamber of Trade and Industry (Csányi, 1998) has repeatedly underscored that especially microfirms and individual ventures are by definition non-bankable. Even if their profitability is adequate, they lack track records and the cost of processing their application often exceeds the after-tax revenue of the bank. Therefore – quite in line with the earlier quoted multi-country study – most microfirms do not even apply for credit and, knowing their vulnerability, assess their prospects realistically.

A major condition for a SME boom is improving domestic profitability, with steady growth of demand and declining inflation, together making calculation and foresight easier. Much of the excessive costs incurred by all ventures, including banks, result from overarching regulation in the collection of public taxes and fees, from difficulties in their access to collateral, and lack of reliable information on the creditworthiness/solvency of partners. This leads to inflated collateral requirements by the banks, defending their own business interests as well as those of their depositors.

Here we have come to a fundamental point: no softening to the cold-hearted banking behaviour is possible if public interest is understood to be broader than that of the entrepreneur. Unless bank-bailouts can be accepted as a regular procedure, no bank can afford soft lending. If this bank is state-owned, the fiscal authority and parliament equally take a justified interest in where public money has gone and with what returns. This puts a constraint on soft money lending on the supply side. On the demand side there is a similar constraint: short of stiff requirements on returns, subsidies may delay adjustment. As a result they may be held directly responsible for

business failures, as adjustment could have been cheaper (or more feasible) at an earlier point of time. This is another form of moral hazard.

Even if we assume that a robust economic recovery, such as has been emerging since 1993 in Poland, Hungary, Estonia and Slovenia, gradually solves much of the problem of microfirm profitability and viability, two further problems remain. First, entrepreneurship is by definition a trial-and-error process in which individuals try their abilities and have to grow up to the entrepreneurial role, or conversely have to give up the idea of earning their living as self-employed. Thus a phase of maturing is probably inevitable before the propensity to grow emerges, and before the use of borrowed resources begins to make business sense. A very large number of firms such as survival ventures, tax-evading forms of employment, or nonprofit activities of various sorts from family plots to community sports clubs may well never graduate. And this is not their success indicator either. For this first group there are no economic grounds for socializing the risk of entering business. If territorial or social grounds do justify spending, these should be made explicit.

Second, even if we presume that extensive deregulation abolishes many of the obstacles presently hindering small-business growth, a basic problem of informational asymmetry remains. Banks as established large organizations can never 'know enough' about their customers, no matter how much they study them, so written as well as unwritten rules of prudential behaviour constrain banks from being active in SME finance.

What is the way out? On the policy-making level an endless game is to be expected in which banks try to pass the burden stemming from informational asymmetry on to the public purse. Meanwhile defenders of the latter are paid to advance propositions to go in the other direction, since 'who else has got more money than banks?' Recently the Hungarian government has been attempting to convince the largest banks to take on special SME packages without extra fiscal compensation (Fónagy, 1999). Banks, as reflected in the study of Csányi (1998), try to pass the same burdens on to one public authority or another.

A more constructive and forward-looking approach would be to capitalize on the Italian experience of letting local savings cooperatives and municipal financial organizations take the initiative. Being embedded in local society, they may more easily overcome the informational asymmetry (and not necessarily by producing even thicker documentation to capture various behavioural features of applicants). The idea is to decentralize risk to the level where sufficient knowledge is available to evaluate it – a policy that does seem to work in northern Italy.

An alternative approach to SME finance expects venture capital funds to hold the key. This approach was criticized earlier for seeing SMEs primarily, or even exclusively, as producers of innovations. This Silicon Valley approach takes little account of the social and regional realities of central, and even less of east, European countries. However, venture capital funds have gradually

been emerging in the region. In Hungary detailed empirical analyses (Karsai, 1998, 1999) have been produced to address the issue, and the findings are summarized neatly by two theses. First, the less that SMEs in Central and Eastern Europe (CEE) are of the Silicon Valley type, the less likely venture capital is to fit their needs. This is largely an empirical issue to be addressed in quantitative terms. Second, the more venture capital funds in CEE behave as typical new entrants in a new market, that is risk-averse, thus putting their bets on obvious success stories, the less likely these are to match the needs of the SME sector. The last point is an important qualification, since if there is no matching need venture capital funds will simply die away.

As illustrated above, the majority of SMEs consists of microventures. There is a trend towards consolidation, but it is the medium-sized enterprise sector that continues to be the weak point in the enterprise pyramid in transforming societies. Microfirms and sole-proprietors simply do not fit with venture-capital financing. From the perspective of venture capitalists the limits to their involvement seem to have been clear. As new entrants, they had to justify their entry into a new market with fat and quick profits. These have been offered by some of the obvious star proprietorships. In Hungary, for example, some small gains emerged in the pharmaceutical branch as well as in computer business. In the uncertain conditions following the Asian and Russian financial crises in 1997-99, venture capitalists tended to adopt a more cautious approach. My recent interviews with fund managers also offer a mixed view, with portfolio investments growing, while equity investors become even more cautious and unimpressed by overall macroeconomic data.

In sum, venture capital is likely to be a limited but still important source of finance for a well-defined segment of SMEs. Meanwhile individual good examples may hardly add up to a macroeconomically significant overall boom, as experience with the East German provinces amply demonstrates.

Two further initiatives should be mentioned, exemplifying the regional approach to SME development in Hungary. One is the development of *entrepreneurial zones* that aim to promote SMEs outside the big industrial agglomerations. The idea is to use entrepreneurship as an instrument to fight regional depression. The second approach is to establish *industrial parks* that offer basically infrastructural advantages with financial incentives playing a subordinate role. The theory of productive services suggests that it is physical infrastructure that matters most for start-up ventures. Industrial parks have left their infancy, but have yet to come of age in Hungary. The number of areas developed, and even more the number of employees, lag behind projections and the lags are more significant in areas where the spontaneous inflow of FDI is inadequate.

This state of affairs justifies a cautionary note. The enabling environment, modelled on the north Italian experience is hard to create at will. Public as well as private commitment may be much slower in coming than official declarations would foreshadow. In many ways FDI rather than anything else

helps to bring about the entrepreneurial spirit and a social environment supportive of enterprising activities, where the young and the bright seriously consider starting up their own ventures locally, rather than elsewhere.

This shows the double edge of the sword: if public money and effort is insufficient, it is likely to be wasted. In this case the externalities used to justify public policy actions do not materialize. And conversely: more resolute public involvement in a few well-defined places may well produce relatively quick results. Examples of such well-targeted measures are deregulation, low taxes, improving institutional infrastructure, enhancing competition policy and enforcing rules to enable entry. What matters most is involving investors and their 'animal spirits': their action retroactively justifies public spending if that really managed to create partnership with the private sector.

### Concluding remarks

This study has highlighted the need for an enabling environment for SMEs that are known to be more vulnerable than larger corporations. We still know precious little about how exactly such an environment comes about and what role is played by path dependency and social intangibles. We have illustrated with the example of one of the frontrunner countries the limits and possibilities of the many financial institutions, funds and incentives, that have been introduced in practice. They are documented in the background study of this chapter. Recent empirical studies (Kolarov, 1999) have shown that organizational culture and attitudinal elements are at least as important factors in successful business growth.

Finance is not necessarily equal to soft money, nor is it necessarily a grant to the entrepreneur. It may well be that public spending assists in generating such externalities as the rule of law or accessibility via the Internet or road. Erroneous selection does not seem to be a major problem, while informational asymmetry and its size-specific repercussions affect domestic and foreign-owned SMEs alike.

The regional approach is not a cure-all, still it is superior to any sort of centralized scheme. Public policy should thus focus on creating a business-friendly overall environment where competing strategies can coexist. Thus employment can be offered to people with varying aspirations, abilities and backgrounds, which is a core function of small business the world over – and even more so in transition societies. Recent experience shows that the recovery of domestic demand helps overcome some of the obstacles listed above, and so does deregulation and cuts in public dues.

### Note

- 1 Regular surveys of SME activity have been conducted in various places, the most important being the KFI and the Department for Small Business in the Ministry of Economy.

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