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Context and Policies for the Transformation and Growth of SMEs

The Case of Hungary with Russian Implications

Bruno Dallago

UNU World Institute for
Development Economics Research
(UNU/WIDER)

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This study has been prepared within the UNU/WIDER project on Small and Medium Enterprises in Transition: How does Entrepreneurship Develop in Post-Socialist States (Transition from Below: The Role of the New Private Sector), which is directed by Professor Robert J. McIntyre.

Professor Bruno Dallago is affiliated with the University of Trento, Italy.

UNU World Institute for Development Economics Research (UNU/WIDER) was established by the United Nations University as its first research and training centre and started work in Helsinki, Finland in 1985. The purpose of the Institute is to undertake applied research and policy analysis on structural changes affecting the developing and transitional economies, to provide a forum for the advocacy of policies leading to robust, equitable and environmentally sustainable growth, and to promote capacity strengthening and training in the field of economic and social policy making. Its work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

UNU World Institute for Development Economics Research (UNU/WIDER)
Katajanokanlaituri 6 B
00160 Helsinki, Finland

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FOREWORD

UNU/WIDER has launched a Research Project on Transition from Below: The Role of the New Private Sector in 1998. Transformation in Central and Eastern Europe is indeed one of the scientifically and operationally most challenging questions in the world during the last decade. The experience gained so far has clearly shown that one of the crucial components of transformation, and a necessary condition for its success, is the development of a strong and dynamic small and medium-size enterprise sectors (SMEs). However, this sector has been disregarded so far in scientific research and policies alike.

This paper that is now published in the Research for Action series in its full length was originally prepared for the research project and subsequently updated. It analyses the Hungarian experience with SMEs development by highlighting the factors and policies that explain the sector features and dynamics and utilizes this experience to suggest an interpretation of the striking differences with Russian SMEs. The case of Hungary is particularly interesting for different reasons. First, Hungary has been a frontrunner in transformation, since she started a far-reaching and complex economic reform well before the other countries, in 1968. Second, Hungary was also the first country to liberalize economic activity for small businesses and to adopt and implement the basic transformation laws. Third, she also was among the very first countries to devise and implement a specific policy for SMEs. Fourth, Hungary adopted a privatization programme of former state owned enterprises based on their sale in the market for real money. This could apparently hamper the establishment of new firms, since capital is likely to accrue to the top-down privatization process. Fifth, Hungarian SMEs are apparently rather successful also in the international market, either directly or as sub-supplier of exporting firms. Sixth, new SMEs are being established largely by individuals who had a particular role in the former political and administrative elite.

All these aspects give the Hungarian experience an interest that goes beyond the country and that can serve to test the influence and outcome of long run, relatively consistent policies in transforming the economic system of a country. In spite of the extremely difficult domestic and external financial situation of the country around 1990, the utilization of market methods for transforming the size structure of firms produced fair results. As Dallago stresses, this is due to a set of factors: the environment of the transformation, the characteristics of the economic system, the features of economic actors and the policies that have been implemented. The outcome is not entirely positive, though, and a forceful policy action is needed also in the future to modernize the sector.

Russia presents a strikingly different situation for both the context (there including the environment and the economic system) and the features of economic actors. Policies have also been different. The comparison between Hungary and Russia in this paper is an introduction to the tricky question of SMEs under-development in Russia and suggests some ideas on possible policy strategies. This comparison helps to evaluate the influence of context, actors and policies on the unfolding and outcome of transformation. It suggests that transformational success and SMEs development are but two sides of the same coin. What prevents transformation hampers SMEs development as much as the failure of the latter obstructs the success of the former.

Giovanni Andrea Cornia
Director, UNU/WIDER
October 1999

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I INTRODUCTION

Economic activity is the fruit of the action of human actors, both individuals and organizations. These actors are endowed with particular features and operate in the existing context by making use of the physical world. Consequently, economic outcomes depend on the general context within which individual actors' activity takes place and on the individual features of these economic actors.

The context includes the environment of the economy and the economic system. The context is characterized by complexity, which has three dimensions: variety, variability, and variance. Contextual variety is produced by the presence of different economic and non-economic variables having differentiated impact on economic activity. Contextual variability is the product of variation through time and space of the values and combinations of such variables. Contextual variance consists in the extent to which the value of a variable is dispersed around its mean value. The economic system comprises the set of variables that co-ordinate, constrain and promote the interaction among individual actors and their relation with the environment in their economic activity.

In this sense the features of existing Small- and Medium-Size Enterprises (SMEs) are explained by three sets of factors: (a) the environment, i.e. the availability of proper technological solutions and social, physical and financial resources, that determine what is feasible; (b) the transaction costs defined by the economic system, that determine what is rational; and (c) the individual features of the actors themselves, which determine what they want and can actually accomplish. Given the variety, variability and variance of the above three sets of factors, one should expect that the SME sector presents different features in different situations. To these three factors, SME policies should be added.

The next section presents an institutional explanation of the factors that determine the quantity, role and economic performance of small- and medium-size enterprises: the environment; the economic system; and individual features of the actors. The 'natural' development of SMEs is defined by these three sets of factors that can be modified via policies as discussed in the last part of section II and in section III. Section IV deals with contextual features in Hungary and sketches the basic features of the Hungarian environment, economic system and individual features. The outcome of these contextual features, i.e. the static and dynamic features of SMEs in Hungary, is the topic of section V, which also includes a critical appraisal of specific SME policies. In the concluding section VI the Hungarian experience is used to suggest SME development policies for Russia.

II THE DETERMINANTS OF THE ROLE AND ECONOMIC PERFORMANCE OF SMEs: AN INSTITUTIONAL EXPLANATION

2.1 The context: environment and economic system

The environment comprises all those variables that are exogenous to the economy. This is so in a double sense. First, economic actors in a particular economy must take those variables and their value as given, since they are unable to change their value via their economic activity. They may even be able, as individuals or as organizations, to change them acting as political or social actors, but not as economic ones. Second, internal economic policy makers are unable to change those variables and their value or could do so only at excessive cost.

The environment includes both economic and non-economic variables, such as external (e.g. the international economy) and natural (e.g. endowment with natural resources) factors, the existing level of economic development and technological knowledge, the existing level and structure of physical financial, and human capital, political and demographic factors, culture, ideology, moral norms, trust. The importance of these variables lie in that the economic actors' attempts to carry out purposive action are embedded (Granovetter 1985) in ongoing sets of environmental and systemic variables. The fact that these variables are pre-existent and that many have persistent nature since they change only slowly are causes of path dependence also in economic activity.

The economic system is the structured and co-ordinated set of formal and informal institutions and structures – including rights, constraints, agreements, and purposeful and spontaneous individual and social action principles – that human beings agree on or accept via learning, social interaction or coercion in order to make their individual economic actions compatible and individually or socially useful to pursue a superior goal or the interests of a specific social group or class. The economic system consists of a network of structured relations that mould, constrain and organize the activity of economic actors in their interaction with other actors and with the environment as they pursue some economic goals. It follows from the above definition that the economic system simplifies the situation and reduces uncertainty for the actors, constrains the variance of individual behaviour (there comprising opportunism), mitigates the problem of small numbers (by creating regularities and norms) and information 'impactedness', reduces the consequences of bounds on rationality, while making control and enforcement more effective and less costly.

In brief, the economic system: (a) structures the impact of the environment on economic actors and softens the limits deriving from the features of the human factor; (b) reduces transaction costs also via increasing institutional returns to scale and limits learning and information costs by simplifying and specializing the choice set; and (c) creates a critical mass of individual activities that may amplify and extend their impact and increase individual returns. In this way, the economic system produces spillovers and externalities that decrease and reallocates transaction costs of economic activity, defines incentives, opens opportunities, and structures individual adaptation and discovery. It also determines the allocation of individual resources and activities by defining the incentive structure.

Since the economic system forms the basis upon which regularities and stable inter-actor relations can be efficiently structured and supported through time, any complex economy is endowed with tangible and intangible assets that are specific to the existing system. These intangible assets include knowledge and capabilities, property rights, labour relations that are specific to a given system and reflect the structural features of the system. Tangible assets include physical assets and the system-specific content of the pattern of labour division, the features and sources of financing economic activity, company organization, flows of international and domestic trade, policy structures, goals and instruments. It should be stressed that in real economic systems the general and material side of assets is hardly and clearly separable from system-specific features. All these assets are system-specific in the sense that if the system changes they cannot be redeployed to alternative uses without full or partial loss of their productive value.

Seen from the perspective of the role and development of the SME sector, the relevant dimensions of the economic system are the nature and role of other (larger) firms and the state, the budget constraint of economic actors, monetary and financial factors, property rights and ownership forms, motivations and incentives, and the way in which corporate decisions are made. The relevant dimensions of the environment are the country endowment with natural resources, population, infrastructure, geographical and geo-political location, culture and social relations (including the social perception of property rights and entrepreneurial activity).

2.2 Economic actors

The third, partially independent variable that explains the outcome of an economy involves various individual features, the economically most important of which is individual capabilities.[1] These include the knowledge and skills and the ability to perform certain actions and pursue goals. Although they are individual, the capabilities of different individuals are co-ordinated and linked together as a consequence of the existing environment and the economic system. Capabilities require investment to be created and produce an outcome when applied to economic activity.[2] Investment in capabilities depends upon the environment and the economic system in which they take place. It requires long periods of time to take effect, in particular as far as tacit skills and complex organizational capabilities are involved. Similar to investment in physical capital, investments in capabilities have a high risk of failure, in particular under circumstances of high environmental uncertainty or institutional disruption. The

1 I distinguish here individual capabilities from social capabilities – i.e. the institutions that support investment in human capital, technological competence and the financial institutions according to Abramovitz 1986 – that in my view are part of the economic system.

2 I follow here Swaan 1998.

effectiveness of institutions and incentives in turn depends upon the level of capabilities prevailing in the economy. If capabilities are initially unfit in the new environment or system, the responses to changes in both institutions and incentives will be proportionally lower.

Capabilities play a crucial role and are particularly complex in the case of horizontal inter-firm co-operation. It is important to distinguish between technical capabilities and relational capabilities. Technical capabilities refer to the knowledge (both codified and tacit) the skills, the ability and the experience necessary to perform the appropriate economic (production or marketing) action. This involves the ability to determine the productive profile of the firm and organize the production process with the necessary complementarities. Knowledge of this kind is at the basis of the technical performance of production processes and determines the use that actors make of technical information. In any given environment and economic system, technical capabilities define what is physically and technically feasible in the economic process and how an investment should be technically implemented in a given economy.

Relational capabilities have to do with the organization and co-ordination of the economic process, because they determine the ability of social actors to co-operate in pursuing their individual goals by making use of economic information. They consist in the knowledge, mainly tacit, and ability to manage relationships with actual or potential competitors, co-operators and other stakeholders in the production process. Therefore, it is relational capabilities that define the structure, actual use, path of development of the technical capabilities within the firm and define the place the firm occupies in her environment. This 'place' varies from that of an isolated small business to that of an active member of an industrial district. Relational capabilities may permit direct control over the entire productive process to be replaced by co-operation with other firms. Therefore, an indispensable complement is trust and the acceptance of some degree of network obligation with respect to present and future conduct. These factors make it possible to avoid the continuous and costly stipulation, monitoring and enforcement of detailed contracts that are thus partially replaced by relational networks. This may make it economically advantageous entering co-operative networks compared to both markets and hierarchies. However, compared to markets and hierarchies, co-operation involves *ex ante* co-ordination that induces each firm to give up certain components of the production process. Since the network has a value to its members, each firm finds rational to give up opportunism in order to protect the co-operative network.

The advantage of network co-operation for SMEs is greater than the differential advantage of relational contracts. As stressed by Loasby, this kind of industry organization enables firms to draw on each other's distinctive (technical) capabilities in the form of specific skills, information and tacit knowledge of processes and techniques (Loasby 1994). This kind of interaction stimulates 'social learning' processes in which a 'social pool' of information and knowledge is created among the participants of co-operative agreements. The effect of learning and information in reducing costs is proportional to the length of the contract. In fact, positive externalities emerge from knowledge and information generated either by individual agents or by the interaction among different agents in a co-operative agreement and are the greater the more stable is the co-operation. These externalities can be in the form of new products and processes, new combinations of resources, enhanced competitiveness, production rationalization, and 'quasi-rents' (Santos 1998: 7).

One should also add that a context based on trust, co-operation with and dependence on others easily supplies actors with powerful incentives. In brief, network co-operation stimulates the production of positive and appropriable externalities and supplies powerful incentives.

Relational capabilities are particularly important for SMEs since they are often enterprises that because of their limited size cannot include all the technical capabilities to produce and market a complex product. Therefore, they have one of the following choices: (a) buy the other components on the market; (b) make one component and deliver it to a larger firm as a sub-contractor; or (c) enter into a co-operative productive or marketing arrangement with the producers of the missing components. The choice between making and buying depends, at least in part, upon whether the firm has the capabilities to manage complementarities and manufacture a certain product (Richardson 1998). If not, it will resort to an outside producer.

It is the third case that is of greater interest here, since SMEs are limited in their technical capabilities to manufacture complex products but often have good relational capabilities. Such firms have the opportunity to co-operate by establishing networks. Disregarding other individual features, relational capabilities depend even more than technical capabilities on conducive environmental and favourable systemic features that support and stimulate such co-operation. Also policies can greatly help the development of such capabilities.

Capabilities – in particular relational ones – are a crucial factor for the development of enterprises. As Benedetti, Mistri and Solari have stressed, district development goes together with a general growth in the complexity of the external environment and of firm-environment interactions (Benedetti *et al.* 1998). Increasing complexity is promoted by factors such as internationalization, technological progress, the increasing role of complex financial variables and cultural change. This may produce uncertainty that in turn strongly influences the firms strategies and may easily give rise to successful risk adverse strategies. These may be of two types: (a) at the district level; and (b) at the enterprise level.

At the district level, the so-called 'flexibility preference', given proper technological conditions, leads to the creation of interconnected systems of small enterprises that are both competitors and complementary. In this context, external economies replace scale economies: 'the flexibility preference is transformed in a shortening of the time horizon of investments and therefore in short production processes substituting long [ones]. It follows that the system "chooses" an organizational form which minimizes the 'sunk costs' by the means of more easily convertible investments. A kind of "lego" productive organization emerges where flexibility results from the extreme specialization of its components' (*Ibid*: 9).

At the level of the individual enterprise, specialization increases the risk deriving from change. This induces small entrepreneurs to diversify by avoiding reinvestment of all the profits in the enterprise, thus keeping the enterprise small. However, the great symmetry of the positions of businessmen and workers in the district firms, sharing the same information on the situation of the firm and who are similarly depending on reputational effects linked to individual performance, give the reproduction of firms within the district ongoing relational features.

These features may prevent the development of capabilities in a modern and complex way. In fact, SME networks in developed market economies – notably industrial districts – are characterized by a peculiar division of labour not only among firms, but also within the firm. The extremely fine division of the production process that the firm performs requires highly specific knowledge and information. Usually, operational people (technicians and skilled workers) have these kinds of capabilities. This is usually the origin of businessmen in district SMEs, who have acquired their capabilities (knowledge and skills) on the job. This is mainly tacit knowledge that is difficult to transmit and possibly replicate. However, it may be diffused in a particularly conducive environment and economic system.

The advantage of this type of technical capabilities is that their production cycle is short. However, the underlying knowledge can hardly be transmitted and its accumulation and development are limited. As a consequence, it is quite appropriate for simple and specialized, immediately applicable adaptive innovations, not for more complex ones. Upgrading the district firms role is only possible via complex and dynamic relational capabilities. These may create complex district structures that produce externalities and permit the modernization of the entire district.

2.3 The interaction of actors and the context

Any specific economic outcome results from the activity of economic actors in a given context. I distinguish three types of actors: (a) small-and medium-sized enterprises; (b) large firms; and (c) policy makers.[3] Each group is boundedly rational in the sense that actors try to pursue their objective function in the best possible way, although they work with their limited knowledge and information. Since the objective functions are different for groups (a) and (b) as compared to group (c), they afford two different sets of knowledge and information types and problems. I assume that businessmen (SMEs and large firms) have good knowledge and information on specific and localized variables ('dispersed knowledge' and information), but they have weak general (centralizeable) knowledge and information. Policy makers are characterized by the opposite situation.

Since they pursue different objective functions, their individual attitude is also different. Simplifying, I suppose that businessmen pursue their own individual gain, while policy makers pursue some kind of social advantage (in our case, they try to create the best

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[3] Following standard usage, enterprise and firm are treated as synonyms. Since I deal with SMEs, I do not distinguish between the individualistic aspects of firms (e.g. the owner or manager as individuals) and the firm as a collective. Consequently, I disregard here agency problems.

conditions for the development of SMEs). This does not necessarily mean that they are respectively opportunistic and altruistic. Indeed, I will show that the features and behaviour of economic actors determine the type of SMEs that develop in a given economy. More precisely, the development of complex networks (such as industrial districts or local productive systems) require (a certain degree of) altruistic businessmen and policy makers and a low degree of variance in this individual feature. How this result is produced and how stable altruism is depend on the context. If both act opportunistically, the outcome will be independent (isolated) SMEs. The case of SMEs that are vertically integrated with large firms is intermediate.

Therefore, SME businessmen and policy makers can be successful in developing complex SMEs structures only within a certain range of values of contextual complexity and individual features. SMEs success (quantity) and nature (quality, such as networks) depend on these two sets of variables. Consequently, there must be a certain degree of compatibility and complementarity between contextual complexity and individual features. Policy makers should try to strengthen such compatibility and complementarity and try to fill gaps whenever this may be feasible. This may be a further important formal source of systemic asset specificity.

Given these individual features of rationality, knowledge, information, opportunism/altruism and contextual complexity, economic actors have an interest in investing resources in order to adapt and gain advantages from social and economic interactions. Sociological and economic literature has detected four different types of economically relevant assets: social, systemic, human, and material (physical and financial) assets. The net present value of that investment forms the actors' capital which creates, respectively, relational, systemic, human, and material (physical and financial) capabilities. Although these assets – and the investment in them that is necessary to create capital, and capabilities – are partially overlapping in real economies, it is conceptually and analytically useful to distinguish them.

It is also important to stress that investment in social, systemic and human assets is particularly time consuming and characterized with high sunk costs. Consequently, social, systemic, and human capital change only slowly quantitatively and in their structure. Given the different types of capital, the actors' spontaneous activity and policies can govern investment in material assets in a relatively easy way, although this is not a risk-free and instantaneous process either. Investment in systemic assets represents an intermediate case, since proper spontaneous processes and policies of institutional reform can modify or transform the economic system in which the actors' activity is embedded. For this reason, the importance of investment in systemic assets is outstanding, since businessmen and policy makers can properly structure the system in such a way that moulds incentives to investment in social and human assets. Investment of scarce resources in different types of assets is partially alternative, partially complementary or even mutually reinforcing. For instance, as we will see in the case of SMEs, investment in social capital may render further investment in systemic, human and material assets less costly and more productive.

The role, structure and development of SMEs in a given economy depends on the interplay among these four kinds of capital. Social capital can be defined as the economic value of social institutions. Social capital is the set of formal and informal social relations that support the prevailing institutions and structures within a given society. They include such variables as mutual trust, moral norms and rules that regulate social life, civic associations, networks, social attitudes towards labour and organized economic activity (Coleman 1990 and Putnam 1993). Social capital structures both formal and informal institutions and in the long run it has strong influence on individual features. In this sense it may promote spontaneous co-operation among social actors or can supply the social basis of hierarchies and helps to overcome the dilemmas of collective action by reducing opportunism (Ostrom 1990). In circumstances were social capital is well developed transaction costs are lower, actors make less use of exit mechanisms compared to voice and adaptation, and also the costs of change (transition costs) may be less relevant. Therefore, social capital is a (partial) substitute for formal institutions that reduce transaction costs.[4]

2.4 The economic system and systemic capital

Individual and collective actors that operate in a given system have to learn to adapt and use those assets and the opportunities they offer creating *systemic capital*. They have to invest valuable resources in system-specific assets, directly or indirectly. In this way, they acquire property rights in the system and become 'owners' of the system. Since those resources may be subtracted from alternative uses, e.g. from directly productive investment in material assets, the overall performance of an economy depends on the balance between the amount and productivity of the resources that are actually subtracted from directly productive use to be invested in system-specific assets and the value of the complementarities, spillovers and externalities that the economic system produces as a result for productive activity.[5]

Different investments in system-specific assets have different returns and represent different types of adaptation to existing institutions and structures which accumulate in the actors' hands to form systemic capital. Although the actors' individual features influence their decision to invest in system-specific assets, it is the rights that actors enjoy over this capital that structure their rationality, knowledge, opportunism/altruism, capabilities and consequently their behaviour and choices. It is worth noting that the existing individual features define the reaction to individual incentives and put limits to individual investment in system-specific assets and thus explain – together with social factors – the individual variance in systemic capital endowment. Systemic capital embodies property rights over system-specific assets, that in turn affect the choice among existing technological solutions and the structure of incentives, and influence investment in human resources, codified knowledge, the features and role of information

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4 On the role of social institutions in reducing transaction costs see Williamson 1975. Denzau and North 1994 consider 'shared mental models' such as beliefs and ideologies as partial substitute for formal institutions in reducing transaction costs.

5 For a more complete explanation see Dallago 1996.

flows. In short, systemic capital defines the individuals' position in the existing economy and its productive outcome.

One should notice at this point that systemic change not only implies the necessity to invest new, valuable resources into new system-specific assets, but also causes the loss of old systemic capital. It also involves additional costs that actors must bear in order to convert (part of) the old systemic capital into new systemic capital. As a result of these processes, complementarities, spillovers and externalities produced by the existing (transitory) economic system are weakened and the system contribution to economic performance is reduced. These processes may even jeopardize production. Because even material (i.e. directly productive) capital includes many system-specific features, systemic change implies that productivity of material capital is also reduced and that actors must afford additional costs in order to adapt their material capital to the new economic system.

It is obvious that the owners of old systemic capital try to resist their loss and look for ways to convert it into new systemic capital, i.e. into rights over assets that have a value in the new system. In fact, (boundedly) rational economic actors are interesting in keeping the value of their old systemic capital, possibly by using it before its value is lost to acquire rights on new system-specific assets. This usually is a powerful aspect of the path dependence of systemic change, since the old systemic capital (to the extent that it is converted into new systemic capital) and the property rights structure it expressed strongly influence the features of the new system.

Since these processes are costly and take time, the effect of systemic change in reducing economic performance continues until the bulk of investment in systemic change is over and the new system starts to produce its own positive spillovers and externalities. At that point, the new system – if better adapted to the environment and to individual features and/or endowed with more powerful incentives than the old one – will produce greater economic performance. My contention here is that expansion of the SME sector can strongly favour this adaptation by making it less costly and more productive in three different ways: (a) by providing strong incentives and activating social capital; (b) by easing the process of conversion of old systemic capital in a productive way; and (c) by fostering entrepreneurship as the fundamental vehicle of innovation.

2.5 Policies

Although social and systemic capital act mostly at the micro-level in a largely spontaneous way, there also are a set of instruments that governments can use to influence institutions and the behaviour of organizations and consequently social and systemic capital, in particular when spontaneous processes and collective action fail to produce the desired outcome. Through policies, governments are able to change and reallocate incentives and rights and consequently altering the choices, behaviour and decision making of actors. Policies can influence not only material capital, but also social and systemic capital. However, policies have limits and they may have unforeseen and unwanted consequences. First, policies are embedded in the existing social and systemic capital in the sense that they may be required to replace missing social capital and in the sense that the informal reaction of actors to policies is also mediated by social capital. Second, the environment and the economic system define and constrain the kind of policies that can be implemented, their formal structure, operational features and the response of (boundedly) rational actors. Given this, individual features determine the actual outcome of policies. The attempt to implement policies that are in sharp contrast with the existing structure of social and systemic capital is likely to make those policies irrelevant and ineffective and may also decrease production. This is a classical case of so-called unforeseen and unwanted consequences, of which transition countries offer many examples.[6]

Policy making takes place at different levels: local, national, supranational and international. The complexity of this function requires a good degree of co-ordination among the different levels, specialization and division of labour among the different organs. These features of policy-making are highly system-dependent and they may be particularly weak during transition. It is at the level of local systems that much codified and tacit knowledge are integrated (Becattini and Rullani 1996: 162-163). In the case of SMEs, local policy making is particularly important.

By considering jointly the factors discussed so far in a simplified way (social and systemic capital are unified under the label 'capital', variance being disregarded) and considering policies as a (partial) substitute for social/systemic capital, my interpretation of SMEs development is as follows:

DIAGRAM 1

	I	II	III	IV	V	VI	VII	VIII
Businessmen	O	O	O	O	A	A	A	A
Policies	O	O	A	A	O	O	A	A
Capital	U	F	U	F	U	F	U	F
Overall	O,O,U	O,O,F	O,A,U	O,A,F	A,O,U	A,O,F	A,A,U	A,A,F
SME outcome	Survival SMEs ('sell')	Independent SMEs ('buy/sell')	Indepen-dent SMEs ('buy/sell')	Opportunistic vertical integration ('make')	Relational vertical integration ('cooperate')	Simple networks ('cooperate')	Simple networks ('cooperate')	Complex industrial districts ('coordinate/ cooperate')

Legend: O = Opportunism A = Altruism U = SMEs unfriendly F = SMEs friendly

Cases I and VIII depict two opposite situations from the perspective of SME development. In case I (O,O,U) all the crucial factors are unfavourable to the development of SMEs, and since even policy makers are opportunistic existing SMEs will just survive without pursuing long-term strategies of development. In case VIII (A,A,F) all the crucial factors (the combination of individual features and the different

6 Raiser 1997 shows how different endowment with social capital and informal institutions in different transition countries produced strikingly different outcomes.

types of capital) are favourable for the development of SMEs and spontaneous processes are supported by SME-friendly policies. The historical experience that is closest to case VIII is the Italian industrial districts and local productive systems development. Since both the individual features of businessmen and capital are the outcome of processes that are long and difficult to control, the crucial question is: What should the role of policy makers be in the cases that diverge from the ideal conditions of case VIII? What kind of policies and policy instruments should policy makers use to foster the development of better structured and competitive SMEs?

Answering this crucial question implies that policies can be a partial substitute for missing 'spontaneous' crucial factors such as individual features and capital. This role can be seen in two radically different ways: (a) as a direct substitute, whereby policies endeavour to supply SMEs with the missing factors (i.e. missing capital and businessmen altruism); and (b) as an indirect substitute, since policy makers try to create proper conditions for fostering the spontaneous supply of the missing crucial factors (i.e. give proper incentives for businessmen to be mutually altruistic and co-operate and for the supply of social and systemic capital).

A second fundamental point is to make clear which policy makers can play the most positive role in the case of SMEs. Since SMEs are usually dispersed on the territory and their activity is usually locally based, it is crucial that policy makers have locally based knowledge, information and capabilities. Here the fundamental question is to see what the role of local governments should be. I will try to answer the above questions in the case of Hungary and then use the results reached in this way to see what could be done in the more complex Russian case.

III SPONTANEOUS DEVELOPMENT AND THE ROLE OF POLICIES

Although transition economies face specific and original problems, it may be useful to look briefly at the lessons of successful experiences.[7] I will use the Italian experience as one that is acknowledged as successful.

Path dependence produces a 'natural' path of economic development, that is more likely than others because actors achieve lower costs in following it. If this path is considered to be undesirable for any reason, it can be changed in two ways. First, actors can co-ordinate their choices and activity via spontaneous collective action. It is a well known result of institutional research that this outcome is not easily possible due to different types of failure of collective action and that the result of collective action may still be undesirable, albeit for other reasons. In this case, policies offer further opportunity.

In transition countries, SMEs are at a great disadvantage due to certain features of the old system (e.g. the very lack of SMEs and relative institutional and organizational structures) and particular conditions of transition (e.g. lack of capital, SMEs averse financial sector, policy support concentrated on privatization). This makes spontaneous processes unlikely to produce the needed systemic and organizational innovation and thus raises the question of policy remedies. By influencing the perspectives of the economy, there comprising uncertainty and risk, and the overall cost and factor remuneration of SMEs relative to larger companies, general and specific policies influence the allocation of resources to SMEs both absolutely and relative to large companies.

The design of policies and the results obtained through their implementation are constrained by the other background variables – the environment, the economic system and individual features. Such constraints mean that policy makers should carefully design and implement sustainable policies that are appropriate to pursue the chosen goal in the existing situation. Policy theory and practice teach that in spite of these limitations, a rather large degree of freedom exists for policy makers.

Why is the role of SMEs in general and in Central and Eastern Europe in particular crucial and why should specific policies be necessary?[8] This is so primarily because SMEs can produce a general improvement in the economic situation, at both national and regional level. In the specific case of countries in transition, the SME role is important because, along with their support to employment, they strongly contribute to investment in new system-specific assets and to the productive conversion of old material capital, thereby promoting transformation and adaptation processes. At the same time, they decrease the value of conservative factors, there comprising transitional

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7 See Reynolds 1996 for an interesting analysis of the role of new SMEs in different contexts.

8 On the role of SMEs in transition cf. EBRD 1999: 146-159.

redistribution and path dependence. Let us review the material and the specific aspects in this order.

SMEs are usually distinguished on the basis of their size, but first it is necessary to distinguish different types of such enterprises. The model I use here includes three forms of SMEs activity: (a) market, whereby small firms operate individually, possibly in market niches, (b) hierarchy, including vertical links between dominant large companies and smaller enterprises specialized in subcontracting, and (c) networks, such as co-ordination and co-operation based on trust and horizontal links among SMEs. Such a distinction is based on SMEs mutual relationships and their relation with large enterprises. This is important, because not only SME features are quite different in each case, but the impact of these enterprises on the economy varies strongly as well.

Within the third category, two different organizational solutions are included:

(a) *Local productive systems (LPS)* are productive activities, based on mutual co-ordination and division of labour, pursued by SMEs that have strong territorial concentration and high degree of productive specialization (IDSE 1998).

(b) *Industrial districts (ID)* are a form of LPS that have a degree of territorial concentration and specialization above a critical value with specific complex institutions and organizations that promote informal co-operation and the division of labour to support external competition. It is a distinctive feature of industrial districts that the local community and firms tend to merge (Becattini 1990), i.e. social and systemic capital become an integral part of SMEs networks.

The above definitions stress that ID are a sub-set of LPS having specific and qualitatively unique features. They also leave the possibility open that LPS and ID may include medium-large (but not very large) enterprises, as is often the case in reality. Different research studies on well established market economies stress not only the importance of SMEs in general, but of their territorial and productive co-ordination in particular. A study on Italian SMEs found that territorial agglomeration stimulates the efforts of enterprises in those activities (such as export services) where co-operation produces greater advantages than competition and it weakens their efforts in those activities (such as research and development) where the opposite is true (Bagella 1998).

By increasing the formal and informal appropriability of information generated by individual local agents and by facilitating the setting up of joint structures for the production of information about foreign markets and common export strategies, territorial proximity has positive results for the export capacity of SMEs. This is because co-operation in the supply and exchange of organizational and informational services produces non-negative effects on the payoff of other local agents. Indeed, these effects can be positive and they are the greater the smaller are enterprises and the geographically closer are their location.

Regarding R&D, inter-enterprise contiguity increases positive spillovers and the benefits of free-riding a 'quasi-public' good (in the sense that it is characterized by lack of rivalry in consumption and only partial excludability) as technological knowledge. This produces lower incentives for individual firms to invest in R&D. The effect is more positive in traditional and scale sectors, where imitation is an effective alternative to direct R&D investment.

Also the form and motivation of the start-up and the entry mode are apparently important in determining the performance of the firm and her 'modernity'. In a 1996 questionnaire study of 147 new manufacturing firms originated through spin-offs in the Italian province of Milan, Arrighetti and Vivarelli found that active motivations – including innovative motivations, innovative learning and higher managerial position in the mother firm – tend to be related to a superior post-entry performance.[9] By contrast, defensive motivations – including actual or potential unemployment avoidance – tend to be related to inferior post-entry performance. These findings support the explanation that the new entrepreneur's project is dependent on technical and managerial competence that have been acquired in the previous job experience: technical 'savoir faire'; organizational skills; knowledge of the market and so on (Bates 1990). This is an interesting case that has great importance for SMEs in transition economies and is supported by Hungarian experience, as explained below.

More complex organizational forms such as local productive systems made up of independent SMEs, and even more so industrial districts, require a substantial amount of social and systemic capital. In fact, the high levels of institutional and organizational order needed to produce co-operation among SMEs is a particularly complex and costly undertaking if only implemented via formal institutions. In this latter case, the rational favourable outcome would be hierarchical co-operation among a large firm and various SMEs, whereby the former solves the problem of enforcement against the potential predatory opportunism of the latter. Self-reinforcing co-operative equilibrium among high numbers of SMEs can develop either by spontaneous co-operation based on social and systemic capital and proper institutions, or through the creation by a third party of sustainable specific formal institutions and organizations that produce external effects supporting co-operation. In reality, the most favourable case is where spontaneous co-operation is supported by a third party.[10]

Horizontal co-operation among firms of similar size, the third mode of co-ordination, (along with markets and hierarchies), is associated with the need of utilizing and handling *ex ante* complementarities between autonomous business units (Richardson 1972).[11] It is based on stable long term relations between autonomous units, where reputation, trust and goodwill play a central role (Santos 1998). Social and systemic

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9 Arrighetti and Vivarelli 1998. Of the 147 firms, 90.4 per cent had fewer than 5 employees at the start-up.

10 Putnam 1993 (p. 214 of the Italian edition) notes that both states and markets work more effectively if the context has a rich social capital.

11 See also Williamson 1985 who defines 'hybrid' forms of governance as markets that show co-operative features which emerge from recurrent commercial transactions based on mutual reliance relation. My contention is that the prevalence of such forms of co-operation in certain contexts and their absence in others depends on the social and systemic capital.

capital favour such an outcome. Each of these factors reduce the agents' uncertainty and risk since they involve some degree of assurance and obligation with respect to the future conduct of the parties in business relationships.

However, co-operation is easily a victim of opportunism and co-operative networks can only be stable if some additional element favours the internalization of co-operative advantages and of the costs of shirking. Such an element can be internal to the horizontal co-operation (e.g. when each SME is a hostage in the relation) or external (e.g. via government policies). In such a context, opportunistic agents would have prohibitively high costs. Other agents would be unwilling to pay the additional costs necessary to specify, control and enforce contracts with an opportunistic agent and would consequently refute to co-operate and threaten retaliation. However, retaliation and being hostage as threats may not be credible enough, since small size can give opportunistic SMEs sufficient flexibility to escape to other networks or reach autonomy. This outcome can only be prevented by particularly high level of social and systemic capital in a low mobility environment or by enforcement by an altruistic third party that reduce exit possibilities or make them excessively costly.

The advantage of co-operative relationships based on trust to individual enterprises lies in their incentive effect, ability to economize on transaction costs and greater flexibility. The incentive effect derives from the autonomy typical of small scale, the feeling of being part of a larger network and the pressure that is mutually exercised within such network. Transaction costs are reduced due to the lower cost of implicit contracts in both their stipulation and implementation. Also enforcement is simpler thanks to informal dispute resolution. Since trust and social obligation are powerful incentives in themselves, the costs of the incentive or the threat necessary to induce a given degree of co-operation and the costs of monitoring and enforcing the incentive structure are lower. Thus while trust improves allocative efficiency, greater flexibility is a source of dynamic efficiency. It permits adaptation of contracts to changing circumstances without recourse to constant re-negotiation and litigation (Kester 1992). As a consequence, co-operation based on the variables of social and systemic capital replace much of the contractual network with relational links whereby each actor depends on the continuing co-operation with the others and takes advantage of externalities this co-operation produces. It is social and systemic capital that create the powerful set of credible commitments and collateral (in terms of reputation, social pressure and the like) necessary for the stability of co-operation.

No policy can entirely replace social and systemic capital. However, when social and systemic capital are insufficient, policies can play a great role in fostering SME co-operative networks. Indeed, such policies give the actors incentives, opportunities and structures that induce them to produce and accumulate social and systemic capital by making the net return to such a behaviour greater than to non-co-operative behaviour. In this sense, it is not necessary for social and systemic capital to precede the implementation of policies and the development of SMEs. Up to a certain extent and with proper policies, the development of SMEs can proceed parallel with the accumulation of social and systemic capital.

Along with theoretical reasons for the viability and efficiency of SMEs, one should notice that the role of SMEs has increased in recent years. In market economies, the intensification of global competition, growth of market fragmentation and market instability, changes in consumer tastes, flexible automation and other changes in production techniques, and changes in the labour market are factors that have resulted in decentralization, vertical disintegration of large companies, and a shift from larger to smaller firms in many branches. Facing these transformations of the economic and systemic environment, SMEs can thrive in a turbulent market characterized by varying demand where output must be adjusted often, and where there is a strong demand for large variety of products. It also appears that SMEs have important effects on regional growth. Given interdependence among regions, one should consider the potential external effects of regional policies. In fact, interdependencies and connections among different economies (Coe and Helpman 1995 and Keller 1997) mean that the global effects of SMEs on growth are not confined to the boundaries of the regions where these firms are located. This is due to the fact that regions are linked to each other by means of investment, trade relationships, diffusion of knowledge and capabilities.

In countries in transition, SMEs are important for additional reasons. As stated at the beginning of this section, SMEs role is important because they give strong contribution to increase investment in new system-specific assets and the productive conversion of old material capital, thereby promoting adaptation and transformation processes. At the same time, they weaken the conservative components of path dependence. In this sense, the innovative value of systemic change – i.e. the reduction of conservative path dependence – is directly proportional with the size and the specific features of the SME sector. It will be the highest when there are many SMEs and they form (innovative) local productive systems. Although this is not sufficient (since other factors, as investments and credit, are also needed), it is certainly a necessary condition for successful systemic change. However, in transition economies social and systemic capital are weak and undergoing transformation, as are individual features. Consequently, specific policies for SME development are needed and they should promote the development of local productive systems, together with the SME co-operation (via sub-contracting) with those large companies that are modern and innovative. A priority goal for such policies is to reduce environmental and systemic uncertainty for SMEs and to establish and promote proper institutions, structures and capabilities, in particular those supporting entrepreneurship.[12]

Given the weakness in terms of innovation of many large companies and the great potential for rent-seeking and involvement in organized criminal networks, it is particularly important in transition countries to govern the allocation of SMEs activities. Three basic SMEs models can be identified: productive, rent-seeking, and survival. By productive I mean here that SMEs activities increase the production of goods and services in the economy in an innovative way. Rent-seeking SME are those that are

[12] An interesting historical example is provided by policies in Meiji Japan. When the old feudal class of *samurai* and *daimyo* were dismissed from the state ranks, they had the opportunity to start productive activities. This was made possible thanks to the support given by the state (in particular by converting their property rights into a stock of wealth, usually in the form of rice) and based on previous business experiences that many among them had in a context of economic liberalization.

established to pursue quasi-rents, e.g. via tax evasion or by concealing illegal activities. Survival is the motivation of those SMEs that are established to avoid unemployment and to secure minimum living conditions to their founders and do not expand, co-operate with other SMEs or subcontract with larger companies. The allocation of SMEs among these groups and the consequent allocation of entrepreneurial effort depends on the specific features of the environment, the economic system, the individual features and the effects of policies.[13] The overall outcome is the result of a process of evolutionary adaptation.

If this context offers actors opportunities and incentives to adapt and transform by investing in systemic change and in new system-specific assets and if the rights thus acquired are enforced by credible third party, the boundedly rational actors' behaviour and choices are progressively transformed in the sense desired by systemic entrepreneurs. However, these processes take time, are costly and show interdependence. In this context and together with proper sequencing, policies are all the more important, because they can address adaptation of individual actors to productive outcome.

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[13] For a path-breaking analysis of the role of institutions in the allocation of entrepreneurship see Baumol 1993.

IV THE DETERMINANT OF SMEs ROLE AND PERFORMANCE: THE ENVIRONMENT, THE ECONOMIC SYSTEM AND INDIVIDUAL FEATURES IN HUNGARY

Previous discussion has stressed the critical relevance of four crucial factors for SMEs development: the environment; the economic system; individual features; and policies.

4.1 The environment

Hungary is a small country that is poor in natural resources except for agricultural land. She has a small population highly concentrated in the capital city and a few other small and middle size cities. The country is located in the heart of Europe and has common borders with the EU, which is her main commercial partner. This is an important condition for developing international transborder subcontracting relations involving SMEs and local productive systems. It also has good relations with her most important partners. The country is an integral part of Western culture and has strong Western aspirations. The increasing economic and political integration in the Western world is greatly contributing to building up new (market) social capital in Hungary. Hungary is now a member of NATO and has started the accession process to EU. The present and future goals of collective economic and political action in the country are clear and neatly – almost bureaucratically – determined giving clarity and certainty to political, social and economic actors.

Thanks to the good and flexible educational system and specialization in mechanical and light industry (and agriculture) within the CMEA, Hungary is endowed with human capital that can be rather easily adapted to the needs in a market economy. Human capital is relatively well-adapted to small scale business. Hungary inherited a relatively well developed civic society from previous periods. Quite important in this sense were the reforms introduced in the 1980s. The society was fairly decentralized and democratic values were important and growing. In spite of many difficulties, the post-transition years did not jeopardize these features nor were public administration and government disrupted. Consequently, social uncertainty – a critical factor for potential entrepreneurs and owners, in particular small ones – never reached threatening level.

Finally, the social perception of property rights is good and they are respected and well defined. The property rights of the pre-Soviet period remained largely registered and the problem of restitution was solved in a socially acceptable way. Criminal organizations, although important, do not appear to threaten social, economic and political stability. Although bureaucratic red tape and the unpredictability of its modifications are a problem for SMEs, it is of decreasing importance. The attitude of large companies towards SMEs – including the numerous foreign companies – is generally not negative, although true co-operation and vertical integration are still insufficient.

Overall the social perception of SMEs, their owners and entrepreneurs is positive, the environment is moderately favourable to SME development and to their progressive integration with large companies as subcontractors. In certain regions there also are some possibilities for the development of horizontal networks independent from large companies.

4.2 The economic system

Whereas the environment forms the general framework that defines the long run potentiality and general features of SMEs development, it is the features of the economic system and of systemic change that define the basic and long-run allocation of existing resources – capital, entrepreneurship and labour – to SMEs. In addition, the economic system and the features of systemic change determine the economic role of SMEs, including features, capabilities and relationships with large companies (Dallago 1999).

The following seven major areas appear to be crucial for the successful development of SMEs:

- *Property rights* should be sufficiently defined and protected, since they allocate ownership and control and define the fundamental incentives for businessmen. Such property rights are neither necessarily perfectly defined nor private (Stiglitz 1999). They should not necessarily cover the *jus abutendi* over assets, as the pre-transition Hungarian experience shows. In Hungary, property rights, which had been centralized in the hands of the state in the late 1940s, started to change in 1957 when compulsory deliveries by agricultural co-operatives were abolished. Since then, property rights were progressively transformed, although in a prudent incremental way. In particular, co-operatives became increasingly independent and were allowed to operate in various fields. Also state owned enterprises acquired some property rights, in particular in the field of production profile and investments (below the level of the largest structure-determining ones), foreign trade, management. The 1982 liberalization of new small economic organizations allowed individuals and state-owned enterprises (SOEs) to establish SMEs or enter into contractual agreements with them. Following this measure, SMEs boomed in both number and activity (Dallago 1989, 1991). The 1984 self-management reform changed the property rights configuration in SOEs also by increasing their autonomy. Between 1987 and 1989 important laws followed that created the basis for the transformation of Hungarian SOEs into market companies. These laws created the basic legal framework for both the separation (right before and during the ensuing privatization process) of many profitable SMEs from SOEs and for the establishment of green-field SMEs, including those established via foreign direct investment (FDI) (Mihályi 1998, Dallago 1994).

- The classical Soviet-type system was characterized by strong political control over economic activity and economic actors and by a soft budget constraint at the enterprise level. This created a shortage economy (Kornai 1980, 1992). While shortage created great opportunities for rent-seeking SMEs, it was hardly a favourable condition for the development of innovative SMEs. The reforms that were implemented in the country starting in 1968 promoted some important change. Although enterprises were still competing for inputs in a mildly shortage economy, they became more sensitive to demand requirements and their budget constraint hardened, at least on the supply side. The state decreased its interference in the life of economic actors. All these changes made it possible and convenient for large enterprises to co-operate with expanding SMEs and reach greater flexibility even beyond official aims. Liberalization that started with transition accelerated these processes, although not always in an economically- and socially-desirable direction and measure. The budget constraint of SMEs was dramatically hardened by the implementation of a rigorous bankruptcy law, although that of large firms was hardened much less. The state was reformed and its machine restructured rather effectively, although it was weakened beyond the desirable point. Most important, the state attitude towards SMEs was changed from tolerance before transition to liberalization and support during transition. However, as is shown later, this support was more on paper than in reality.

- Since it is organizationally impossible to plan SMEs activity directly from the centre, some *market freedom, and a flexible price* system are a necessary condition for SMEs development. SMEs operated in branches where markets enjoyed partial liberalization, prices were totally or partially freed since 1968 and in particular in the 1980s. Although bank credit was important and there was a two-tier bank system since 1987, SMEs seldom had access to official credit. Transition brought complete and rapid liberalization of markets and prices with ensuing domestic competition, further development of a market based bank system, difficult but continuous development of capital market, a tax system based on VAT. As explained in the next section, these developments were only partially favourable to SMEs.

- A proper structure of *motivations and incentives*, with large room for personal gain and material incentives and free of ideological hostility to independent economic activities – is a fundamental condition for the development of SMEs. The motivation and incentive structure was progressively transformed since the end of 1956 and was based more on material incentives than on ideology and political campaigns. Individuals were allowed a certain degree of freedom in economic matters and some limited co-participation schemes were introduced into enterprises and even more so in co-operatives. Private activity was liberalized, but it was limited to individual or small size entities until early 1980s. The introduction of unemployment was sometimes proposed by reformers and job rights were attenuated, but never to such an extent as to jeopardize the basic features of the Soviet-type system, including labour hoarding and significant shortages. So the fear of unemployment never became an effective threat. Consequently, one can conclude that the leading individual motivations and incentives in pre-transition Hungary were the increase of one's income and wealth and some limited economic freedom and self-realization. These features were favourable to SMEs development and became even more so following transition.

- The processes of *decision making*, including policy making and corporate governance, went through important changes since 1968, in particular in the 1980s. State administration was mildly centralized, with some important decentralization to counties. Functional technical central organs had great and increasing power in the economy, particularly the Finance Ministry. It dramatically increased its power to the expense of branch ministries, in particular during the 1980s. The latter were greatly reduced in number. The role of managers in corporate governance increased substantially in the early reform period, even more so in the 1980s. Major exceptions were large investments, in particular those that involved international projects, and relatively minor decisions in the field of labour in the post self-management period.

- These transformations had some important, although limited impact on SME organizational forms, since they opened the way for the establishment and development of an important group of SMEs having mixed features. These included labour-sharing organizations (such as VGMK and GMK), so-called small co-operatives and various other forms of leasing and contractual relationships that had a quasi-private nature, although the physical capital usually belonged to the socialist enterprises (Dallago 1989, 1991 and Laki 1998). Transition was rather effective in the field of corporate governance, in particular thanks to market privatization and the great role of FDI. Both spontaneous and small privatization – the latter mostly to the advantage of insiders – produced a booming number of mostly private SMEs. More problematic has been the situation in those enterprises that remain temporarily or permanently in state hands, and were or were supposed to become buyers of SME production. This situation had some mixed consequences for the development of SMEs, as I will explain in the next section. Quite important is the process of decentralization of public administration that is under implementation, with delegation of SMEs policies to local administrations.

- The country had progressively diminished its dependence on the CMEA countries well before transition started and granted producer enterprises a certain freedom to deal in the *international market*. The government regulated the activity of these enterprises by the use of a quasi-market exchange rate that was progressively unified for the entire economy in the 1980s. These reforms only had an indirect impact on SMEs, since the latter either produced directly for final domestic consumers or supplied large SOEs. However, the progressive opening of the economy and the society transformed the structure and quality requirements of demand and opened new opportunities for both legal and irregular small businesses. Transition brought full internal convertibility of the currency and its external quasi-convertibility. The liberalization of external relations and beginning of preparations for EU accession caused the dramatic decrease of economic ties and business with former CMEA countries and rapidly increased integration with Western countries, in particular EU countries. These processes opened new sources of investment and domestic support, including those specifically for SMEs, and strongly increased external competition. New opportunities were opened for SMEs, but also new dangers appeared.

To conclude, the pre-transition economic system had some favourable features for the development of SMEs, giving them both directly and indirectly a relatively important space and role. Directly important were those features of the old economic system that allowed for the development of SMEs before transition. Indirectly important features were those that prepared the ground for the development of SMEs after transition. Among the former, the most important were liberalization of co-operatives activity that started with agricultural co-operatives as early as 1957, decentralization and limited liberalization of quasi-private SMEs in the 1980s, and some commercial laws approved between 1987 and 1989. Among indirect features, the increased role of material incentives and quasi-market motivations, increased autonomy of enterprises and the role of managers in corporate governance, regulatory activity of the state replacing central planning, liberalization of foreign trade and of the price system, mild liberalization and transformation of the financial sector (in particular, banking), improved infrastructure and spreading motorization.

All these factors rendered the Hungarian economic system more similar to a market system than any other in the region, and while its institutions, structures and co-ordination framework were not of a market nature neither were they traditional Soviet-type. At least as important, those changes produced actors whose motivations, capabilities and decision-making were relatively close to those of actors in market economies, at least on the supply side. Transitional reforms had a relatively easy task in producing a great number of SMEs. Indeed, this took place amidst weak or missing SME policies and structures, such as credit and tax system. It was enough to introduce freedom of enterprise to see booming numbers of SME. However, the next section shows that these features were insufficient to produce a modern and competitive SME sector. In addition, some transitional changes retarded SME development, in particular restrictive fiscal policies. It should be noted that such changes destroyed potential demand for SME production and resources for SME investment, but also the effect of the market privatization of large enterprises in diverting resources away from potential establishment of new SMEs should be considered.[14]

4.3 Individual features, entrepreneurial inclination and perception, motivations and capabilities

Various surveys based on samples of varying size, including the Hungarian Household Panel Survey, tried to evaluate the entrepreneurial inclination of Hungarian people in different years (Lengyel 1997).[15] Major findings are that such inclination increased substantially with the beginning of transition – when 40-45 per cent of people interviewed said they were considering becoming an entrepreneur. A worsening macroeconomic situation and the difficulties met by real businessmen radically decreased this percentage to 19-23 per cent in the following years (1993 and 1994),

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[14] Cf. Uvalic 1999 on obstacles to SMEs development.

[15] For an interesting sociological explanation of local differences in entrepreneurial attitudes in Hungary see Kuczi and Makó 1998.

below even the 1989 level. Even if one discounts the 1990 data for the illusions and enthusiasm raised by the first steps of transition, such a drop is clear evidence of disillusion with a rapidly deteriorating context in the first years of transition.

It is also interesting to observe that, compared to other countries in transition, Hungary does not show a different pattern of entrepreneurial inclination (Kuczi and Lengyel 1997b, Kuczi and Makó 1998). This apparently supports the idea that pre-transition economic reforms did not play an important role in fostering entrepreneurial attitudes, although it leaves open the possibility that the reforms influenced who actually became businessmen and how businessmen operated. Indeed, there are great differences in the composition and features of actual businessmen and the Hungarian survey supports the theory of entrepreneurs as being decisively influenced by occupation, level of education, personal values and connections, along with demographic factors. This influence acted through the decade of the 1980s. This is a major difference compared to other countries, one that stresses that major changes were introduced in the economy and the society well before transition started.

In Hungary, the social composition of businessmen did not change as a result of the political transformation, although their number greatly increased. Only the proportion of university graduates among the businessmen increased substantially (from 20 per cent in 1988 to 27 per cent in 1993). The middle class as producer of businessmen was already there when transition started. After the political change in 1989, the group of middle class businessmen expanded by including those who were expelled from or left large enterprises and was enlarged by those members of the previous political and economic leadership who could put enterprise transformation and privatization to their own use. It is interesting to notice that there is no significant difference in the magnitude of material capital or economic influence between the two groups. This is to say that the factors that determined the formation of the group of entrepreneurs and owners should be looked for mainly in the situation produced in the early 1980s. This is certainly an interesting case of path dependence, in which the past – by moulding of allocation of resources, the social environment and shared values – is important in determining the present.

Motivations supporting the decision to start a business are predictably mixed. Contingent and survival factors played and still play an important role (CIPE 1994 and Laki 1998). This is hardly a situation that can foster innovation and stable job creation, but it may be important and useful as a starting phase of entrepreneurial development. However, the situation has improved with time. This has also been due to the stabilization of employment and possibly the decrease of opportunities.

The analysis of the relationship between capabilities, the environment and the economic system, in periods of rapid systemic and structural change such as transition in Central and Eastern European countries, shows that the more a particular capability contains tacit aspects, the more strongly it continues to reflect the incentives and institutions of the old system (Swaan 1998). Also, capabilities which have a high degree of tacit, system-specific components show backwardness during transition as compared to countries of a similar level of development. Finally, differences in the level of capabilities among post-socialist economies are smaller than differences between random pairs of countries of a similar level of development. These findings also hold for Hungary and highlight that investments in new system-specific assets take time and effort to mature, at both individual and organizational level. Consequently, the process of change is lengthy and costly. Policies should take this into account, but this was not the case. Indeed, the level of fiscal burdens, unpredictability of policies and bureaucratic red tape – i.e. factors linked to administrative organization and policies – are the main obstacles to the establishment and expansion of new enterprises now (see Table 1), as much as they were in 1993 (CIPE 1994). However, respondents show that these factors hold a decreasing relevance, while that of market variables – notably, the intensification of market competition – is increasing. To conclude, although entrepreneurial inclination does not present major problems, capabilities are only moderately favourable to the development of a modern SME sector, but improving.

TABLE 1

PERCEIVED OBSTACLES TO SME GROWTH IN HUNGARY, 1997 AND 1998

(PER CENT OF RESPONDENTS EXPRESSING AGREEMENT)

Obstacles to growth	October 1997	October 1998
High tax and social security burdens	84	78
Unpredictability of economic regulation	62	58
Strong competition	53	57
Insufficient demand or orders	48	45
Unfair competition	46	44
Shortage of capital	40	37
Payment arrears of customers	30	31
Shortage of credit	27	26
Obsolescence of existing equipment	17	19
Procurement problems	14	16
Shortage of labour	9	9

Source: *KFI* 1998: 165 and *KFI* 1999: 141. The sample consists of some 2000 small enterprise owners and managers who were interviewed in October 1997 and October 1998.

A study based on the analysis of the origin of non-agricultural male, full-time businessmen, using 1992 CSO data on social mobility, largely supports the above conclusions and offers an interesting dynamic picture (Róbert 1999). The study presents a causal model showing the extent to which becoming a businessmen is influenced by the family background (the father's occupation), investment into schooling (professional training, academic training), the market experience (experiences in the labour market) and the political background (communist party membership, that also explains the businessmen's relational network). By dividing the 1940-92 interval into five periods (four in the case of party membership), the study analyses the changes over time of the factors that determine how and why someone becomes a businessman. The outcome shows both continuity and trend interruptions over the entire interval. The effects of family origin at first diminished but since the 1980s has gained strength again. Investment in human capital as represented by professional training was very useful for some time, but later – again, since the 1980s – their return diminished. However, the effect of investment into academic training ('cultural capital'), has proved to be more lasting, but decreasing with transition. Finally, the influence of political factors shows that the length of party membership ('political and social capital') is more important for becoming a businessman than the simple fact of being a party member (political loyalty). Interestingly, the study shows that the conversion of political capital into economic capital had already started in the late 1960s. During transition the role of human and cultural capital became more important than political capital.

This conclusion is supported and extended by the surveys implemented by the Institute for Small Business Development (*KFI* 1999: 139-140). According to the findings, '[g]rowing enterprises tend to be operated by entrepreneurs having filled jobs requiring higher educational qualification and/or more senior managerial positions earlier. Most owners of growing enterprises used to be professional employees, while those of no-growth companies were mostly skilled workers. In the group of growing companies, the proportion of entrepreneurs having occupied a managerial position of some sort earlier is also much higher than elsewhere.' (*ibid.*: 140) Age is also important together with gender: '… growing enterprises are typically led by middle aged males, while the managements of those envisaging no growth include a larger proportion of women and members of the older and younger generations' (*ibid.*: 139).

V SMEs IN HUNGARY

5.1 Quantitative growth, structure and market impact

In Hungary, the explosion in the number and activity of SMEs began in the years immediately preceding the beginning of transition, boomed in the first years of transition, and then stagnated since mid-1990s (see Table 2). The larger part of those enterprises that are active are still in trade, although their share is decreasing (27.8 per cent in 1998). Second to trade are enterprises in real estate (24.5 per cent in 1998 and rapidly increasing), that also include leasing, computer business, and enterprises providing business services. Other expanding branches are catering, financial services, education and healthcare, where in 1998 operated respectively 5.7 per cent, 1.8 per cent, 1.5 per cent and 2.3 per cent of all active enterprises. Manufacture and transport are shrinking (respectively 10.6 per cent and 5.9 per cent of all active enterprises in 1998), while other sectors are stagnating (agriculture: 5.0 per cent and construction: 8.5 per cent in 1998) (*KFI* 1999: 76). The SMEs share in the overall number of enterprises and in overall employment is substantially greater than in EU average, although not as high as Italy or Japan (see Table 3). This is particularly true for micro-enterprises and also – as far as employment is concerned – for medium-sized enterprises.

TABLE 2

REGISTERED BUSINESS ENTITIES IN HUNGARY

	1990	1991	1992	1993	1994	1995	1996[a]	1997[a]	1998[a]	1999[a]
Corporation with legal entity							136 917	158 662	174 250	177 436
limited liability company	12 159	41 206	57 262	72 897	87 957	102 697	122 044	143 109	157 990	160 647
co-operative	7 134	7 232	7 694	8 175	8 252	8 321	8 362	8 330	8 230	8 191
Partnership & unincorporated enterprise							167 426	179 912	203 691	211 835
limited partnership	n.a.	n.a.	n.a.	67 301	89 001	102 560	127 725	140 043	161 857	170 762
Sole proprietorship	387 340	519 450	606 207	688 843	778 036	791 496	745 247	659 690	648 701	660 139
Corporation & unincorporated total							1 049 590	998 264	1 026 642	1 049 410
Government & social security							14 809	14 633	14 957	15 300
Non-profit institutions							50 601	54 418	58 866	61 907
ECP-institution							309	300	292	272
Total							1 115 309	1 067 615	1 100 757	1 126 889

Source: Hungarian Central Statistical Office (http://www.ksh.hu). Data for 31 December of each year.

Note: [a] The definitions used to classify economic organizations were revised in 1996.

TABLE 3

ENTERPRISE SIZE AND EMPLOYMENT CHARACTERISTICS, EU AND HUNGARY, 1996

	Enterprise Size (Number of Employees)				
	Micro (0-9)	Small (10-49)	Medium-size (50-249)	Large (>250)	Total
Enterprises					
number 1000, EU	17,285	1,105	165	35	18,590
per cent distribution	*93.0*	*5.9*	*0.9*	*0.2*	*100.0*
number, 1000, Hungary	619	15	4.4	0.6	639
per cent distribution	*96.9*	*2.3*	*0.7*	*0.1*	*100.0*
Employees					
number 1000, EU	37,000	21,000	15,070	38,220	111,410
per cent distribution	*33.2*	*19.0*	*13.5*	*34.3*	*100.0*
number 1000, Hungary	848	288	532	488	2,156
per cent distribution	*39.3*	*13.4*	*24.7*	*22.6*	*100.0*

Source: *The European Observatory of SMEs, Fifth Annual Report* 1997, p. 14 and calculations by Ipargazdasági Kutató és Tanácsadó Kft., based on data from the Economy Analyses and Information Technology Institute of the Central Statistical Office (from *HU* 1999b).

These data and the trends they suggest must be treated with caution. First, not all SMEs are private in the true sense of the word. Since the early 1990s the Hungarian Central Statistical Office does not report the ownership structure of the economy.[16] One can infer with reasonable certainty that nearly all sole proprietorships (*egyéni vállalkozás*) are private in the full sense of the word. Partnerships (*társas vállalkozás*) and limited partnership (*betéti társaság*) apparently have clearly dominating private owners (Laki 1998: 76 and references). Other forms of enterprise such as limited liability companies (*korlátolt felelösségü társaság*) and non-profit institutions (*nonprofit szervezet*) usually have mixed ownership structure involving private, state, local council and foreign ownership. Table 4 depicts the employment structure according to type of enterprise.

[16] The Hungarian Central Statistical Office introduced a new specification of economic organization starting from 1995. This classification identifies three broad groups of enterprises: companies, budgetary institutions, and non-profit organizations. Also, legal and non-legal entities are distinguished.

TABLE 4

EMPLOYMENT BY TYPE OF ENTERPRISE

	1992	1993	1994	1995	95/92
Government institution (*Költségvetési szerv*)	15.7	17.4	20.7	22.8	1.46
State-owned enterprise	33.2	21.8	10.0	8.5	0.24
Municipality-owned enterprise (*önkormányzati vállalat)*	4.8	5.4	4.4	3.7	0.75
Traditional co-operative	7.4	5.9	5.0	3.7	0.44
State-owned corporation (*állami tulajdonú gazdasági társaság*)	7.1	11.8	14.0	12.1	1.71
Partially privately owned corporation	8.6	10.8	13.3	11.9	1.38
Privately owned corporation	13.9	17.0	21.2	24.7	1.83
Sole proprietorship (*Magán vállalkozás*)	9.5	9.9	11.5	12.5	1.33
Total	100.0	100.0	100.0	100.0	---

Source: *MHP* 1996: 15 (quoted in M. Laki 1998: 79). Data for March of each year.

A second reason for caution is that not all registered enterprises are active (see Table 5). There are various reasons for fake registration, including tax evasion[17] or avoidance and the aim of obtaining cheaper credit. Fake registration is often due to precautionary motives whereby prospective entrepreneurs register their business fearing future restrictive legislation or regulation. It may simply also reflect failure to register the death of a bankrupt business. Given this complex of motivations, one should expect that fake registration is higher for small private businesses, as indeed is. According to the Central Statistical Office data, nearly one out of three small private businesses (sole proprietorship) is registered but not active and this share has been stable during the last few years. A similar proportion exists for co-operatives. The correspondent proportion for all types of enterprises is nearly one out of four. For all other forms of enterprises (excluding the state, non-profit organizations and those involving employees participation), the share is one in six or less.[18] As a consequence, the share of small businesses in overall employment is lower than one would expect from looking at their impressive number. One should also notice that the number of sole proprietorships, by far the main component by number of SMEs, decreased by almost 13 per cent (or by 96,546 units) between 1996 and 1998 due to more restrictive regulations.

[17] According to the semi-official journal *The Hungarian Economy*, 'A great number of small enterprises were set up with the basic aim of tax evasion and not with the aim of doing business. In all probability the spectacular increase of their number is attributable to this.' *HU* 1999a.

[18] Based on data from http://www.ksh.hu. See also KFI 1999:75. This share is substantially lower than in most transition countries. In the Czech Republic the share of active SMEs is a bare 40 per cent of registered ones (personal information received at the Ministry of the Economy).

TABLE 5

RATE OF ACTIVE ENTERPRISES

(ACTIVE ENTERPRISES AS PERCENTAGE OF REGISTERED ENTERPRISES)

	31.12.1998	*31.12.1999*
Corporation with legal entity	83,9	84,4
Of which: limited liability company	*84,9*	*85,1*
co-operative	*68,9*	*71,9*
Partnership and unincorporated enterprise	85,8	87,3
Of which: limited partnership	*86,8*	*88,2*
Partnership		86,0
Sole proprietorship	70,7	70,8
Corporation and unincorporated enterprise, total	75,9	76,4
Government and social security organizations	100,0	100,0
Non-profit organizations	100,0	100,0
ECP-organizations*	100,0	100,0
Total	*77,5*	*78,1*

Source: Elaboration on data of Hungarian Central Statistical Office (http://www.ksh.hu).

Note: * ECP is Employee co-sharing programme (or *Munkavállalai Résztulajdonosi Program*).

A third ground for caution is given by comparing Hungarian data with EU data (see Table 6). It is not easy to interpret these data without additional information. However, if one looks at the diverging pattern of different comparative ratios, such data arise the doubt of diverging compliance and behaviour of different size enterprises compared to that prevailing in the EU, in particular as far as very small and medium sized enterprises are concerned.

In the labour market, micro and small enterprises were for years the most dynamic component, indeed the only type of enterprises that increased employment. Between 1992 and 1994 they together were able to counterbalance the loss of employment in medium-sized and large enterprises (the latter alone lost almost 295,000 jobs, while medium-sized enterprises lost more than 31,000). However, they lost momentum in 1995 and even more so in 1996: in the former year they jointly created almost 95,000 jobs, but medium-sized and large enterprises lost jointly more than 197,000 jobs. In 1996 all types of enterprises increased employment, but the final outcome (+84,000 jobs) was the result of the achievements of the large enterprises (almost +41,000) and micro-enterprises (almost +32,000).[19] In 1997 large enterprises lost again employment (by almost 66,000). Micro-enterprises continued to loose energy (although increasing

[19] *KFI* 1998: 112-114, *KFI* 1999: 81-85. Cf. also T. Laky 1999 and Kálmán 1998. These data are based on tax declarations and exclude public sector employees. This leads to some doubts about the reliability of data, in particular for the smaller enterprises where irregular employment is widespread. KFI and CSO set the upper limit of medium-sized enterprises at 300 employees, while keeping the other categories as defined by Eurostat. The new Act on SMEs (implemented since 1 January 2000) fully adopts EU size categories.

TABLE 6

COMPARATIVE DATA ON THE NON-PRIMARY PRIVATE SMALL- AND MEDIUM-SIZED ENTERPRISES IN THE EU AND HUNGARY IN 1996

Name/ Relation	Micro (0-9)	Small (10-49)	Medium (50-249)	All SMEs (0-249)	Large (>250)	Total
Average size (persons)						
EU	2	20	90	4	1,035	6
Hun	1.4	19.6	128	2.6	825	3.4
Hun 1998	2	23	111	..	867	5
Turnover/venture (ECU million)						
EU	0.2	3.0	16.0	0.5	175.0	0.8
Hun	0.04	0.55	3.39	0.07	55.07	0.12
Hun 1998	0.04	0.95	3.92	..	42.80	0.16
Value added/person (ECU 1,000/person)						
EU	30	40	50	35	55	40
Hun	6.24	5.3	5.8	5.9	15.3	8.0
Hun 1998	2.5	6.1	7.3	..	11.0	6.5
Labour cost as a per cent of value added						
EU	38	63	60	52	53	53
Hun	60.75	66.73	79.23	67.41	42.08	56.51
Hun 1998	83	81	80	..	84	82
Average size						
Hun/EU	0.70	0.98	1.42	0.65	0.80	0.57
H1998/EU1996	0.87	1.13	1.23	..	0.84	0.77
Turnover/enterprise						
Hun/EU	0.21	0.18	0.21	0.15	0.32	0.16
H1998/EU1996	0.19	0.32	0.24	..	0.24	0.20
Value added/person						
Hun/EU	0.21	0.13	0.12	0.17	0.28	0.20
H1998/EU1996	0.08	0.15	0.15	..	0.20	0.16
Labour cost/value added						
Hun/EU	1.60	1.06	1.32	1.30	0.79	1.07
H1998/EU1996	2.18	1.29	1.33	..	1.58	1.55

Source: *The European Observatory of SMEs, Fifth Annual Report* 1997, p. 14. For Hungary, calculations by Ipargazdasági Kutató és Tanácsadó Kft., based on data from the Economic Analyses and Information Technology Institute of the Central Statistical Office (from *HU* 1999b). Data for Hungary 1998 are from *KFI* 1999: 21

Note: Data are only for the private economy, excluding forestry and fishing. Data refer to 1996 unless specified.

employment by more than 20,000). Medium-sized enterprises (more than +8,000) and particularly small ones (+30,551) became the most dynamic components. However, overall employment balance became negative again (-6,811). This trend was reversed in 1998, when employment increased by more than 68,000 units, in spite of continuing decrease of employment in large enterprises (by more than 26,000). The latter was easily compensated by the continuing dynamism of medium-sized enterprises, the upswing of micro ones and fair performance of small enterprises.

Employment in different size enterprises is shown in Table 7 below.

TABLE 7

NUMBER AND DISTRIBUTION OF EMPLOYED BY ENTERPRISE SIZE

	Employed (000)					Distribution (per cent)				
	1994	1995	1996	1997	1998	1994	1995	1996	1997	1998
Micro	871	957	989	1,009	1,058	30.4	34.6	34.7	35.5	36.3
Small	355	363	372	403	429	12.4	13.1	13.1	14.2	14.7
Medium-size	555	525	528	536	556	19.4	19.0	18.5	18.9	19.1
Large	1,086	918	959	893	867	37.9	33.2	33.7	31.4	29.8
Total	2,867	2,764	2,848	2,841	2,909	100.0	100.0	100.0	100.0	100.0

Source: *KFI* 1999: 84. The data originate from tax declarations.

Looking at the ownership structure of registered capital in double-entry and simple book-keeping enterprises, it is interesting to notice that (see Table 8):

(a) the role of foreign capital has been or is fundamental even for and micro-enterprises and those without employees;

(b) the role of the state has been forcefully decreasing in all size category of enterprises in roughly the same proportion in all categories (in 1998 it was approximately one fourth its 1992 level), but proportionally much more in enterprises without employees;

(c) the most dynamic component has been foreign capital, that greatly increased its role in all size categories, reaching on average 37.9 per cent of all registered capital in the country by 1998; a similar trend can be observed for domestic companies (domestic capital in company form), that dramatically increased their presence in all size categories, but most dynamically in microenterprises;

(d) individual owners slightly increased their share, but this is the result of an improvement in the group of small enterprises and medium-size enterprises and a relative loss in the remaining categories.

TABLE 8

CHANGES IN OWNERSHIP STRUCTURE OF COMPANIES WITH DOUBLE ENTRY AND SIMPLIFIED BOOK-KEEPING BY SIZE, 1992-98

	Domestic Private persons			Foreign			State		
	1992	1995	1998	1992	1995	1998	1992	1995	1998
Without employees	25,1	19,2	11,4	21,6	32,0	34,6	25,1	3,1	1,0
Micro-enterprises	36,6	33,1	32,2	22,8	26,7	26,5	18,9	8,4	3,0
Small enterprises	20,3	26,0	23,1	20,6	26,1	30,0	29,5	10,3	4,5
Medium enterprises	17,3	21,0	16,7	15,2	33,2	39,2	28,8	13,7	9,2
Large enterprises	3,6	2,9	3,0	6,0	26,8	42,3	71,7	44,7	21,6
Total	10,3	12,0	11,7	10,6	28,3	37,9	55,3	29,8	13,2

Source: *KFI* 1998, *KFI* 1999: 87. The data originate from tax declarations.

Table 9 shows two important features of Hungarian small enterprises: (a) their undercapitalization, and (b) the great role of the irregular economy. Although the share of own capital of small enterprises in total own capital has been slightly increasing, it is almost irrelevant compared to the small enterprise contribution to GDP and even more so to employment. A clear confirmation of undercapitalization is that the ratio of registered capital to own capital has been continuously decreasing over the 1990s for sole proprietorships and became less than one (0.91 in 1997 and 1998). As to micro-, small and medium-size enterprises, the ratio is greater than one and increasing, yet it is substantially lower than in the case of large enterprises. Second, the Central Statistical Office has also calculated the enterprise contribution to GDP from the output side, collecting data that permit adjustment of the fiscal side data on the irregular economy (Dallago 1995). The correction considers two elements both that are relevant primarily for the smallest enterprises: a part of productive capital is actually used for consumption and part of the income produced remains undeclared. Both items increase actual income compared to the declared one – a conclusion that is supported as well by data on turnover reported in Table 10. Further evidence of tax evasion is that the number of enterprises that the CSO considers as being active is 19 per cent greater than the number of those enterprises that pay taxes (*KFI* 1999: 81).

Turnover data support the view of the weak performance of smaller enterprises in the last half of the 1990s (see Table 10). Until 1994 the net turnover of SMEs – in particular micro- and small enterprises – increased very dynamically. The latter while the net turnover of large enterprises decreased. However, after 1994 smaller enterprise (without employees and micro-enterprises) growth slowed down and their share over total net turnover (excluding the public sector) decreased substantially (from 26.7 per cent in 1994 to 26.1 per cent in 1996 and to 23.7 per cent in 1998).[20] Large enterprises forcefully increased their net turnover, in particular since 1997, so that in the following year the structure of total net turnover changed to their advantage (from 36.2 per cent in 1996 to 38.2 per cent in 1998). Small enterprises also experienced a dynamic growth

20 These shares are calculated on data of KFI 1999: 93.

TABLE 9

DISTRIBUTION OF OWN CAPITAL AND CONTRIBUTION TO GDP OF HUNGARIAN ENTERPRISES, 1992-98

	Distribution of own capital from tax declarations				Contribution to GDP from tax declarations				Contribution to GDP, corrected by CSO methodology			
	1992	1994	1996	1998	1992	1994	1996	1998	1992	1994	1996	1998
Without employees	5,0	6,9	6,1	7,0	5,9	4,4	4,1	3,3	19,3	20,4	21,0	*
Micro enterprises	4,0	4,8	6,6	8,7	10,0	9,0	10,6	10,9	6,2	6,2	10,6	23,9
Small enterprises	6,2	7,2	8,7	10,6	10,6	14,1	13,4	13,8	9,4	11,9	10,7	11,5
Medium enterprises	16,5	17,0	18,3	18,3	16,2	21,9	21,7	21,5	14,3	18,6	17,4	19,4
Large enterprises	68,2	64,1	60,3	55,3	57,3	50,5	50,3	50,4	50,8	42,8	40,3	45,2
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0

Source: *KFI* 1998, pp. 118-121; *KFI* 1999: 88-92.

Note: * together with micro-enterprises.

that increased their share of total net turnover from 16.8 per cent in 1994 to 18.5 per cent in 1998. The performance of medium-size enterprises stagnated below 20 per cent.

The significance of these data is decreased by the fact that data at comparable prices for all size groups were apparently calculated by utilizing the official inflation rate obtained for the entire economy and by the dubious reliability of data based on tax returns.[21] The divergent development of performance is explained by the revival of the Hungarian economy and by the fact that less efficient, state-owned enterprises were privatized and/or restructured. At the same time, smaller enterprises experienced the difficulties already discussed. This conclusion supports the view that the great achievement of smaller enterprises is entirely the outcome of their increase in number, while productivity and individual size stagnated. However, the situation is highly differentiated by branches (see Table 12). In fact, in some branches smaller enterprises are decisive both for their number and performance (e.g. healthcare and social services, education, real estate, trade, construction, fishing, personal services – all branches were small enterprises generate more than half the total net branch turnover). In other branches their performance is still substantially below Western European average (e.g. manufacturing). Medium-size enterprises have relevant weight particularly in agriculture, construction, trade, real estate, financial intermediation.

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[21] Just to give one example, turnover of sole proprietorships – that include enterprises of different size, although mostly small and accounting for some 600,000 employees (including owners) in 1998 – registered an astonishing increase of 26 per cent in 1997. This was due to the introduction of the compulsory minimum sales revenue in that year. However, in 1998 sales revenue abruptly decreased by 14 per cent. KFI 1999: 97.

TABLE 10

DISTRIBUTION OF NET TURNOVER OF ENTERPRISES BY SIZE CATEGORY AND GROWTH (AT COMPARABLE PRICES)

	per cent					previous year = 100				
	1994	*1995*	*1996*	*1997*	*1998*	*1994*	*1995*	*1996*	*1997*	*1998*
Without employees	7.1	6.3	6.5	5.5	4.6	100.0	90.0	104.6	92.4	90.4
Micro enterprises	19.6	20.4	19.6	19.2	19.1	100.0	105.3	97.9	108.0	106.9
Small enterprises	16.8	17.4	18.0	17.8	18.5	100.0	104.4	105.5	108.7	112.1
Medium enterprises	19.5	19.5	19.8	19.5	19.7	100.0	101.4	103.4	107.9	109.0
Large enterprises	37.0	36.4	36.2	38.0	38.2	100.0	99.7	101.3	115.5	108.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	101.3	101.9	109.8	107.8

Source: *KFI* 1999, pp. 92 & 93. Data based on tax returns.

Export data also show the dualism of Hungarian industrial structure. According to data based on tax statements, a rapidly increasing share of exports is by large enterprises. This was 64.9 per cent of overall exports in 1998, up from 53.7 per cent in 1996. Medium sized enterprises supplied 20-22 per cent of the total until 1996. The share of small enterprises fell below 10 per cent (9.7 per cent in 1998) from a high 10.9 per cent in 1994, and that of micro-enterprises decreased from 12.5 per cent in 1994 to 7.8 per cent in 1998. These structural changes took place amidst forcefully expanding exports. As a consequence, and in spite of declining shares, the absolute value of exports increased for all size categories. Compared to 1994 at constant prices Hungarian exports doubled and those of large companies increased by 2.43 times. However, even exports of micro-enterprises increased by 27 per cent and those of small and medium-size enterprises increased respectively by 79 per cent and 64 per cent. The only exception were enterprises without employees, that decreased exports by one fourth and their share from 3.0 per cent (and from 3.9 per cent in 1996) to 1.1 per cent. Compared to their net turnover, large enterprises also show the largest and rapidly increasing share. Medium-sized enterprises follow with a similar pattern, although with a somewhat softened dynamics and substantial stagnation in 1996 and 1997. Among smaller enterprises, those without employees appeared more dynamic than the others until 1996, but then their situation changed abruptly. These data are presented in Table 11.

However, the data in Table 11 derive more from differences in the overall weight of individual size categories than from different propensity to export, although dynamics could well be divergent for different size categories. In fact, according to a survey, the difference in export propensity is more within each size category than among different categories. Indeed, one third of medium-sized enterprises (101-250 employees) sell more than half of their production on foreign markets. The corresponding share is 28.6 per cent for small enterprises (up to 50 employees) and 20.3 per cent for large enterprises (more than 250 employees). This feature is supplemented with the prevalence among strongly exporting firms of those in foreign ownership (Tóth 1998a), while the most dynamic exporters, at least in 1995, were micro-enterprises, followed by large enterprises (Tóth 1998b).

TABLE 11

CONTRIBUTION TO HUNGARIAN GDP AND EXPORTS BY ENTERPRISE SIZE, 1992-98

	Contribution to GDP, corrected by CSO methodology				Exports according to tax declarations				Exports as per cent of turnover according to tax declarations			
	1992	1994	1996	1998	1992	1994	1996	1998	1992	1994	1996	1998
Without employees	19,3	20,4	21,0	*	4,0	3,0	3,9	1,1	7,0	5,0	9,1	4,7
Micro enterprises	6,2	6,2	10,6	23,9	10,1	12,5	9,3	7,8	8,6	7,6	7,1	8,0
Small enterprises	9,4	11,9	10,7	11,5	9,6	10,9	10,8	9,7	9,7	7,7	9,1	10,3
Medium enterprises	14,3	18,6	17,4	19,4	17,7	20,3	22,2	16,5	13,1	12,4	16,9	16,3
Large enterprises	50,8	42,8	40,3	45,2	58,7	53,3	53,7	64,9	15,5	17,1	22,4	33,2
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0

Source: *KFI* 1998, pp. 121, 124; *KFI* 1999: 92, 98, 99.

Note: * together with micro-enterprises.

While one should be careful in handling these data, comparing export data to GDP data yield some interesting observations. Notice that the table reports corrected GDP (also including the irregular economy). Also, we can suppose that it is more difficult to hide export activity than production, so export data based on tax declaration are more reliable than non-corrected GDP. On the contrary, turnover data are probably as unreliable as non-corrected GDP. It is difficult to state that large enterprise data on exports are more reliable than small enterprise data. Indeed, the opposite may even occur, since it is well known that transnational companies make use of transfer prices, although evidence is still scattered. However, it is difficult to say whether this refers more to large enterprises than to any other type of enterprise. Foreign ownership is widespread among the smallest enterprises, so we should expect that transfer prices would distort the turnover data of all size categories. As to GDP underreporting, the effect is nearly entirely due to enterprises without employees and in part also to micro-enterprises. If we exclude these categories, the ratio of exports to GDP as reported in Table 11 for the other size categories is early proportionally undistorted.

Leaving these doubts aside and assuming the data included in Table 11 are reliable, we observe that the backbone of Hungarian exports is made up of large enterprises. This group is not only contributing almost two thirds of the exports of the country – and this is a rapidly increasing share – but is also quickly increasing its orientation to foreign markets. Conversely, SMEs export share is now rapidly decreasing after having increased substantially to the mid-1990s. Given the lack of support policies and the difficult circumstances under which small firms operate, it is remarkable that even the smallest enterprises have been able to register such an export performance for such a long period. This is further proof of their potential, repressed by missing or wrong policies. Given proper environment and policies, that potential could be expanded. The recent drawback may be proof that SMEs exhausted their 'spontaneous' potential and badly need policy incentives and support.

The above doubts (on reliability of data) and conclusions (on the unexploited potential of small and medium-sized enterprises) are confirmed by considering other indicators. In particular, the structure of costs of different size enterprises is quite different. This is apparently due to (a) different technologies used by enterprises of different size (more capital intensive by larger ones, more labour intensive by smaller ones), that are partially compensated by lower wages and depreciation allowances and higher interest rates paid by small enterprises; (b) concentration in different branches of production: Table 12 shows small enterprises are concentrated in traditional light manufacturing and in traditional services; (c) the different extent of vertical and possibly horizontal integration, whereby smaller enterprises make greater use of vertical integration and have to pay higher transaction costs, e.g. for intermediaries; and (d) lower market power of small enterprises as reflected in higher prices paid for material inputs.

TABLE 12

THE BRANCH STRUCTURE OF TURNOVER BY ENTERPRISE SIZE, 1998

	Without employees	Micro enterprises	Small enterprises	Medium enterprises	Large enterprises	Total
Agriculture, game, forestry	2.3	14.7	22.9	42.9	17.2	100,0
Fishing	0.9	18.0	37.8	26.7	16.6	100,0
Industry	0.7	4.6	8.6	18.0	68.0	100,0
Construction	4.9	21.8	27.8	23.9	21.5	100,0
Trade, repair	3.4	28.4	29.8	22.8	15.6	100,0
Hotels and catering	3.2	21.9	20.2	19.5	35.2	100,0
Transportation, post, telecommunication	1.4	13.3	13.8	12.0	59.5	100,0
Financial intermediation	1.4	8.8	22.7	22.7	44.4	100,0
Real estate, renting	9.0	36.1	25.7	23.6	5.6	100,0
Education	14.3	44.1	33.3	8.2	0.0	100,0
Healthcare, social services	9.1	54.0	18.8	7.9	10.3	100,0
Other communal, public and personal services	14.1	27.8	15.6	19.7	22.7	100,0
National economy, total	2.7	17.0	19.1	20.8	40.4	100,0

Source: *KFI* 1999: 96. Data from 1998 tax returns.

Table 13 below presents some interesting further reasons for reflection in the case of partnerships. Costs of material and services, wages and social security payments increase with the size, while intermediate goods, subcontractors' fees and other expenses decrease. This apparently suggests that the value chain is shorter in small enterprises than in large ones. However, if one considers the dominant role of small firms in labour intensive services using qualified labour (see Table 12) and lower labour productivity in smaller enterprises (see Table 6), these data appear doubtful. There may be evidence here to support the hypothesis that wage expenses and social security payments are understated and possibly intermediate goods overstated, as the CSO maintains. Data on profitability could support, at least in part, this conclusion. In fact, and although the share of loss-making enterprises has constantly declined since mid-1990s and most markedly in 1998, the proportion of loss-makers is inversely proportional with size.

TABLE 13

THE COST STRUCTURE OF PARTNERSHIPS BY ENTERPRISE SIZE IN 1998

	Without employees	Micro enterprises	Small enterprises	Medium enterprises	Large enterprises	Total
Cost of materials	7.8	8.7	14.1	22.8	33.0	22.2
Cost of services purchased	4.9	4.0	4.2	5.2	6.0	5.1
Intermediate goods	28.7	46.2	49.4	34.3	21.6	34.0
Subcontractor fees	12.3	12.0	9.7	7.0	5.6	8.0
Salaries and wages	2.0	3.0	4.8	8.0	7.9	6.3
Other personnel costs	1.2	1.0	1.0	1.4	1.3	1.2
Social security contributions	0.9	1.3	2.1	3.4	3.4	2.7
Depreciation	4.2	2.3	2.4	2.8	4.5	3.4
Other costs/expenses	38.1	21.6	12.3	15.0	16.6	17.1
Total costs	100,0	100,0	100,0	100,0	100,0	100,0

Source: *KFI* 1999, p. 103. Data from tax returns.

However, this could partially be the outcome of different branch allocation of enterprises.

As to efficiency, data only exist for those enterprises which have simplified and double bookkeeping. Tax returns for individual entrepreneurs do not include some important data on capital. Following the booming years immediately before and after systemic change, the relative position of smaller enterprises is worsening compared to large enterprises. Both net turnover per employee and net turnover per unit of capital are higher in smaller enterprises than in large ones, that have much higher – and increasing in both absolute and relative terms – capital intensity. However, large and also medium-size enterprises are increasing both indexes more rapidly than smaller enterprises, a sign that the fruits of restructuring are ripe. At the same time, the process of capital concentration grew sensibly through the 1990s and large enterprises own a growing share of capital. As to profitability, all indicators improved remarkably since 1992, when all were negative, except for micro-enterprises. The indicators improved for all kinds of enterprises year by year, with the exception of 1998, when there was a relative deterioration. As to micro-enterprises, and in spite of positive results since 1996, indicators of profitability are the lowest due to the permanent losses of enterprises without employees (see Table 14). (*KFI* 1998: 131-134; *KFI* 1999: 107-109).

TABLE 14

RATE OF RETURN ON OWN CAPITAL BY ENTERPRISE SIZE (IN PER CENT)

	1992	1994	1995	1996	1997	1998
Micro enterprises	2.1	-2.3	-1.8	5.9	7.8	7.4
Small enterprises	-5.9	3.8	7.4	9.8	16.6	14.7
Medium enterprises	-7.4	1.0	5.6	8.9	10.9	10.1
Large enterprises	-4.2	2.7	3.1	4.3	10.4	10.3
Total	-4.3	1.9	3.4	5.8	10.8	10.2

Source: *KFI* 1999: 110. Data from tax returns.

As to taxation and subsidies, the situation of smaller enterprises strongly worsened during the 1990s and became negative since fiscal payments are higher than subsidies. The situation of the smallest enterprises (those without employees and micro-enterprises) has been particularly difficult. However, by considering also social security payments the situation appears more balanced (*KFI* 1998: 135-144; *KFI* 1999: 111-120 and Tóth 1998).

Tax benefits are disproportionally concentrated at partnerships with double-entry book-keeping. Large enterprises enjoy the largest part of tax benefits and this share has been increasing through time: from 26.0 per cent in 1992 to 88.5 per cent in 1998. By more than doubling their share in 1994, they were able to keep the volume of tax benefits unchanged even in the two years – 1994 and 1995 – when the overall volume fell to less than half the previous level. The overall volume of tax benefits started to grow again in 1996 and with it also grew further the share of large enterprises. Another relevant feature is that in 1997 and 1998 enterprises with foreign participation received the bulk of benefits (70 per cent). Although there is a variegated situation in the case of individual tax benefits of different kinds, the disadvantage of SMEs is clear and growing. Within this group of enterprises, only medium-size enterprises still receive a fair share of tax benefits (9.4 per cent of the total in 1998, down from a high 27.5 per cent in 1994). All other kinds of SMEs have seen their share drastically reduced (overall, to 2.1 per cent in 1998 down from 52.7 per cent in 1992).

Different is the situation for subsidies. Here the two extreme groups (large enterprises and enterprises without employees together with micro-enterprises) experienced a declining trend of their share to the advantage of small and medium-size enterprises. However, in 1998 the share of subsidies increased for all size categories of SMEs.

Compared to the above, the share of overall business taxes paid by large enterprises has been decreasing from 45.0 per cent in 1992 to 30.3 per cent in 1998. Somewhat similar has been the trend that enterprises without employees followed (from 7.2 per cent to 5.0 per cent). All other size categories substantially increased their share of taxes (overall, from 47.7 per cent to 62.6 per cent). However, in 1998 a mild reversal of the trend took place for small, medium-size and large enterprises.

If we consider the above elements together, relative to net turnover, we find that the tax burden (payable tax – subsidies – tax benefits, this sum divided by net turnover) of smaller enterprises (without employees, micro- and small ones) has been the highest. Conversely, the tax burden of medium-size and large enterprises has been negative, i.e. they enjoyed net transfers from the budget. This feature became particularly evident in 1997 and 1998.

The picture changes when we consider social security payments. Large enterprises still pay more than half the total, although their share is decreasing (from 59.4 per cent in 1992 to 50.6 per cent in 1998). Similarly decreasing is the share of social security contributions paid by enterprises without employees (from 3.4 per cent to 1.2 per cent). Conversely, micro-, small and medium-size enterprises pay a constantly growing share (from 37.3 per cent to 48.2).

By also considering social security the situation of different size categories appear more balanced (see Table 15). First, no group enjoys net transfers. Second, large enterprises pay, together with medium-size ones, the largest share of overall income transfers. However, both shares are decreasing in time, similarly to that of enterprises without employees and small ones. Consequently, also the total share is decreasing. Third, the only size group that has been witnessing a mild worsening is that of micro-enterprises.

TABLE 15

SHARE OF WITHDRAWALS AND SUBSIDIES OF ENTERPRISES SUBJECT TO SINGLE- OR DOUBLE-ENTRY BOOK-KEEPING (IN PER CENT)*

	1992	1994	1995	1996	1997	1998
Without employees	2.36	3.35	2.21	2.51	2.69	1.97
Micro enterprises	1.60	2.20	1.64	2.25	2.14	2.09
Small enterprises	3.57	3.38	2.75	2.66	2.65	2.39
Medium enterprises	4.72	3.97	4.02	3.47	3.49	3.09
Large enterprises	5.10	5.26	4.48	3.99	3.06	2.71
Total	4.25	4.05	3.47	3.27	2.90	2.60

Source: *KFI* 1999: 120. Data from tax returns.

Note: * (Social security contribution + Payable tax – Subsidies – Tax benefits)/Net turnover.

This complex picture requires some policy interpretation. Overall and compared to net turnover, the situation of different size groups is becoming more uniform, although this is not true for individual components There is apparently ground here to formulate the following policy hypothesis: (a) Large enterprises have greater strength to obtain greater tax benefits. This also serves the goal of attracting foreign investment. (b) This is true also of taxes and, to a limited extent, of subsidies. (c) Social security contributions present a different picture that can be explained in part with greater evasion and lower labour qualification in smaller enterprises. (d) Policy is apparently granting SMEs – particularly smaller ones – few tax benefits and subsidies compared to taxes they have to pay, knowing how difficult it is to collect from them social security payments due. However, lately there was an apparent improvement here, except for enterprises without employees.

Fixed capital formation is mostly concentrated in large enterprises, thanks mainly to tax benefits and much larger depreciation than in other size categories. However, their share in overall fixed capital formation declined from 71.0 per cent in 1994 to 55.0 per cent in 1996. Since then there was a mild recovery to 57.3 per cent in 1998. The best performance belongs to micro-enterprises that (together with enterprises without employees) increased their share from 5.0 per cent in 1994 to 14.6 per cent in 1996. But then their share decreased to 12.3 per cent in 1998. Small enterprises witnessed a mild increase from 11.1 per cent in 1994 to 13.2 per cent in 1998, while medium-sized enterprises increased their share from 13.4 per cent in 1994 to 17.2 per cent in 1998, albeit through rather wide yearly fluctuations.

Such variations are partly explained by the extremely rapid increase of capital formation in the decade. This was a bare 1 per cent of GDP in 1992. It increased to 14 per cent in 1994, 22 per cent in 1996 and closed to 29 per cent in 1997. In 1998 it decreased to 26.5 per cent, probably a sign that the period of intense capital accumulation is over. Within this trend, large enterprises kept their lead over the entire period concerning their ratio of fixed capital formation over their contribution to GDP, which was constantly superior to aggregated ratio for all enterprises. Given the stagnating share of GDP that large enterprises produced since 1994, their decreasing share in overall capital formation derives from their capital formation increasing relatively less than overall capital formation in the country (from 14.0 per cent in 1994 to 26.5 per cent in 1996). This happened in spite of the above mentioned large enterprises leading performance in this indicator, from 19.3 per cent in 1994 to 29.4 per cent in 1998. Conversely, the performance of micro-enterprises was particularly remarkable. In front of slowly increasing share of GDP production (from 13.4 per cent in 1994 to 14.2 per cent in 1998), their share of fixed capital formation over GDP increased from 5.5 per cent to 24.8 per cent. Although constantly lower than the economy average of capital formation, the share of micro-enterprises increased rapidly from 5.0 per cent in 1994 to 12.3 per cent in 1998 and approached their share in GDP. The same reasoning applies, although in varying degrees, to small and medium-size enterprises.

This is further evidence of great potential of this sector. All this is particularly remarkable if we consider the difficulties that SMEs have in getting external financial support and stresses how important is the expansion of the economy to solve their problems. Overall, the financial position of SMEs is weak and not improving (CIPE 1994: 20-27; *KFI* 1998: 144-150; *KFI* 1999: 120-129 and Lawrence 1993: 406-407). SMEs suffer for liquidity problems (except medium-size enterprises) and their position weakened slightly in 1998. Own funds in financing enterprises decreased in 1997-98 in the case of SMEs so that external sources play a bigger role than in the case of large enterprises. External financial sources for Hungarian enterprises are on average 40 per cent of total capital, while the corresponding figure in Western European countries is 50-70 per cent. Because of high interest rates, it often happens that, enterprises must utilize credit in order to pay the service of former credit.

Banks are extremely prudent in lending to small businesses. Moreover, the medium and long-run credits granted by Hungarian banks to small enterprises have mostly been financed by external resources. These subsidized credit programmes offering easy terms include budget appropriation to support different actions and pursue different goals (e.g. economic and technical development, technological co-operation between SMEs and large enterprises, job creation, support to competitiveness, expansion of SMEs supplier contacts, trade development, upgrading quality, tourism, rural development, environmental protection agriculture). They also include domestic preferential and targeted credits (MAV micro-credit, regional micro-credit, investment credit for SMEs, German and Japanese Start and enterprise credits, export credits, Phare credit, different privatization credits), foreign credits (EIB, Phare, EBRD), and EU accession support (*KFI* 1999: 186-212).

Although these are intended to be 'easy term' programmes, enterprises obtain less than half of the available amount, because of the rigorous conditions required, great bureaucratic requirements, length of the processes needed to obtain credit, and general conditions that are not suited for small businesses. Another problem lies in the difficulty that banks have in collecting relevant information on the applicants. As a consequence, many applications are rejected, but at the same time many enterprises succeed in obtaining multiple credits from different sources. Because banks consider the interest rate spread insufficient to cover the risk connected with small enterprises, they often require collateral of 250-300 per cent of the credit granted. This is clearly unbearable for most small enterprises.[22]

True, suppliers' credit share in enterprise financing is inversely proportional with the enterprise size, with the partial exception of enterprises without employees. However, bank credit plays a small and decreasing role in the case of micro- and small enterprises. In 1998, these enterprises received overall a bare 3.6 per cent of overall bank credit (down from 11.2 per cent in 1993), a figure that was lower even in absolute terms compared to 1993 (63.8 HUF bn. compared to 85.7 HUF bn.). The support of the numerous existing privileged channels for promoting and financing SMEs – the MVA[23] and the various guarantee and venture funds – have a rather modest impact, while their managing and working costs are often relevant. The complexity of procedures, the tiny average size of SMEs, high collateral requirements, banks aversion to SMEs lending are all factors that have kept small enterprises away from existing sources and even caused a decrease in the volume of preferential loans since 1995 (*KFI* 1999: 155-174 and 186-212; Matheika 1998: 65; Király and Várhegyi 1998).

Venture capital hardly exists and what exists does not play the function that in other circumstances is traditional and innovative. The June 1998 Act on Venture Capital hardly has any impact and the Regional Venture Capital Funds are just moving the first steps1995 (*KFI* 1999: 57-58; Karsai 1998).

5.2 The features of the market

The growth of SMEs sector has been more the direct or indirect result of the transformation of large state owned enterprises and autonomous organizations than of the development of the pre-existing private and quasi-private sector, however large the latter was. Indeed, the new SME sector came out more from the experiences and connections that managers and employees in the state sector gathered in the pre-transition period – in particular in quasi-autonomous organizations such as *VGMK* – than from producing directly in the private sector. The explosion of SMEs in the country did not derive from privatization either: 'These are not "privatisers", but they were set up by workers and clerks who left the state sector, and those who previously occupied

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[22] On the role of financing SMEs see Csaba 1999.

[23] *Magyar Vállalkozási Alapitvány* or Hungarian Foundation for Enterprise Promotion, a Government sponsored, independent organization established in 1990 to support the emergence and development of SMEs.

lower positions in the enterprises structure (division directors, team leaders)' (Laki 1998: 7-8).

Due to its heterogeneous origin, the SME sector in Hungary is not homogeneous. It includes at least three main, partially overlapping groups:

(a) those SME, usually traditional in character and small in size, that represent the development of SMEs existing before transition. This sector, being traditional and having lived largely in the niches opened by the shortage that characterized the 'socialist' sector, is ill-suited to take advantage of the transition to a market economy. Adaptation processes are difficult here and many of these SMEs either fail or barely survive. The dominating strategies in this sector are aimed at survival and risk avoidance and make use of longer and more intensive working time (often in the form of second jobs) with limited investment and technical progress. In these conditions, they are seldom able to pursue growth and expansion of their business or to make use of inter-firm co-operation and to adopt new organizational forms. Indeed, most of these enterprises are not even interested in expanding above a certain modest size (Laki 1998: 78-80; *KFI* 1999: 136-140).

(b) the SMEs that operated in full or in part in the irregular economy in the pre-transition period. According to various estimates, the irregular economy produced an income around 15-20 per cent of the registered national income (Dallago 1990). Although an important part of these activities pursued individual private gain (another part pursued the institutional goal of implementing the plan in a shortage economy), they hardly had a market nature. Indeed, they had features typical in a shortage economy and were replaced by a new irregular economy or went through radical transformation during transition.

(c) those SMEs, usually more modern in character, larger in size and more open to foreign relations, that came mostly out of the dissolution of the state and co-operative sector. This process started in mid-1980s when deep and far-reaching reforms were introduced in the 'socialist' sector. Following these reforms, firms gained much larger autonomy. In spite of self-management that was introduced in many firms, this allowed ambitious, smart or more simply unscrupulous managers to take control or ownership of the sound parts of 'socialist' firms by reorganizing them. This process was particularly forceful in the so-called 'spontaneous' privatization, concentrated mainly in 1988-89. This process continued in the next years through the different stages of the privatization process (Mihályi 1998 and Dallago 1994). Traditional SMEs were largely cut off these processes. A part of this modern SME sector also derived from the adaptation and transformation of quasi-private organizations that were introduced since 1982.

It is important to explain why pre-existing SMEs were unable to develop in the new environment, in spite of their large number and the general liberalization of private activity. These organizations hardly had a true market nature and behaviour; as a consequence, they were not endowed with the knowledge and capabilities necessary to successfully survive market competition and lacked the fundamental business prerequisites – in particular, fixed capital and financial resources or the possibility to access to financial resources on the basis of having valuable collateral. As a consequence, liberalization and privatization following transition hardly helped their development and expansion. Indeed, the preponderant part of existing private enterprises did not take part in the privatization of state owned enterprises and, at most, bought a modest part of their equipment from state owned enterprises.[24]

On the contrary, privatization dramatically changed the environment and introduced a powerful threat in the form of competition coming from other private and foreign businesses, that jeopardized the market niches and segments they were occupying. On the input side, privatization and hardening budget constraint of still state-owned enterprises cut the privileged relation that pre-existing SMEs had with large companies. The 'old' SMEs had to compete on the output side and gather the financial resources needed to buy inputs. Being generally unable to finance investments,[25] they had to concentrate on producing low-priced traditional goods (which usually have a high price-elasticity) and work with modest profit margins. This, in turn, prevented them from financing more ambitious investments and modernization. They remained often strongly connected to the (extended) family as the source of premises, labour and capital. Their market also usually remained local.

Under the conditions prevailing during transition, probably the most important asset that these enterprises were endowed with were personal relations and connections with the managers of the state-owned and co-operative enterprises. To the extent that those managers became private owners and entrepreneurs right before or during transition, small entrepreneurs could enter the process as subcontractors. There are two other reasons why some of these enterprises could catch good opportunities during transition, though. One is that some of those small enterprises were established by managers and politicians themselves before transition, who could take advantage of transition by strengthening their enterprise in the process of privatization or liberalization.[26] A second reason is that SMEs before transition were organized and represented by their professional associations (*Kisosz* and *Kiosz* were made the representatives of small enterprises and artisans in 1949). Although this was under the control of the only party in power and although their monopoly had already been broken in 1988, they could act as pressure groups as first reform and then transition started.

The third, best endowed type of SMEs found its origin in systemic change. Indeed, this group is the result of two major processes: (a) separation of the healthiest parts of

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24 According to the evidence quoted by Laki 1998, in particular pp. 112-114 and 138, small entrepreneurs explain this lack of participation with asymmetric information and personal networks to the advantage of insiders. But there are many other reasons to support the view that most small enterprises found the environment more unfavourable to their activity in the post-1989 period.

25 Laki 1998: 164 quotes evidence showing that in 1993 only 1.1 per cent of those enterprises that were established more than two years earlier implemented investments to pursue innovation and technical development in the last two years.

26 According to the sources quoted in Laki 1998: 73, Party members were over-represented among quasi-private small entrepreneurs and they often also occupied key positions in the state productive apparatus. In this way, they were quite well informed on the investment and production plans of SOEs.

former SOEs right before or during privatization; and (b) foreign direct investment. In fact, true modern 'green-field privatization' based exclusively on domestic capital has been rather unimportant until now, due to the endemic lack of private capital, the conservative and risk-averse attitude of banks and the concentration of the modest amount of capital in private hands to buy enterprises during privatization. This sector is new only in part, because it is largely the outcome of the reorganization and modernization of the old industrial apparatus. Also, it is not necessarily made up of entirely private enterprises. Mixed ownership is spread, involving true domestic private ownership, foreign ownership (not necessarily private), and domestic state ownership. This sector forms the most dynamic and modern part of the Hungarian economy.

Considering their size, small enterprises with fewer than 50 employees (including also enterprises of sole proprietors without employees[27]) do not form a homogeneous group either. We can distinguish four main groups (*KFI* 1998: 151-153). The most numerous one is made of all those very small businesses that only pay personal income tax. This group, to a large extent, consists mainly of self-employed individuals who made this choice often to escape actual or potential unemployment. Their number amounts to almost two-thirds (63 per cent in 1996) of all small enterprises, but their share in number of jobs is around one third and their share in turnover is a bare 13 per cent. Their situation was quite difficult until 1995 and it was only in 1996 that their (registered) income increased substantially, thanks to changes introduced in the tax system. Their investment level nonetheless remains exceptionally low. In spite of the most recent revival, the above data suggest that much tax evasion is hidden in this group.

A second group is made of micro-enterprises (with less than 10 employees) in company form (*társas mikrovállalkozás*). Their number is approximately one third of all small enterprises (34 per cent in 1996), but their weight in employment and in turnover (sales proceeds) is greater (respectively 38 per cent and 48 per cent). Their situation is somewhat better than that of the previous group, although improving more slowly than the economy on average. Investment is also rather low in their case.

Small enterprises (10-49 employees) in company form (*társas kisvállalkozás*) make up the third group. Although this group is small in terms of numbers (3 per cent of the total of small enterprises), it is very important in terms of both employment (26 per cent) and even more so in turnover (39 per cent). Their relevance mainly lies in their superior performance since this group has the best labour productivity and capital efficiency of all Hungarian enterprises. Although their investment capacity is limited (but the best in the group of small enterprises) and the average tax burden is the highest, both turnover and exports are rapidly increasing, the former more than the economy average. Also their profitability is among the best (only medium-sized enterprises fare better).

The fourth group includes small individual entrepreneurs with 10 to 49 employees. This is a very small group of enterprises (0.2 per cent of smaller enterprises), although its

[27] The Hungarian CSO does not include among enterprises those individual businesses that pay personal taxes but do not pay company taxes. They are included in the family sector.

performance is remarkable in terms of both employment (2 per cent) and turnover (2 per cent).

Along with size and legal-organizational differences, it is important to understand the evolution of these different groups of enterprises. There is some difference of opinion in the country on these features, but most observers stress the prevailing traditional, risk-averse and in a certain sense even rent-seeking character of these ventures. It is often stressed that the origin of small enterprises is more the result of the devolution of the state and co-operative sectors rather than in a genuine greenfield investment. Most of the enterprises were established with just the legal minimum amount of capital, which is very low. It is also for this reason that small enterprises are so concentrated in low capital intensity traditional activities. These enterprises do not want to grow and are consequently unlikely to produce a group of modern SMEs (Laky 1998, Kuczi and Makó 1998).

Along and beyond heterogeneity of origin, it is important to assess specific development perspectives when analysing a phenomenon that is by nature so variegated. Different features of SMEs also reflect in varying degrees of optimism on the future and different internal organization. Along with an important group of mostly small SMEs where stagnation, traditional internal organization and pessimism prevail, there is also an important group of small enterprises – apparently originated through green-field investment – that are well established and plan the future with increasing optimism (Laki 1998: 148-153). Indeed, a part of them intends or is planning to increase employment and implement investments, even important ones.[28] This may be remarkable in an environment that was very difficult and until recently unfriendly. Let us remember that small enterprises sell approximately half of their production to families and that real income of families has been falling until 1996 and started to grow only in 1997; that small enterprises had to recover set-up costs in such circumstances; that they had to learn to be independent in a largely new environment and economic system; that had to re-establish networks and find markets that the transition jeopardized or that had only slightly developed.

These enterprises adapted well to market environment and start to show the internal organization – in particular in the labour market – typical of successful market enterprises. They are also trying to create an internal climate that favours co-operation and to build permanent relations with their key employees by rewarding them well and giving them a role and responsibility that stimulates their active participation in the life of the enterprise. These people, by the interaction of their skills and experience, are becoming specific to a particular enterprise. It is in this group that potential networking and the development of local productive systems could take place.

The divergent situations and perspectives of small enterprises derive from three factors: (a) the different capability features of enterprises and entrepreneurs, including their

[28] According to *KFI* 1998*:* 158-161 and *KFI* 1999*:* 136-139, 8.9 per cent of these enterprises were planning to increase both employment and investment and 45.5 per cent to increase at least one. The remaining 45.6 per cent is planning no growth. The survey was carried out in October 1998 on a sample of 1965 small enterprises.

technical, organizational and market knowledge, networking and bargaining skills (largely coinciding with size); (b) their branch of activity; (c) their dominant sale market; and other, such exogenous factors, as policies, regional location and chance (e.g. a foreign investment that fosters demand for subcontracting). Medium-sized enterprises have the best prospects and are more optimistic about the future. The optimism of smaller enterprises decreases with their size (*KFI* 1998*:* 157-164; *KFI* 1999*:* 131-140). It is no surprise to find that most growing small enterprises are in growing branches, such as manufacturing, trade, real estate business, computer services and the building industry. Most stagnating or shrinking small enterprises operate in stagnating and decreasing branches such as transport, catering, education and healthcare.

There is a rather precise relation between legal form and final market. Among SMEs that sell mainly in the retail market there is a decisive preponderance of sole proprietorship, generally very small in size. SMEs selling to other enterprises are mainly partnerships with relevant foreign ownership. While optimism on the economy and own situation improves with size (*KFI* 1999*:* 129-131), there also is a rather precise correspondence between inclination to growth and prevailing sales to other enterprises. In the case of growing enterprises there is also a much larger share of sales to the public sector and to foreign markets. Tóth (1998b) finds an important positive correlation between growth of employment and of exports. Therefore, we can characterize the typical growing enterprise as a partnership with an important share of foreign capital selling mostly to other enterprises and operating in expanding branches. Stagnating enterprises are usually sole proprietorships in domestic ownership, operating in stagnating branches and selling to retail market.

It is interesting to find, that in Budapest, the largely dominant economic centre of the country, there is the lowest share of growing small enterprises and the highest share of those stagnating. The best off regions are those of pre-existing industrialization and those where economic development is pulled by foreign investment (often coinciding with the former) or by policy packages of crisis management financed by the state or international organizations (*KFI* 1998: 163-164). One further aspect that deserves careful attention consists in the distortion of markets and competition (Bara 1999) that may easily jeopardize the future of SMEs.

5.3 Enterprise networks

In the period since the beginning of transition, a part of Hungarian SMEs have begun to develop new patterns of interrelationships.[29] In fact, an increasing number of small enterprises are pursuing greater specialization by narrowing their productive spectrum (Laki 1998: 153-159, 167). They also increasingly rely on negotiated 'friendly' market division and other forms of inter-enterprise co-operation. Interestingly, most of these trust and co-operation relations were developed by the present entrepreneurs before the transition. There apparently are an increasing number of successful cases of this kind of 'primitive' networking, complemented by more sophisticated forms, such as price-fixing cartels.

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[29] On the role of SMEs in so-called Outward Processing Traffic (OPT) networks, see Pellegrin 1996.

There also is a totally different development. In order to diversify risk in an uncertain and depressed economic environment, many small enterprises enter contractual agreements with large enterprises either as producers of components or suppliers of maintenance, repair and sale services. An inevitable consequence of this choice is that small enterprises give up other markets and autonomy in exchange for greater safety and lucrative business.

The question of concern here is whether these interrelationships show any sign of possible and consistent development of local productive systems. This is a fundamental precondition to consider whether and what kind of policies could or should be implemented. The analysis of the results of a research project on the taxation and market environment of SMEs in Hungary carried out in early spring 1998 and previous analyses help throwing some light on the topic.[30]

By 1993, the crucial period for restructuring the Hungarian economic system was over and the Hungarian industry started to grow. Until 1992, the dominant large enterprises were basically self-sufficient since they barely relied on sub-contractors. Also medium-sized enterprises (with 100-300 employees) significantly decreased the number of their large business partners, although they were developing closer relationships with other medium-sized enterprises. The main reason for this size autarchy was market and payment uncertainty. State owned large enterprises in particular had and continue to have liquidity problems and accumulate payment arrears. Consequently, smaller enterprises tried to become independent from them in order to avoid greater risk of frequent breaks in payment and contractual discipline and the uncertainty deriving from the precarious situation of large enterprises. Previously existing business relations were often interrupted and a polarization of inter-enterprise relationships took place: reliable enterprises with good payment record preferred businesses with other reliable enterprises, while unreliable enterprises, often with liquidity problems and payment and tax arrears, were segregated. The latter group included only domestic companies, while virtually all foreign-owned companies joined the former group. Growth has also been concentrated in the former group of enterprises.

The survey shows that size is not relevant in determining financial discipline and liquidity problems which are indeed strongly branch-specific. Less disciplined enterprises with liquidity problems are concentrated in construction and partly in manufacturing, less so in trade. These phenomena also differ systematically by ownership type, being particularly important among enterprises in public ownership and least important among foreign-owned enterprises.

The development of business networks is not accompanied by significant cross ownership which developed in a certain measure up to 1992 but decreased in the following years so that effective cross-ownership links are now truly exceptional. This is

[30] See Tóth 1998a and the literature quoted therein. The survey was carried out by means of self-completed questionnaires that were answered by 288 enterprises chosen out of a sample of 3389 firms of different sizes above 20 employees that operate in manufacturing, construction and trade. Sub-contracting firms were excluded from this survey.

so for all but smaller companies, where the probability of ownership links increased during the first half of the 1990s. As to large and medium-sized companies, limited cross-ownership supports business relationships. About half of the companies covered by the survey reported that among the company owners or the companies they own there is at least one with which they have supplier relationships. This is particularly true for companies with foreign ownership. These links usually go together with the use of 'transfer prices'. This suggests that, although legally independent, these companies actually form unified business networks that include enterprises that are similar in many respects, including ownership. Consequently, domestically owned enterprises seldom enter the networks of foreign owed enterprises.

Networks are apparently rather loose and unstable, but potentially significant. Smaller enterprises either sell to households or they are the suppliers of larger domestic companies. Medium-size or large domestic enterprises do business in their group or sell to foreign companies. Enterprises owned by foreigners usually sell to foreign located companies. These features suggest a rather clearly segmented structure, in which smaller domestic enterprises produce based on relationships between families or acquaintances. They usually do not supply transnational companies or other companies abroad. Networks are based on such factors as the outstanding importance of trust and reputation, the feeling of belonging to a minority group (such as Germans), some organizations that develop at the local level: foundations for promoting entrepreneurship, entrepreneurial clubs, and informal groups of different type. Institutions and organizations strengthen the mutual perception of a balanced mix of duties and expectations, which in turn favours co-operation. Large enterprises have a fundamental role in helping to establish small businesses and supporting their development with equipment and other facilities, technical advice and demand. Within the proper environment, difficulties (such as lack of capital and limited availability of good machines) push entrepreneurs to intensive, deepening and enlarging co-operation. Chance factors, such as the arrival of important orders from foreign enterprises for serial production of a particular product have similar effects (Kuczi and Makó 1998).

These findings suggest that market segmentation is already established in the Hungarian economy, whereby enterprises with different ownership and size characteristics operate in different segments and competition is primarily within each segment. Consequently, there barely is any real competition among enterprises belonging in different segments, in particular between foreign-owned and Hungarian enterprises.

5.4 The consequences of transitional depression and general policies

The beginning of the transition coincided with a deep and prolonged economic crisis that strongly affected SMEs. Small private producers expanded their market share during the 1980s, but their traditional markets witnessed a deep crisis in the 1990s. Small firms generally produced for final consumers and consumers' income and demand dramatically fell during this period. In spite of this, the number of small firms exploded and their market share increased substantially. The activity of individual enterprises also increased. It was the state sector that shrank most rapidly, which opened new and increasing room for private producers.

The rapid decline and near demise of large state owned firms therefore opened new, important and increasing opportunities for those private small firms that produced consumers goods. However, this same process jeopardized the situation of another important group of small enterprises, a group that would be bound to expand rapidly due to transition. These are those small enterprises that already produced or intended to produce components, spare parts and services for large companies. Such subcontractor enterprises already existed before transition, but their role promised to expand dramatically following systemic change. As noted above the bulk of these new businessmen were previously middle-rank managers in the state or co-operative sectors. When transition made it possible, they established their own business, possibly with the help of the 'mother' firm and with the hope of continuing to work for the latter. Given the optimistic expectations on the outcome of transition, they hoped to rapidly increase their activity. The near demise of the state sector of the economy had negative consequences for this group of enterprises, at least until large private companies started to expand forcefully. As seen above, when the economy started to expand again this group of enterprises became the most dynamic one, together with those enterprises producing for foreign markets.

The situation also presented a double face on the input side. Liberalization and the rapid increase in the number of suppliers made the procurement of inputs easier. Price and enterprise liberalization, hardening budget constraints and rigorous budgetary and fiscal policies made shortage rapidly disappear (Kornai 1993). However, disruption of old business links, uncertainty prevailing in the market, increasing competition among sellers and the appearance of great numbers of new actors whose reliability and credibility were unknown rapidly increased information and networking costs. At the same time, the rapidly worsening situation on the labour market and in state owed enterprises and business uncertainty in a depressed economy prevented many small entrepreneurs from growing. Indeed, many of the small businessmen were private businessmen only on a part-time basis since they also had a job in a large enterprise and preferred to keep it.[31]

The successful macroeconomic stabilisation policy implemented in 1996 (the 'Bokros package', named for the Minister of Finance in the centre-left coalition government) had unfavourable consequences for SMEs in the short run, in particular for small enterprises. It restricted domestic demand and since small enterprises are strongly linked to the domestic market as their main sale market and particularly concentrated in the service sector, these policies hit them particularly hard. This effect was strengthened by other restrictive measures intended to balance the state budget (in particular, decreasing economic subsidies). Large enterprises suffered less since they were supported via a policy intended to promote exports and curtail imports (*KFI* 1997).

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[31] According to Laki 1998: 105-106, 22.4 per cent of small entrepreneurs (sole proprietors) were such only part-time, while this share was 33.8 per cent in 1987. This feature continues in the transition period, when approximately half the sole proprietors are full-time (*KFI* 1998: 104). Their share approached 60 per cent in 1998 (*KFI* 1999: 78).

Other disadvantages and difficulties for SMEs, and in particular for small enterprises, derived from the legal environment that remained unstable and rather unpredictable because of frequent and sometimes contradictory changes. In the medium run, the success of stabilization and other factors substantially improved the macroeconomic situation beginning in 1997. This had some positive consequences also for small and medium sized enterprises, as seen above, but much more so for large companies.

The crisis of the small enterprises is evident in all indicators: share of employment and GDP; sales proceeds; exports; and own resources all either stagnated or decreased to the advantage of large and medium-sized enterprises since the mid-1990s. This outcome inverted the trends that dominated the first part of the decade when large enterprises were in difficulty, (mainly because of restructuring) and small enterprises were forcefully expanding (mainly by occupying market niches abandoned by large enterprises or entering new niches). The recent revival of the Hungarian economy was the result of the activity of large enterprises, not the small ones. This also derived from different factors, among which policy discrimination against small enterprises (and preference for large ones) and contradictory macroeconomic measures stand out. In mid-1990s, the various forms of support for enterprises and also the public procurement system favoured large enterprises, while fiscal burdens hit small enterprises more heavily, as was mentioned above.

5.5 European and national policies

Policies for SMEs are usually motivated by the relative disadvantages that these firms have compared to large ones. The main disadvantages are on the side of information, capabilities and knowledge, co-ordination problems in managing complex productive processes, inability to exploit scale economies, asymmetries when dealing with banks and other financial organizations, as well as difficulties in planning and implementing technical progress. Although these problems exist in any economy they are magnified during transition. The paradox is that, although the need for active and passive policies during the transition is particularly great, the state at all levels from central government to municipalities to functional and sectoral agencies is politically and technically weak. This weakness derives from the swing of political mood to the private side of economic spectrum and from the objective necessity to restructure the state apparatus to make it able to manage a market economy.

Hungarian governments were fast in setting up policies and structures for the promotion of enterprises, usually following the example of Western European countries. However, these policies and structures were not specifically addressed to SMEs and their implementation lagged behind in both time and resources. The first complex programme for the specific support to SMEs was approved in 1997 by the centre-left government, although parts of the policy started to be implemented earlier (*IKIM* 1997). This was followed by a new strategy prepared by the new conservative coalition in 1999.

In spite of some organizational change, the two documents do not differ much technically. One major difference is that the former document strongly linked SMEs policy with the attempt to decentralize public administration, territorially delegating many policy instruments and structures to regional governments and municipalities. Co-ordination was also attempted with private (entrepreneurial associations) and mixed structures (Chambers of Commerce). Although the government made the Ministry of Industry, Trade and Foreign Tourism responsible for the co-ordination of intervention, the large number of Ministries, organizations, bodies, national and international funds that had SMEs as the target of their intervention and activity, jeopardized policy implementation. The outcome was the substantial lack of co-ordination, information asymmetries, duplication of interventions and bureaucratic red tape that discouraged SMEs from utilizing the opportunities that were created. Only a risible share of SMEs actually made use of the potential support (Laki 1998: 114-123).

One particular aspect that discouraged SMEs was that a large part of financial resources were allocated through the bank system that was generally averse to dealing with SMEs. The role of the banking system – in spite of its fast growth in the transition period – has been particularly negative for different reasons. One negative institutional feature is that Hungary lacks small banks specialized locally in micro-credit. SMEs have to resort to the large commercial banks, for whom dealing with SMEs is a secondary and rather unrewarding activity. The quality of bank services for SMEs is generally considered low and SMEs have to compete with large firms and with the national and local governments in raising credit. As a consequence, only a few SMEs make use of bank credit, leaving family and friends, together with suppliers, as by far the main source of external resources. Even if bank credit is somewhat more important for financing the working of enterprises, the share of small firms in the credit allocated by banks has been constantly decreasing.[32]

The booming number of small enterprises, their economically fragile features, the weakness of medium-sized enterprises, and the problems caused by the transformation and restructuring of large enterprises reflected in their falling performance, were all features very well known to each post-transition government. Each of the three coalitions that governed the country since 1990 tried repeatedly to work out and implement proper measures for strengthening and modernizing the SME sector. In spite of these plans and effort, the aim remained largely unattained.

An important policy development was the approval of a government decree in April 1997. By producing a general map of the existing financial sources for SMEs, the implementation of the decree substantially improved the information network and made information more complete and less costly. However, central SMEs policies became more passive during 1997 and the implementation of most programmes either stagnated or slowed down. The allocation of micro-credit at the local level also slowed down and then stopped. The same thing happened with the preparation of a General Act on small enterprises. The frequent change and unpredictability of regulatory measures continued, causing enterprises serious problems. Among the positive changes, one should note the

[32] A representative sample survey in 1993 found that two thirds of small entrepreneurs used family savings for founding their business and 30 per cent of them utilized credit obtained from relatives and friends. Only one fourth of them made use of credit obtained from banks or support programmes. The share of small enterprises in bank credit decreased from more than 11 per cent in 1993 to 7 per cent in September 1995 (Laki 1998: 128-131) and to a bare 3.6 per cent in 1998 (*KFI* 1999: 129).

adoption of the so-called single-window system, simplifying the requirements for establishing enterprises. Also other components of the administrative system became simpler and less costly and recently more favourable to business. Social security contributions were reduced for business in 1999, although this effect was offset by the substantial increase of health contributions and the transformation of payment liability in tax type liability.

Various modifications of labour regulation and vocational training contributions were also introduced, generally to the advantage of business. A government resolution in 1999 rules that compulsory membership of Chambers shall cease on 1 January 2001 and a new tax reform has been planned for 2000 (but already postponed). Although some simplification already started in recent years, it is only a general reorganization that can put an end to a decade of frequent, significant change in each tax category, that was due to the needs of the central budget. In view of such a change, no major change characterized fiscal regulation in 1999, except for the Act on Personal Income Taxation (*KFI* 1999: 25-57).

A survey carried out by the Budapest Chamber of Commerce and Industry in 1999 investigated the effect of regulatory changes on the operation of enterprises. The survey found that the value of tax payments in 1998 would have increased on average by 1.3 per cent when calculated by using 1999 tax regulations. However, this increase was distributed unevenly through different size categories. Tax burden of micro-enterprises would have increased most, by 8.2 per cent, that of small enterprises by 5.4 per cent, that of medium-size ones by 2.3 per cent and those of large enterprises by 0.5 per cent. Given the increase of net turnover, this actually means that tax burdens decreased slightly on average. However, enterprises experienced a further growth of administrative burdens and complexity, that were felt particularly by smaller enterprises (*KFI* 1999: 35-36).

Along with the problems in the financial and fiscal spheres, there may be other reasons why central policies have not been effective so far. One is certainly the objective difficulty of preparing policy instruments at central level which fit a reality that is highly variegated regionally, technologically, by branch and by many other features. Therefore, a necessary precondition for solving the policy problem of SMEs was the reform to decentralize the state administration which started in 1997. Other important reasons are the starting conditions of the industrial structure and priorities that governments chose. The starting structure was quite unhealthy from a market point of view, consisting as it did of a powerful group of (mostly economically artificial and inefficient) large enterprises, substantial and rapidly increasing number of small enterprises (traditional in character and serving the domestic market) and few medium-sized enterprises. For good or bad, governments decided to give high priority to the privatization and restructuring of the large companies and to attracting foreign capital. This deflected both attention and resources away from the possible support to SMEs. Also, until it was clear what kind of industrial structure privatization and liberalization would produce, it was difficult if not impossible to decide what kind of policy to implement in the lower-priority SME sector.

Because of these features it was politically and technically difficult, if not impossible, to devise a proper package of measures for promoting SMEs. Probably the time is coming when this will be possible after having been necessary since long. By now, the regional decentralization of public administration is under way and is supported by EU integration.

5.6 The role of local governments and policies

During the last few years, in particular since 1994, Hungarian governments started to be quite convinced of the importance of local processes and their indispensable contribution to the crucial goals pursued by the country: the completion of economic and social transformation, diffused and territorially balanced economic and social development, and European integration. The fulfilment of these goals has the aim of dealing with crisis areas, promoting new development processes more appropriate to local conditions, supporting equity and restructuring, and completing the basis for the new development model based on the market and the new international position of the country. Local promotion of locally based SMEs is a crucial component of this programme. In this regard, there is no great difference between the mid-1990s when the country was governed by a centre-left majority, and the late-1990s when the conservative majority is in government.

As stressed above, the partially alternative, but partially complementary features and conditions of local governance in a transition country such as Hungary could be:

(a) Direct support for the rise, restructuring, and development of SMEs as autonomous market actors by directly establishing them and by supplying existing SMEs with preferential financial support. Actions of this kind are motivated by: the insufficient number of SMEs at the start of transition and by their weak structure in the following years; by the lack of own financial resources; and by the aversion of financial organizations to SMEs. In all these cases direct intervention or support by the public hand may be required for a transitory period to give a crucial push to the development of SME sector. From this perspective, SMEs are seen as autonomous actors that serve market niches: they neither depend on or compete with larger firms nor enter stable, horizontal co-operative networks with other SMEs. Their contacts with other firms are purely market-based.

(b) Indirect support for SMEs by creating a supportive environment, including the provision of infrastructure, the supply of financial and real services, and a creation of proper tax and administrative system. If a sufficient number of SMEs exist – which possibly have materialized a few years after transition – and if the crucial problem is to favour entry and exit mechanisms by supporting restructuring, competitiveness and the growth of the strongest SMEs into larger firms, then more flexible indirect forms and instruments of support should be preferred. In fact, they can stimulate the active participation of existing actors, assist the growth and modernization of the most promising among them, and foster expansion of market supply. This approach emphasizes the creation of SMEs friendly infrastructure and the specialized market supply of financial and real services by locally-based, public or mixed (public/private) organizations. As to the tax and administrative systems, the goal should be to remove the disadvantage that SMEs have compared to larger firms.

(c) A further goal, that requires more active policy making and implementation, consists in pushing SMEs to co-operate to the fulfilment of economic and social development goals at the local level (such as improving the supply of goods and services that are of crucial importance for the living standard of the population in less developed regions), and help them in the implementation of those goals when needed. These goals may be motivated by the general features of transition – in particular the requirement of also fostering the development of markets at the local level – and by the urgent need to start and support a new development path. SMEs should receive a particularly important role in these developments, both in their own right and to compensate for the consequences of the centralized industrial structure inherited from the old economic system.

(d) A more ambitious goal is to support SMEs in vertical integration with larger firms. Here the idea is that policies should be used to foster the development of a modern industrial structure, whereby firms of different size co-operate on the basis of their own advantages in order to improve the efficiency and competitiveness of industrial groups and the economy on the whole. This strategy is likely to be coupled with policies of increasing openness.

(e) A more complex policy strategy, which is partially alternative to the previous one, favours the networking of SMEs on the domestic and international market. The underlying idea is that networking SMEs can have specific advantages that may render them irreplaceable market actors. This strategy may be further motivated by the weakness of large firms and the willingness to have a strong group of competitive firms within open markets.

Although the strategies under (c), (d) and (e) are not necessarily locally based, the local dimension is crucial in each case since SMEs tend to form locally-based systems. Local governments have a crucial role to play in the case of each strategy, but the specific features of this role strongly vary according to the strategy pursued. The role of local governments may also have to change since the above strategies are not necessarily alternatives, but they may be partially complementary or succeed each other through time.

In Hungary the transformation of local governments is still under way and much is still only on paper. Therefore, it is only possible to sketch a general, partly unfocused picture of the evolving role of local governments in the support of SMEs development and more generally a locally based economic development. The brief assessment of the ongoing reform of the system of local governance that follows takes account of the five conditions mentioned above and attempts to judge the sustainability of the reform initiative. One important starting point of the reform is that it is the product of careful planning, involving the co-operation of many organizations at both central and local level, some conflict, and extensive bargaining. As in any such case, the implemented reform cannot be perfectly consistent.

The reform. A general reform of territorial administration organization began in 1996. The reform is more the result of central initiative than of decentralized demand and it is motivated in large partly by the prospect of EU access. The change of government in 1998 introduced some major organizational changes that slowed down the pace of transformation for a while. The attitude of local governments and social forces is highly differentiated. The lower levels of local government, administration and initiative support the reform more strongly than the intermediate county governments. The attitude of counties has been ambiguous or plainly hostile to the reform for years and only recently appears to have changed following some modification in the original reform blueprint.

The central government took the reform initiative by means of Act XXI of 1996 on Regional Development and Regional Planning. This occurred after the Ministry for Environment and Regional Policies became convinced that the inherited administrative organization was an obstacle to local development and to the establishment of advantageous relations with EU regions. Hungarian counties are too small compared to EU regions, producing potential difficulties in the process of EU integration, and in particular in securing access to EU structural funds. Moreover, with increasing administrative decentralization counties would be too costly to govern and too small to effectively and efficiently manage the implementation of development projects. Consequently, seven so-called planning-statistical regions have been under organization since early 1997, each consisting of a voluntary grouping of 3-4 counties with a combined population between 1 and more than 2 million. Each region gathers relatively homogeneous counties that have similar problems. These are supplemented with two development (or functional) regions dealing with particularly important, complex or delicate areas (the Budapest agglomerate and the Balaton region).

The Act intends to reorganize not only the approach to territorial questions, but more importantly to give a clear territorial base to the new market development strategy. In fact, such new concepts as the entrepreneurial strip (vállalkozási övezet), favoured area (kedvezményezett térség), areas of structural transformation (szerkezetátalakitás térségei), innovation centres (innovációs központok), and depressed cross-border area (hátrányos helyzetü határmenti térség) are introduced here as the basic instruments for policy activity at the local level, that largely coincide with SMEs support.

The implementation of two decrees in 1996 and 1997 started the process of actual decentralization. They were within the framework of the regional reform and were addressed to improving the situation of small enterprises, decentralizing and better co-ordinating policy making. Particularly important was the 1997 Act regarding regional development because it decentralized to regional and local governments a substantial part of the policies and resources addressed to small enterprises. An Act was also passed on small enterprises and venture capital companies and the Ministry of Finance appointed a ministerial commissioner to co-ordinate the programmes and the resources addressed to small enterprises. A special fund to subsidize interest on investment loans for small enterprises was also financed and the first Regional Venture Capital Fund was established in September 1999 (*KFI* 1997; (*KFI* 1999)).

In spite of these changes, counties continue to be the basic element of territorial organization and crucial decisional-making responsibility remains with them. In the economy, this is concentrated in their Councils for Territorial Development which manages the financing of local projects (funded almost exclusively by central budget appropriations). These councils organize competitive bidding for public contracts at county level, in which individual public or private organizations take part, and choose winners. Their role is important for small enterprises also in public procurement, of which local governments and their institutions have a share of more than one third. SMEs get a very tiny share of public procurement contracts and this little share is primarily related to local governments (*KFI* 1999: 58-62). Although the Councils' discretionary power is great, a representative of the Ministry is a member of the Council and can stop any decision. The 1996 Act also calls for the establishment of Councils for Regional Development to manage those questions that involve more counties.

The developing system of local governance has some deficiencies, but is apparently able to make some positive contribution to the promotion of economic and social development at the local level, including the establishment of SMEs, job creation, and encouragement of innovation and entrepreneurship.[33]

Municipalities can now compete for central funds that they may use to create conditions promoting entrepreneurship and innovation. For instance, various municipalities have contributed to establish industrial parks, incubators, and other structures for the promotion of entrepreneurship. Other structures, such as entrepreneurial clubs, have been established by the initiative of private individuals or group of individuals, although often with the support of municipalities. Behind these actions is the hope of creating an environment and a diffused entrepreneurial culture that will offer opportunities and incentives for potential investors and entrepreneurs. Structures that are set up should decrease the costs of establishing business. Intervention by the public hand – either alone or in co-operation with private individuals and organizations – has the role of overcoming the lack or insufficiency of private supply which are consequences of the features of the pre-transition, economic system and the difficulty of transition.

Counties are the traditional basic unit of local governance. Although they support municipalities in their effort to promote SMEs, their situation is difficult and their activity and goals are rather ambiguous. Counties lost much of their resources, funds and personnel in the early 1990s to the central government and municipalities. However, they are still responsible for various matters such as schools, hospitals and roads that are of crucial importance for local development. Their attitude towards the new decentralization strategy has been ambiguous for some time, since they felt they were under attack and their position was likely to be further jeopardized. More recently, the counties have started to adapt and act in a more co-ordinate and co-operative way along

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[33] The following consideration are based on *OTK* 1997, *KFI* 1999 and other official decrees, newspaper articles and consultations with various experts.

the lines of the new regional project. The outcome so far is a still weak system of local governance in which the central government has the crucial role in decentralized matters. However, the impact of the central government was greatly weakened by the reorganization implemented in the early 1990s, since part of the responsibility of counties was allocated to different ministries and different funds, making co-ordination difficult.

In this new situation, municipalities become the most active and innovative actor in local governance. Municipalities often establish important and apparently effectively working partnerships with the private sector, in particular with SMEs and associations of SMEs. Municipalities have indeed great incentives to develop their community and local economy, but, competition for central funds, duplication of projects and lack of co-ordination with other communities can easily result. In fact, only a weak intermediate level of governance exists, since the role of the counties has been weakened, the regions are only making their first steps, no alternative spontaneous institutions exist, and municipalities are too small to set up such institutions. The central government continues to be the fundamental player. Persistent centralization and branch approach favour the pursue of rents, lack of co-ordination and poor integration of projects.

Seen from the perspective of SMEs, the underdevelopment and the still rather unfriendly attitude of the fiscal and financial systems are a great problem that local governments are unable to solve. Territorial governments and organs have only a very modest power to influence the fiscal treatment of enterprises according to the local situation and their own priorities, while decentralized financial structures for local credit are still missing. Although local (municipality and county) development companies are growing, their contribution is still modest, except in drawing up projects and managing some structures (e.g. industrial parks).

A further important aspect is that the budget constraint of local governments is rather soft because of access to central funds, while that of the central government became quite hard. The main consequence is that the central government (ministries, central funds) has to ration funds for local initiatives, although it lacks sufficient instruments to consistently choose the most innovative and productive projects. This partly explains why entry and exit mechanisms in the SMEs sector do not work properly. Bargaining both ex ante and ex post can help to find acceptable solutions in a quasi-market fashion, but this is a costly and not always efficient decision making process. This system favours conservative choices and the use of conservative labour and industrial policies, which is a further obstacle to the modernization of the SME sector. It is only a consistent implementation of the regional reform, strengthened by the decentralization of resource allocation and responsibility, that can produce a context promoting the development of a strong and modern SME sector and can support the integration in the EU.

In spite of these shortcomings, local governments in Hungary – in particular municipalities, but in the future also regions – are becoming increasingly important for supporting the foundation and activity of SMEs. Along with the role outlined above, they can: (a) sell or rent their own land for a low price; (b) impose local taxes and grant tax exemptions or reductions for new enterprises; (c) support employment via social policy; and (d) foster the supply of real services. In the recent past they could also lend micro-credit, but now this is forbidden. The impact of all these activities is still modest, but the trend is clearly rising.

Local governments also act with specific organizations, often with the help of the national government and international agencies, particularly in major crisis areas. Various development agencies of different types (institutes, foundations, companies), working according to different principles (nonprofit, purely for-profit, or both), have been established in this spirit, directly or indirectly supporting SMEs, in particular smaller ones. Many of these agencies are locally based. They may have a mixed nature and are established by local governments (usually individual municipalities or groups thereof, but also counties and now regions) and other organizations, such as national-level banks. The goal of these organizations is to attract enterprises to the region or the local area, supply credit and information for small and medium-size enterprises, supply venture capital, usually to SMEs, or to pursue much more specialized aims, such as building pilot firms for innovation in selected fields.

Other agencies are local branches of national structures. They are usually set up by the national government, often together with foreign sponsors and have offices in each county. Their goal is directly to support the development of enterprises by supplying real or financial services (such as credit guarantee) to SMEs or to support counties, municipalities, and private investors that want to start similar initiatives.

The actions implemented so far by local and national governments have supplied in particular indirect support of SMEs by contributing to the creation of a supportive environment, including infrastructure, supply of financial and real services, and a proper tax and administrative system. Some importance was also assigned to pushing SMEs to co-operate in the fulfilment of the goals of economic and social development at local level. Much less effort, if any, was assigned to support SMEs in vertical integration with larger firms or to encourage the networking of SMEs on the domestic and international market.

One should also notice that, in spite of their great and increasing number, few local agencies have any real impact on the local economy. Most of them have very modest structures, small financial means and weak operational capacity. However, their development is rapid and their role is becoming more important for SMEs. The situation of local branches of national organizations is similar.

5.7 A new strategy for local development and SMEs?

The government established following the 1998 elections introduced some major changes in local organization and governance. After some months of uncertainty that stopped the implementation of territorial reorganization, the most visible and important such change was that a different – reorganized and strengthened – ministry obtained the control over regional development. This is the Ministry for Agriculture and Countryside Development (*Földmüvelésügyi és Vidékfejlesztési Minisztérium)*. This has been a radical reorganization that reflects power relations within the new government. Although apparently no radical change of strategy took place, the meaning of administrative decentralization changed substantially (*FVM* 1999).

The accent – and relative resources – of policy intervention and supporting resources have clearly shifted from regional development as a complex concept and set of activities to the development of the countryside considered as the area where modern agricultural activity takes place. The goal of regional policy shifted, at least in principle, to agricultural support and modernization including development of those locally-based non-agricultural activities that either can be considered as a side product of agricultural activity or that are complementary to a developed agricultural countryside. Political considerations apart, this strategy is apparently an attempt to preserve the traditional character of the Hungarian countryside, threatened by EU integration, by supporting its modernization.

A major difference with the strategy followed by the previous government is that policy support to the development of SMEs is now clearly split in two parts making co-ordination problems inevitably more complex. There are the Ministry of Agriculture Programme for the broadly conceived agrarian sector and a programme of SME support in other branches that is clearly separated from regional reorganization. The Ministry of Economic Affairs in the new government presented its medium-term strategy for micro and SMEs in December 1998 (*MKGM* 1999a) and prepared a proposal for a specific law for SME support that has been enforced since 1 January 2000. The strategy and the law include some important leading ideas that are worth discussing briefly (*MKGM* 1999b).

First, the most important goal of the strategy is to strengthen SMEs ability to create jobs. This aspect is stressed throughout the strategy, so that we can consider it as the top priority. Although it is rather obvious to stress this aspect in a high unemployment situation, the document does not present a clear strategy to reach this goal. Overall, this priority suggests that the role of SMEs is seen as residual to that of large enterprises. In this perspective, SMEs are bound to become more dependent on large companies as their way to modernization and to enter this way the international division of labour.

This impression is strengthened when looking at social and economic policy goals. Some of the goals are general: improve the small businessmen's status and capabilities; make them a pillar in the bourgeois value system; open opportunities to all groups in the society; strengthen law abiding behaviour; consolidate existing SMEs and improve their technical level and innovation ability; support participation in EU integration and globalization. Two goals are more specific: increasing SMEs share in the domestic market and strengthening their access to the world market. The latter goal is concretized in the support given to the development of subcontracting, which is intended to play the role of a bridge fostering co-operation between large companies and smaller ones. All this should first produce convergence of growth rates of different size enterprises and then would result in SME growth rates to surpass the economy's rate.

The goals of this strategic policy, the strict schedule for working out the supporting legal framework and the latter rapid approval represent important progress, but require a short comment on two strategic questions: First, are specific goals and policy instruments appropriate to pursue those goals? Second, does this strategy sound or does it imply a waste of potentially existing opportunities and resources? As to specific goals and instruments, one important positive aspect of the strategy is that it approaches SMEs by differentiating instruments according to enterprise size. These are divided into three groups: micro- ('family') enterprises, small enterprises and medium-sized enterprises. For the first group, the basic instruments are radical reduction of administrative requirement and simplification of tax payments (in particular, by expanding flat rate taxation and widening the so-called 'one-stop-shop' system of providing administrative services), micro-credit, the support to employment of family members, the unemployed and new entrants on the labour market, and the supplying expert consulting. These are standard measures that do not go beyond traditional policy schemes. More important in my view is the government commitment to facilitate the development of mutual support schemes and lending while providing guarantees. It will be important to see how this commitment will become operational.

Particularly important and interesting are the instruments for small enterprises. Traditional instruments of reducing and simplifying administrative and tax burden are offered also in this case, together with information services, credit guarantees and interest payment support and support for training purposes. Particularly important here is the government intention of facilitating access to risk capital for those small businesses which are capable of rapidly developing and implementing major investment projects and of strengthening inter-enterprise relations and developing enterprise networks.

The most ambitious goals are set for medium-sized enterprises whose development should be addressed particularly to foreign markets. These firms should play a strategic role in connecting large transnational companies and small domestic enterprises. The government claims that existing financial sources (those offered by financial institutions and capital market and the existing competitive schemes) are suitable for achieving these objectives and fit for future improvements.

A further general set of instruments which will affect all kinds of SMEs are decentralized regional and rural development measures, including funds earmarked for specific regions, support systems for enterprise zones, industrial parks and business incubators along the lines already envisaged and implemented by the previous government. Further, the strategy includes the important goals of much needed improvement in the predictability of the economic environment, security of law for entrepreneurs and provision of fair competition rules. This, together with the equalizing fiscal burdens with those of large enterprises in the planned (but postponed) 2000 tax reform and announced measures to promote legalization of irregular jobs, pursue the goal of fighting the underground economy.

A major change has also been announced in the system of government support for economic activities. The basic principle of government support for enterprises will be to further finance projects instead of financing institutions. This could strengthen past improvements, reducing the bureaucratic burden. However, the danger exists that such a measure will centralize the public action for SMEs, making it more rigid. The outcome will depend on the actual implementation of the decision. The use of such funds will be controlled through appropriate monitoring systems. Also important is the intent to establish an independent fund for SMEs under the supervision of the Ministry of Economic Affairs, starting with the 2000 budget.[34] This is intended to give transparency, co-ordination and predictability to budgetary support of SMEs development programmes. The fund will be used to finance various programmes including: micro-credit and support to technical development; promotion of regional risk capital funds for small businesses; expansion of guarantee schemes (and encouragement to decentralized guarantee associations); promotion of small enterprises access to the international markets and to franchise systems; support to small businesses purchase associations; financing tasks related to subcontractors programmes;[35] as well as support to the establishment and maintenance of incubator houses, to educational and training programmes, and to real services and infrastructure also related to the SMEs EU access.

The strategy also takes a position in the long-debated issue of establishing specific credit institutions for SMEs by stressing that lending to SMEs is the fundamental responsibility of credit institutions and there is no need to set up independent SME banks. Government support for lending terms and conditions is considered to be sufficient. Unfortunately, here the document totally disregards the important problem of granting some kind of administrative and fiscal facility and possibly logistic support to independent local private or co-operative banks (similar to what the document promises to organizations offering guarantees on a voluntary basis) that would specialize in credit and other kinds of support to local SMEs. It is a major weakness of the strategy that the successful experience of nearby European countries, such as Austria, Germany or Italy is overlooked. Also overlooked are recent developments in Hungary with savings' co-operatives.[36] A last important point concerns the organizational system dealing with SMEs. According to the strategy, only minor changes are needed. The Ministry of Economic Affairs will co-ordinate the various central organs and co-operate with decentralized ones.

The overall government plan appears to address important goals by using an approach that should be fruitful in many senses. Any final judgement should wait until the law becomes fully operational. However, one major weakness appears to be the lack of consideration of – let alone support for – local productive systems. In such a way it apparently supports the idea of the Hungarian SMEs as modern, dynamic and efficient subcontractors to transnational companies, in particular those that have invested in the country. In the present situation this may be a realistic goal, one that certainly should be

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[34] This is the SME Budget Appropriation, consisting of HUF 5.8 billion (*KFI* 1999: 188).

[35] On the Target Programme for Subcontractors see *HU* 1999d.

[36] Király and Várhegyi 1998: 224, after rejecting themselves the idea of a centralized SME bank, stress how, after the state consolidation in 1992-93, co-operative banks started to merge and grow. There are presently 243 savings co-operatives with more than 1,800 branches, with a 5 per cent and increasing market share. The Authors conclude that "... saving coops should play the decisive role in SME finance", possibly in co-operation with local branches of the National Savings Bank (OTP).

part of any strategy for SMEs. However, such a strategy appears to be economically weak and politically dangerous, because it would perpetuate the economic weakness and dependence of the country that could go to disadvantage of development opportunities. No potentially dynamic and autonomous role in the domestic and world markets is even envisaged for SMEs. Neither support for local productive systems nor consideration of the possibility of promoting transnational productive systems among SMEs of different countries. Here the strategy overlooks an important possibility that the EU third programme for SMEs for 1997-2000 already provides and even the criticism that Agenda 2000 moves to SMEs in Hungary and other Central European countries is not taken into its full meaning.[37] Another major weakness of the current strategy is the complete disregard of the important role of local small credit institutions. The importance of co-operation among SMEs in the field of joint maintenance and financing of certain R&D infrastructures is mentioned only once, but no government action in this direction is envisaged.

The law is operative since 1 January 2000. It apparently implements a progress in the direction mentioned above. In fact and along with a carefully organized co-ordination of policy intervention under the supervision of the Ministry of the Economy, the law includes – among the programmes that the central budget can finance – two goals that could strengthen interfirm co-operation and the development of local productive systems. These are the support to co-operation (a) among enterprises in the fields of production, trading, and input procurement plus SMEs joint approach to their financial market, and (b) among SMEs and between these and R&D organizations. The goal of the latter action is to implement joint research and development programmes, the achievement and marketization of results therefrom (§6). Along with these goals, the law provides for numerous ways to solve the problems of SMEs, starting with financing of their development.

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37 On the problems and prospects for Hungarian SMEs deriving from EU access see *HU* 1999b and *HU* 1999c.

VI LESSONS OF THE HUNGARIAN SME EXPERIENCE: THE CASE FOR RUSSIA

The Hungarian and Russian economies present great differences, together with some similarities. One striking aspect is that the number of SMEs in the two countries is similar (although not that of other indicators), in spite of the much larger size of Russia. Although various scholars speak and write of an excessive number of small businesses in Hungary, there is no doubt that in Russia SMEs are too few. They are also too weak and often simply fighting for survival, being hardly a dynamic factor in the Russia economy. This raises two sets of questions: (a) Why are SMEs so few and weak? Why are Russia and Hungary following a clearly divergent path as far as SMEs development is concerned? (b) Can anything be done to improve on the situation and if so what kind of suggestions and lessons can the Hungarian experience supply? And what is the reasonable and sustainable (set of) instruments and goal(s) that policies should try to utilize and pursue? I will address the two questions in this order.

(a) SMEs in Russia are few and weak under any perspective. According to an OECD study, (OECD 1998, Glinkina 1999 and Radaev 1999) the number of SMEs is far below the average of other transition countries. Along with policies, there are several explanatory variables for this fact that belong in the environment, the economic system and the actors' individual features. Among environmental variables, the following deserve mention: the vastness of the territory, the prolonged economic depression during transition, the long bureaucratic tradition, the activity of criminal organizations, the historical absence of diffused small and medium size entrepreneurship and the lack of political representation of small enterprises interests.[38] The relevant features of the economic system include those of the Soviet system and its legacy (and of pre-Soviet traditions), political and bureaucratic interference in business life, there comprising the dominance of the large military production complexes, undeveloped business infrastructure, Soviet economic and administrative policies, campaigns and ideology. The latter strongly and consistently opposed private enterprise and even autonomous behaviour by managers was discouraged, when not persecuted. Only the underground economy during the Brezhnev period was tolerated. But it had features possibly even less favourable to support entrepreneurship during transition that it had in Hungary, since it depended on more serious shortages and more pervasive political/administrative power.

To these one should add various unfavourable features of the present economic system, including uncertain property rights, lack of regulation of labour relations and the

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[38] The OECD study notes that traditionally Russian entrepreneurs belonged in two categories: the large entrepreneurs linked to the political power, and the entrepreneurs from different ethnic minorities. One should remember that this same pattern survived in a peculiar way during the Soviet time, when large enterprises dominated in the socialist sector and ethnically based small entrepreneurs were the backbone of the second economy. See Grossman 1977.

features of the financial and the fiscal systems that are averse to SMEs.[39] Also noteworthy is that ministries and agencies in charge of SMEs policy implementation changed several times and some stability was only reached in the second half of the 1990s. International organizations have played a role in promoting financial and real initiatives (including setting up micro-credit programmes and structures such as business centres and incubators, aimed at supporting SMEs. While most of these initiatives have been directly addressed to local realities, the OECD study notes that the different initiatives are uncoordinated, often too complicated for small businesses, and rarely situation- and user- specific. Although the quantity of resources utilized and the number of programmes implemented and structures established have been important, their actual impact has been modest. Finally, it is unclear whether these programmes and structures are sustainable when international support ends.

Regional and local governments are the most important suppliers of SME support, since they draw up and implement programmes of SMEs support (e.g. regional credit guarantee funds). Predictably, the record of different regional and local governments is quite different, with some governments being very active, while others still have to move the first step. Their role is not always positive, since their activity often increases bureaucratic interference and fiscal burdens, introduces additional bureaucratic barriers and delays, and may result in excessive controls and reporting requirements, or even corruption and bribe-taking.

Finally, one should also consider individual features of economic actors. In a comparison of entrepreneurial attitudes in five transition countries, Kuczi and Lengyel find that entrepreneurial inclination is even greater in Russia than in Hungary.[40] Further differences with Hungary are that in Russia the threat of unemployment is a very weak (well below average) incentive to induce individuals to think about establishing a private business. Also the role of the irregular economy is greater: nearly half of those who have income in addition to that from their official job would like to become entrepreneurs as against one third in Hungary.

Contrary to the Hungarian situation discussed above, the authors find that in Russia the chances of actually becoming an entrepreneur are principally determined by the size of the political capital (the role played in the former political and administrative

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[39] According to the OECD 1998: 11, fiscal uncertainty is hampering SMEs development, with arbitrary and cumulatively very high levels of taxation (as high as 90 per cent of profits, although profit tax is presently at 35 per cent). Small businesses do enjoy various federal and regional fiscal privileges. To this one should add lack of capital, weak financial system, high interest rates, and little short-term lending. Finally, equipment leasing schemes are undeveloped and credit conditions are inappropriate for starting businesses. The periodic resurgence of inter-enterprise arrears, the spread of barter and curtailment of aggregate demand by means of restrictive monetary and fiscal policy are also particularly damaging for SMEs. Consequently, private high interest credit and informal and semi-legal forms of financing are widespread.

[40] Kuczi and Lengyel 1997b posed the question 'Would you like to be an entrepreneur?' to a sample of 1196 Hungarians and 1197 Russians. Those who answered 'yes' were respectively 28.3 per cent and 30.3 per cent in mid-1990s. Interestingly, those who answered 'no' were 57.3 per cent and 39.6 per cent (the others answered 'it depends'). About the same proportion of respondents answered 'no' or 'I don't know' to the question 'Do you plan to launch a venture within a year?'.

leadership)[41], while educational level and belonging to a professional group are not significant explanatory factors. The reason for this difference appears to lie in the fact that in Russia the process of establishing private businesses only started in the late 1980s, when the leadership was under the pressure of great and growing insecurity. Establishing a private business was a defensive reaction which attempted to convert old systemic capital into a new one by exploiting privileges before they faded away. These findings are supported by the OECD study cited above. There are no studies on capabilities in Russia that I am aware of. However, one can easily infer from the features of the Russian context, small businessmen, the origins of small businesses and their shorter experience that their owners and entrepreneurs are likely to own less market capability than their Hungarian colleagues, in particular in the form of tacit knowledge.

In spite of unfavourable environment and systemic features, there was a boom of SMEs since the beginning of transition. SMEs started to develop in Russia in the late 1980s, especially after the partial liberalization implemented through the 1988 Law on Co-operation. Liberalization became complete after 1991 when all types of property became legal. Since that same year SMEs became a distinct policy subject for legal regulation and support at both federal and regional level. They became as well the main channel for converting state-owned assets into private property.

The number of SMEs was 15,880 in 1988, and 45,830 in 1990. Co-operatives were three quarters of the total number of small enterprises. The number of SMEs was 268,000 at the end of 1991, and had increased to 896,900 by the end of 1994. This growth was concentrated in the administrative centres and large urban areas of the Central district, and also North Caucasus, Ural and West Siberia districts. The growth in the number of small enterprises stopped after 1994 and there were 842,000 registered small enterprises on 1 January 1997.[42] Most of them are in trade with less than one seventh in manufacturing. However, one third of these enterprises are not active. While at the beginning of the decade most small businesses were in state ownership (which may explain the relatively low number and large size of SMEs), by 1997 almost 85 per cent of small businesses were privately owned and more than 10 per cent in mixed ownership. However, the weight of the private sector was lower in terms of employment (68 per cent), investment (57 per cent), sales (68 per cent) and profits (69 per cent), while that of mixed small businesses was remarkably higher (respectively 20, 36, 22 and 23 per cent).

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41 According to Kuczi and Lengyel, this includes a small group of former functionaries of the party and the communist youth organization, a larger group of former state official, and the most important group of former SOE managers. These findings are supported by Kryshtanovskaya and White 1996. The OECD study adds two further groups: skilled professionals and dealers in the underground economy. Radaev 1997 also supports these findings.

42 Figures are reported in OECD 1998. It is not completely clear yet why this happened, nor is it clear whether this stop entirely reflects a true stagnation or it is simply a statistical illusion (e.g. due to increasing numbers of small businesses going underground). The uncertain situation of small enterprises and the lack of a proper institutional structure play clearly a crucial role. Also the prolonged depression of the Russian economy and widespread inter-enterprise arrears and barter (which are particularly damaging for small businesses), are among the main negative factors.

In 1995 employment in small enterprises amounted to some 9 million full-time employees (13 per cent of the active population), plus another 1.3 million of part-time and 3.6 million contract employees. This means that small businesses in Russia have on average 10.4 employees. Although they have a bare 3.4 per cent of assets, it is estimated that the sector contribution to Russian GDP is around 12 per cent and that they produce 30-35 per cent of profits.

All these figures only give an approximate picture of the relevance of small enterprises, since there are various measurement and reliability problems. Small enterprise statistics and the definition of small enterprise changed several times and different definitions are used for different official purposes. This makes inter-country and inter-temporal comparisons difficult. One further problem is that the category of medium-sized enterprise is not used in Russian policy.

(b) Second, in order to draw suggestions for SMEs policy goals and instruments from the Hungarian experience one should first consider carefully the fundamental differences between SMEs, their context and policies in the two countries. The summary presentation of Russian small businesses in the previous paragraphs stresses that there are some similarities in the environment, the economic system and the actors' individual features. These derive from the past decades when the two countries shared a partly similar economic system and strictly co-operated in economic as well as political matters. Although important, these factors are insufficient to cancel pre-existing differences and to hide important dissimilarities during the Soviet-type period. These were further increased and widened by strongly divergent transition policies, in particular those institutional policies dealing with privatization and corporate governance. Given these dissimilarities, one should expect that SMEs in the two countries follow divergent paths during transition. Russia is bound to have a different structure of SMEs and these should play a different role than in Hungary. However, a greater development of SMEs than so far should take place in Russia and the Hungarian experiences should be useful. Since Hungary adopted a limited liberalization of small businesses well before transition, it accumulated policy experiences over a much longer time span. In the following I will limit myself to some notes on Russian SME policy seen through Hungarian glasses.

The already quoted OECD study observes that entrepreneurs and businessmen now enjoy a positive image, also thanks to a relatively favourable policy framework, although a certain ambivalence persists. The state, although not hostile, proves to be rather indifferent towards SMEs. General policies are far from satisfactory, since they are still characterized by heavy and frequently changing fiscal policies and administrative requirements, although the situation differs greatly from region to region. One important feature is the way that various programmes and instruments have been proposed, worked out and even approved. SMEs programmes were originally formulated by regional and local governments, but lately the federal government has also entered the arena. The first such effort at federal level started as early as 1991, but was stopped during the Gaidar government, that gave top priority to macroeconomic stabilization. The first federal programme for supporting small businesses was prepared in 1994-95 and others followed.

The idea behind these programmes is to create a context favourable to small business rather than to support SMEs directly (OECD 1998: 54-89). Examples of provisions of these programmes are as follows: comprehensive infrastructural development of urban areas; delegation of funding activity to regional programmes; establishment of SMEs credit guarantee funds; provision of incentives for vertical integration of small businesses with large corporations and financial-industrial groups; and support training programmes. These activities were to be implemented via a network of specialized organizations and structures: SMEs support foundations; banks and insurance companies working on SMEs development; business incubators; development agencies; business training centres; and information networks. More recently, in its *Main Guidelines for SME Development in Russia and Its State Support Until the Year 2000*, the State Committee for Support and Development of Small Enterprises (SCSME) slightly modified these priorities in the sense that, along with the continuing focus on regional decentralization and development of priority branches, it strengthened the emphasis on the creation of new businesses and on the use of SME policy to support weak social groups.

Federal SME support programmes have received modest political support thus far. This is reflected in the limited amount of financial resources that the state budget devotes to this end (a bare 0.001 per cent in the 1994-96 programme and 0.16 per cent in 1996). The support actually granted was even less. Along with the modest amount of resources for policy implementation, programme implementation and enforcement also lag behind. Sometimes, apparently favourable decisions are never implemented. A further problem is implementation equity, since political and administrative influence is an important distorting factor. In some regions the situation is relatively satisfactory, but no adequate solution has been found yet to solve the crucial problem of co-ordination with the federal level. A certain amount of federal resources is decentralized to regionally-based funds. However, these funds often have very modest resources and their activity is sometimes more addressed to attenuating the local consequences of the general economic crisis than to promoting genuine market actors.

The policy situation sketched above clearly stresses that the main question is a political one. The relation between federal and local governments is still to be solved and SME policy receives low priority. Along with the solution of these political questions, the following differences appear most significant:

(1) Russian *environment* is substantially different from the Hungarian one. Russia is a large country rich in natural resources; large population is (although mainly concentrated in cities) dispersed on a vast territory; infrastructure is relatively undeveloped; the location of the country is rather peripheral to her most important and dynamic European and Asian partners and to the process of European integration; and Russian culture is relatively closed (McDaniel 1996). Reform experiences before transition had dubious – if not destabilizing – outcomes: transition coincided with the disruption of the Union, the public administration and the state apparatus and functions; the loss of world power status; and uneasy relations with old and new neighbours. Centripetal forces in the 'subjects of the

Federation', great ethnic problems, socially harsh effects of macroeconomic policies, ensuing widespread poverty, a great role of criminal organizations, prolonged political instability add to the unfavourable environmental features, together with the still uncertain social perception of private property rights.

(2) Many of these environmental features disadvantage small businesses more than large firms. On this basis we should expect that Russian SMEs should be fewer than in Hungary, more traditional in their technical profile (low capital intensity and labour-intensive techniques), more threatened by organized criminality, corruption and bureaucratic red tape and to have a lower social status, hence lower policy priority. As a consequence, their situation is dominated by uncertainty and a short time horizon and their activity is mostly limited to local markets.

(3) In spite of a relatively long period when the two countries shared the Soviet-type system, the Russian *economic system* presents distinct features: Russia kept a traditional centralized system until 1986 and the changes introduced with *perestroika* were too short-lived and contradictory to have a permanent effect on actors, except in increasing their uncertainty; the state is a weak player and is unable to properly carry out many economic functions; large enterprises remain dominant and keep a soft budget constraint via inter-enterprise arrears and arrears in payments to the state; the economy demonetization via barter and arrears jeopardize tax reform and the development of capital markets; banks are still hardly transparent and strongly intertwined with politics and industry;[43] changes in property rights came later and were less clear; priority was given *de facto* to insider privatization with managers emerging as the strong component of insiders, together with financial-industrial groups. The structure of motivations and incentives remained mainly bureaucratic in nature with insider privatization and inter-enterprise arrears attenuating the income and profit motives.

(4) *Individual features* also present some similarities and differences. There are not great differences concerning entrepreneurial inclination. As seen above, self-reported entrepreneurial inclination is even greater in Russia than in Hungary. Other important differences between the two countries are that in Russia unemployment is a very weak incentive to establish a private business, while the irregular economy is a powerful explanatory factor. Further, chances to actually become an entrepreneur are principally determined by the size of the political capital, while educational level and belonging to a professional group are not significant explanatory factors. Given the above, it is easier to understand why so few SMEs exist in the country. Those who were in the right position (had the right political capital and *also* were highly educated) used the opportunity to get a larger business.

Finally there are some remarkable differences in *policies*, along with some similarities as explained above. This concerns both general policies and SME specific policies. This

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[43] Recently the situation improved in the sense that the negative attitude of banks toward small businesses has been somewhat overcome.

opens two sets of crucial questions: (a) should the aims and goals of policies be the same in the two countries? and (b) is the existing policy diversity motivated by differences in the environment, the economic system or individual features? Since the complexity of the subject is great, I will limit a tentative answer to these questions to SMEs specific policies.

To say that the aim and goals of SME-specific policies should be the same in the two countries is to state that SMEs should have similar quantitative and qualitative features. This can be so only if one supposes that the two countries share the same economic system and are in transition towards the same system, although possibly at different speeds. This idea has been implicit in much policy advice and implementation, in particular by international organizations such as the IMF.[44] This approach fails to consider the powerful factors that push transition countries – in particular Hungary and Russia – towards different types of capitalism.[45] Since the two countries are moving towards systems in which SMEs are both quantitatively and qualitatively different, SMEs policies should also be different.

Given the above analysis, how can we assess present Russian SMEs policies that are different from Hungarian policies in both their extent and content? Are such differences motivated by differences in the environment, individual features and in particular the economic system? Only in part, I think. No doubt, the Russian environment is more difficult and complex than the Hungarian one. This explains a certain delay in working out and implementing specific policies. At the same time, environmental disadvantages require more determined policies and we have seen that thus far this has not been the case. Just the opposite: SMEs policies have rather low political relevance in Russia, while in Hungary they are now high on the governmental agenda.

Environmental complexity and variety are both much greater in Russia than in Hungary and therefore require for a greater degree of administrative decentralization in the economic domain, with greater latitude for local governments in SME policy-making. This requires much greater co-ordination of effort between the federal and local governments. Here the difference with Hungary is striking, since such decentralization is being clearly pushed by the central government, although in a somewhat contradictory manner. In Russia it comes mainly from the sometimes opportunistic efforts of local governments, that the central government has been unable to co-ordinate. Here the Hungarian experience can supply with many important insights and suggestions that could help Russia to ease centre-periphery conflicts and give the inevitable bargaining process a constructive nature.

Individual features, in particular those of owners and entrepreneurs, are also partially different in the two countries. Given the different origin of this social group and its presumed capabilities, it appears that the active promotion of entrepreneurship should receive a central place in Russian policies. It is particularly important to offer equity of starting points to different social groups and individuals with active policies, so to

44 See, e.g., Citrin *et al.* 1995: 85-87. For a policy oriented criticism of this approach see Stiglitz 1998.

45 Examined elsewhere by Dallago 1997.

radically broaden the social basis of entrepreneurship – this is important not only for having more and better motivated owners and entrepreneurs, but is also a necessary condition to strengthening competition in the Russia economy. Hungary offers various examples of how this can be done, but this activity in Russia should be pursued more forcefully than in Hungary, to compensate for the disadvantage in individual features.

Finally, since my analysis indicates that the economic system of the two countries is bound to become increasingly different, policies should consider that the features and role of SMEs is also likely to be different. In particular, since the Russian economy is larger, more closed and richer in raw materials than the Hungarian economy, the military sector more important, the market less developed and consumers' demand less sophisticated and diversified, large national enterprises are bound to have greater role and large series production more important. Consequently, the best prospect for SMEs modernization, which will also better serve final, mainly local-level consumers, lies in vertical integration as suppliers to large firms. Policy intervention and relative structures should carefully support this approach. It is made more appealing by considering the spread of inter-enterprise arrears and barter in the Russian economy, which are apparently difficult to eradicate. This creates a highly unfavourable context for SMEs and hampers their development. Vertical integration could substantially attenuate the impact of this payments failure and allow for the development of the SME sector even in the unfortunate event of stabilization policy failure.

Alternative policies are certainly possible but if they disregard the existing features of the three crucial variables that form the general context for SMEs – the environment, the economic system, and individual features – they are bound to fail and destroy those opportunities for SMEs development that continue to exist, in spite of the difficult economic situation.

The August 1998 financial crisis and Putin's election have partially changed the situation. The Rouble devaluation has directed domestic demand to domestic production. This has favoured SMEs, particularly the great majority that operate in traditional branches supplying products with high price elasticity. However, Putin's election is probably the sign of changed political mood that is producing new priorities and a different approach also to economic policy making. Apparently this is mostly favouring large domestic companies. If so, the above mentioned hypothesis of a potentially great role for SMEs as subcontractors in vertical integration with large companies is more timely than before. What remains to be seen is whether there exists the political and economic leadership's agreement on a consistent policy package to support SMEs.

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