

DEVELOPMENT OF SMALL AND MEDIUM-SIZED ENTERPRISES IN HUNGARY

This paper aims at giving a snapshot on the major trends of SME development in Hungary. After a brief historical background, the focus is put on the current changes taking place in the Hungarian enterprise policy. A major transformation is underway in the SME financing as a result of the substantially increasing EU funds available for enterprise development. This process is also supported by the favourable competition policy rules applicable for the SME sector in the EU. These changes are also supported by the increasing competition between commercial banks for financing possibilities, the target group of which policy is the SME sector. Besides, the concentration of the SME support system with the aim of increasing effectiveness of state subsidy for SME sector is also carried out.

JEL: F15, L21, L25

Following the change of the economic and political regime and as a result of the transformation that took place from the early nineties on, the number of market actors multiplied and private property became predominant in Hungary. The size structure of enterprises underwent radical changes. Small and medium-sized enterprises (SMEs) became the most numerous category and took over the bulk of activities that used to be performed by large enterprises earlier. To date, small and medium-sized enterprises play a significant role in economic and social life. 99.9% of all enterprises are SMEs, employing more than two-thirds of the employed and responsible for the production of almost half of gross added value.

EU policy towards SMEs

In the process of European integration it was in the 1980s that the role, situation and strengthening of SMEs at the level of the Community became an important task. This was the *raison d'être* of the First Multi-Annual SME Programme. In June 2000, the European Charter for Small Enterprises was elaborated; in April 2002 all candidate countries joined to this Charter. The programmes are implemented under the auspices of the DG Enterprise and Industry of the Commission, but also integrated SME programmes are formulated on the related tasks (R&D, innovation, education-training, job creation, etc.) of the other DGs. As competition and innovation have moved more and more into the foreground, one of the focal points

¹ Tamás Novák is Ph.D, senior research fellow in Institute for World Economics of the Hungarian Academy of Sciences, address : H-1014 Budapest, Országház u. 30., phone: +36 1 224 6700, fax : +36 1 224 6761, e-mail: tnovak@vki.hu

of the SME policy became the strengthening of entrepreneurial mindset and behaviour. In 2003 the Green Book on 'Entrepreneurship in Europe', in 2004 the 'Entrepreneurial Action Plan' were published. The revision of the Lisbon Strategy strengthens these programmes and integrates the tasks stronger than before to enhance competitiveness and innovation.

The European Union wishes to promote the start up of SMEs and their development, the strengthening of an entrepreneurial mindset and behaviour in two equally important ways: on the one hand, by providing a favourable business environment, by improving the framework conditions; on the other hand, by programmes backed with funding. These supporting measures are applied in the individual Member States through national programmes, realizing and complementing the EU policies. The national programmes in Hungary have so far concentrated too much on individual financial aid and preferential treatment.

The European Charter for Small Enterprises has identified ten major areas for strengthening small enterprises. Governments are called upon to report annually on progress made and conferences regularly discuss the national experiences. These are now going to be linked to controlling the implementation of the Lisbon action plans. Recently published EU resolutions frequently repeat the underlying idea of the Charter, i.e. 'Small enterprises are the backbone of the European economy' and the 'Think small first' slogan. The Community Strategic Guidelines to Cohesion Policy 2007-2013 formulates SME-related targets in conformity with the Charter, but in a broader context with regional emphasis. In November 2005, the SME strategy of the EU was revisited. The new document 'The Implementation of the Community Lisbon Programme. Modern SME policy for employment and growth' should give new impetus to the Union's SME policy. The five priority areas of the measures are as follows:

1. Promoting entrepreneurship and skills.
2. Improving SMEs' access to markets.
3. Cutting red tape.
4. Improving SMEs' growth potential.
5. Strengthening the dialogue and consultation with SMEs stakeholders.

The European Council on 23-24 March 2006 in its Presidency Conclusions (Points 26-31) confirmed these objectives and so did the Presidency Conclusions (Point 20) of the European Council held on 15-16 June 2006. The quoted titles of the five chapters in the new strategy indicate the focal points. The question arises: Are these objectives and tasks represented with adequate weight in the Hungarian SME strategy and programmes as well? Or does the different situation of the Hungarian SMEs justify other priorities? Before answering these questions, I need to reflect to the misleading translation of the first priority area 'Promoting enterprises and entrepreneurial skills'.

In the international and EU terminology, a definite distinction is made between enterprise and entrepreneurship. Enterprise is a form of organisation, whereas entrepreneurship is a kind of mindset and activity. The current Hungarian official language, however, does not make the same clear distinction – and the official translation of EU documents also follows this bad practice. For example, the first task set by the European Charter for Small Enterprises is 'Education and training for entrepreneurship', which has been translated into Hungarian as follows: 'The education and training of enterprises'. This mixed Hungarian terminology deprives

the EU priority of its essence; it does not reflect the strong emphasis contained in EU documents.

Nowadays, the EU and the OECD talk about SME and entrepreneurship policy instead of SME policy only. Far greater emphasis than before is accorded to strengthening entrepreneurial thinking and risk-taking attitude, for two reasons. On the one hand, more start-ups, new enterprises are expected, which sharpen competition and press market players to improve their performances. On the other hand, also recent surveys confirmed that the larger proportion of the self-employed, the owner/managers of micro- and small enterprises (and many medium-sized enterprises) do not aim to grow. Entrepreneurship for them is preferred as independent life-style. The OECD study prepared for the Ministerial Conference in Istanbul assumes that three-quarters of small enterprise owners are 'life-style entrepreneurs'; only one-quarter endeavour to achieve growth and only one-fifth of them (i.e. 5%) actually achieve real, significant growth. Therefore, strengthening entrepreneurial thinking among SMEs is considered to be very important, needless to generate more jobs and higher growth rates.

SMEs in Hungary

During the nineties, the structure of Hungarian enterprise sector changed dramatically. Regarding their number, SME-s became absolutely predominant. Entrepreneurial activity measured by the number of SMEs in Hungary compared to the EU Member States is second after Ireland. The structure of the SME sector became similar to the least developed countries of the EU (Portugal, Greece) by the turn of the century. The relative number of enterprises and their size are almost the same, and their income generating capacity is also increasing.

The overwhelming majority of operating enterprises (96-97%) is a micro-enterprise employing less than 10 persons. Their share in EU comparison is high, however the average size of enterprises is among the lowest in the EU. An average enterprise employs 6 persons in the EU and only 4 in Hungary. As the sectoral structure of the enterprises is concerned, most of them are operating in the services and trade sectors, while the manufacturing, construction and the productive sector in general is low.

During the past few years a number of processes took place that substantially modified the characteristics of the sector. Their situation is basically different from the situation of the nineties. As a result, the system and objectives of SME development have to be adjusted to the new situation. In order to catch up to EU-level and increase the competitiveness of the SME sector, the strengthening of the operating SMEs and improving their performance is a precondition. The role of SME in employment is increasing and this should be a most important task regarding SME development policy.

The regional distribution of SMEs in Hungary shows significant imbalances in favour of the capital and the developed regions. The aim of the economic policy is also to decrease regional differences and thus eliminating the duality currently present in the country through the enterprise support and the employment policy.

The situation of SMEs in Hungary is basically determined by a contradiction. On the one hand, they have a significant and increasing role in GDP production and employment. On the other hand, due to several factors, their technology level is low that makes very difficult for them the competition with larger firms. The same

goes for their productivity and adjustment capacity. The lack of sufficient own resources makes their competitive position even more difficult.

The group of SMEs is very heterogeneous: according to the EU definition it covers three groups of enterprises of very different characteristics: micro-enterprises (0-9 employees); small enterprise (10-49 employees; medium enterprises (50-249 employees). These groups have very different characteristics, so it is not justified to speak about the SME sector without clear distinction between its subgroups.

In Hungary SMEs have increasing importance. The share of SMEs in total revenues of enterprises is 59%, in export amounts to 35.6%, they account for 48% of total own capital of the enterprise sector and produce around 51% of GDP, while 74,2% of the employed work in SMEs. Investments of SMEs showed great volatility between 2001-2004. Investments performed by the total enterprise sector increased by only 1% in real terms during this four year period, but SMEs were much more active. In 2004-2005 SMEs have increased their credit stock significantly indicating strong investment activity.

Table 1

Investments of SMEs		
Size	Share of different group of SMEs in investments (%)	Investment dynamics in 2004 (2001=100)
0-1 employees	14	137
2-9 employees	14	102
10-49 employees	20	155
50-249 employees	13	91
SMEs total	61	119
Over 250 employees	39	82
Total	100	101

Source: Hungarian Central Statistical Office

The Hungarian SME sector shows several differences comparing to the EU average. The most significant differences compared to the EU average are the following:

- In Hungary 61 SMEs exist per 1000 inhabitants while in the EU25 only 49.
- The productivity of SMEs in Hungary is lagging behind large enterprises more than in EU25. Its reason is partly the inadequate capitalization (25% of SMEs have less than 1800 euro as own capital)
- The productivity and competitiveness of Hungarian SMEs is also far from the majority of SMEs in the EU.
- The technology level is low (R+D expenses in Hungary is under 1% while in EU 25 is around 2%)

Table 2

Contribution of SMEs to Economic Performance in Hungary and in the EU

	Micro-enterprises	Other small enterprises	Medium enterprises
Contribution to employment (%)			
Hungary	37.8	17.7	15.9
EU	39.6	17.4	13.0
Contribution to GDP (%)			
Hungary	18.3	16.0	18.3
EU	21.2	14.1	15.7
Share of export in revenues (%)			
Hungary	1	8	16
EU	9	13	17
Relative level of labour productivity (average=100)			
Hungary	49	97	115
EU	53	80	121

Source: Román

The Hungarian business environment has been deteriorated in recent years due to unfavourable changes in the macro- and microeconomic environment even comparing to the Visegrad Countries.

- According to the World Bank certain items of the entrepreneurial environment are very different in Hungary compared to the Visegrad countries. Market environment generally is favourable, however the institutional and regulatory conditions are unfavourable.
- The best performing area is credit availability, the worst are those of administrative character (e. g. management of permits).

Table 3

Ranking of entrepreneurial environment according to the World Bank

	HU	CZ	PL	SL
Establishing an enterprise	72.	77.	92.	48.
Management of permits	119.	87.	120.	40.
Employment and dismissal	85.	60.	64.	74.
Ownership registration	96.	55.	75.	6.
Credit availability	24.	21.	86.	28.
Investors protection	34.	68.	22.	118.
Taxation	98.	70.	106.	69.
External trade	38.	24.	34.	60.
Enforcement of contracts	31.	21.	104.	81.
Terminating an enterprise	50.	101.	23.	44.
Average of rankings	52.	41.	54.	37.

Source: Doing business 2005

New Directions in the Hungarian Enterprise Development

As a result of the EU membership and in order to help SMEs to improve their competitiveness in the new economic environment, in 2005, the Hungarian government started to elaborate a new SME development strategy for 2007–2013. Interventions identified under the new strategy aim at remedying market failures and will be limited in time. The main goal will be to deliver the development services to a much higher number of enterprises than before. The new strategy plans to reduce administration cost of the utilisation of development resources.

In this period resources will be channelled to the enterprises essentially by a market-conform financial intermediation system. The participants of this system are expected to become, within a few years' time, fully integrated sub-systems of the money market, capable of autonomous operation, without further donor financing. In the period of 2007–2013, the European Commission intends to allocate part of the Structural Funds to financial programmes, through a mechanism called JEREMIE. It would be useful to adjust the national financial programmes for SME development to this mechanism, as that would facilitate the drawing of the resources concerned on the one hand and help ensure efficient programme implementation on the other.

Typically, the following enterprises would be financed through financial intermediaries:

- Enterprises not financed by the commercial banks cost-effectively of scale reasons, with a good potential for growth, requiring a small initial credit amount (micro-crediting).
- The potential target companies of capital investment that would not be financed by the traditional capital market actors due to their very small size.
- Enterprises active in areas characterised by high regional risks, but showing a good potential for growth.

The main principles of the new enterprise development programmes are as follows:

Functional Approach

Policy development should start out from functions instead of organisations. This will open up much wider perspectives for potential measures. Implementation should be assigned to those organisations that will serve this aim best.

Sustainability

The current, almost 100%, donor-dependence of the programmes must be reduced. The main reason for that is not the need to save budget resources, but the recognition that self-sufficiency is the most effective primary incentive for and also the best measure of client-centred, useful services. In the absence of that, the intermediary organisation's most important client will remain the donor, instead of enterprises.

Institutional Development, Capacity Building

Instead of financing operation, the policy objective should be to develop structures capable of self-sufficient operation. It needs to establish the legal and regulatory

environment for capacity-building and operating new type of instruments (e.g. organisations capable of efficient micro-crediting).

Co-ordination Based on Market Mechanisms

The current mechanisms of implementation monitoring and control are essentially administrative in nature. The outcome of the reform would be a system governed by market co-ordination through competition, the success indicator being the increase in the generation of value added.

SME-financing in Hungary

A crucial area as regards SME development in Hungary is the availability of financing. There is a clear tendency that SMEs are not very much relying on bank credits in Hungary, 80% of enterprises operate without credits. This ratio in more developed countries is 15–20%. At the same time however there is an increasing importance of SMEs for commercial banks, due to certain factors. On the one hand, in our days there is a huge liquidity in international money markets indicating an increasing importance of acquiring new clients and investment possibilities for banks. On the other hand, the need for new investment opportunities is also strengthened by the dynamically increasing credit activity of and competition among commercial banks. However, in spite of these favourable changes for SME, start up enterprises with low capitalisation still hardly can obtain the necessary volume of credits. This continues to be an important market niche.

Table 4

Share in the total enterprise credit (December of the given year) %		
	2001	2005
Micro-enterprises	12.9	17.1
Small enterprises	9.3	17.7
Medium enterprises	17.4	18.5
SMEs total	39.6	53.3

Source: Hungarian Central Statistical Office

The other very important channel of finances for SME-financing is the System of State Aid for the sector. Important actors of state aid and financing of SMEs are development institutions. As regards the enterprise development system, in Hungary significant changes took place in recent years. In order to improve credit availability for the Hungarian SMEs, the concentration of enterprise development system is going on. At the end a one-stop shop institution is to set up ('Bank of Entrepreneurs') handling all instruments available for enterprise development. This kind of concentration has several advantages.

- Resource concentration: Connecting EU sources, domestic state support and market sources)
- Increasing competitiveness: Savings in state budget
- Concentration of functions: Increasing transparency
- Concentration of competencies: Cutting overlaps

The SME financing from state resources is made easier by the EU-regulation too. In spite of the strict regulation of competition, the conditions of state aid to SMEs are less rigorous than to big enterprises. The reasons of this special care are manifold: the important role of SMEs in employment; SMEs are generally not disturbing trade between Member States; the development policy of Member States concentrate on SMEs.

A third channel of SME-financing theoretically could be Venture Capital Investments. However, in Hungary enterprises mainly finance their activities with credits rather than corporate bonds. Issuing bonds is limited to few, basically foreign-owned enterprises. Especially start-up business face difficulties in obtaining financing. Surprisingly however, in the case of development capital, there is no lag behind the EU. According to data from 2004, such investments amounted to 0.119% of GDP in Hungary compared to 0.085% in EU15. All in all, this channel for SME financing is still not very important.

Between 2007-2013 financing prospects of SMEs may improve substantially as Hungary is expected to receive huge amount of support within the framework of the EU structural policy. The National Development Bank connects development priorities of enterprises and the EU resources. The availability of market based financial resources also improves significantly: the concentration of the state development system may play an important role in it. Certain changes in the competition policy accepted by the EU (e. g. regulation on de minimis aid) may increase the volume of state supported credits as well.

Table 5

Development resources between 2007 and 2013 (EUR billion)

EU support	22.6
Domestic financing	7.5
Other domestic resources	26.4
Total	56.6

Source: National Development agency (Hungary)

Regional imbalances in SME development

Since the 1970s, changes have taken place all over the world in the area of competitiveness conditions. The increasing importance of flexibility (the ability to adapt rapidly) and human relations took precedence over economies of scale, assembly lines and traditional comparative advantages. Therefore, the chances of small companies involved in the manufacturing of marketed commodities have improved, while the role of corporate groups (value chains) and regional relations – clusters (networks) – has grown. The spatial structure of the economy has also been modified, centres providing a wide range of services and peripheries making use of these services have been established. This is why the best-known innovation centres of our times are regions.

In the light of the above the European Union has taken wide-ranging and diverse measures to accelerate the development of networks, to decentralise innovation and technology policy, to transform universities into enterprising institutions and to establish a network of industrial parks. Since 1994 about one hundred European

regions have made attempts to implement the Regional Innovation Strategy recommended by the EU.

A fundamental problem of regional development in Hungary is that the regions do not (yet) have centres except for the capital. The regional institutional system is still weak, in spite of all the recent development efforts. Regions do not have any institutional system or financing resources, etc., suitable for promoting (local) development. In Hungary these assets are primarily owned by companies, municipalities and counties (if at all).

In the rapid development of centres further difficulties are posed by the small size of Hungary's regions and their centres by international comparison and the low level of transport infrastructure development between the centres and between the centres and their peripheries. An additional problem is the lack of regional specialisation, which is indispensable in the context of successful competition, and the fact that national development concepts do not treat specialisation as a priority. Therefore, when implementing development decisions we frequently encounter the lack of skilled labour and the lack of vocational qualifications among the increasing number of those unemployed. In potential regional centres the structure of research, consultancy and education should be aligned with the knowledge demands of productive sectors. But the establishment of centres is made difficult by the fact that they only have occasional relations with businesses, although it has to be noted that internationally competitive universities and research institutes, which accumulate innovative knowledge, are not only to be found in the capital cities but also in several other provincial cities, both in Central Europe and in Hungary. No networks of knowledge users have been established around universities, while regional development concepts do not contain any tasks that could co-ordinate or harmonise available 'knowledge' and practical demands.

The weakness of incubators for start-up enterprises also frequently prevents micro- and small-sized enterprises from fully utilising regional development opportunities.

According to the GEM report, Hungarian companies are generally dissatisfied with services meant to promote their activities, which inevitably are local. Though they acknowledge that a significant improvement has taken place in the areas of banking, accountancy and legal services, further development is necessary in terms of their quality, price and availability. The poor information-communication infrastructure is also a major obstacle to the development of networks.

Table 6
GDP per capita in the regions of the EU (at 2002 PPP, EU25= 100)

Rank	Region	GDP/capita	Rank	Region	GDP/capita
1	Inner London (UK)	315	246	Vychodne Slovensko (SK)	39
2	Brussels (BE)	234	247	Northern Great Plain (HU)	38
3	Luxembourg	213	248	Opolskie (PL)	37
4	Hamburg (DE)	188	249	Northern Hungary (HU)	37
5	Ile de France	176	250	Swietokrzyskie (PL)	36
6	Vienna	174	2251	Podlaskie (PL)	35
7	Berkshire et al. (UK)	162	252	Warminsko-Mazurskie	34
8	Provincia Bolzano (IT)	160	253	Podkarpackie (PL)	33
9	Stockholm	158	254	Lubelskie (PL)	32

Source: Eurostat

Due to the listed factors, it is not at all surprising that the performance of the majority of Hungarian regions is rather low. In the 254 NUTS 2 (Nomenclature of Territorial Units for Statistics) EU regions there are two Hungarian regions among the ten lowest performers on the eastern border of the EU.

The outlined difficulties are further aggravated by the fact that the Hungarian documents on regional development barely reflect or contribute to the implementation of local development ideas and efforts due to the weak interest representation capacity of regional institutions, and definitely far less than is common in international practice. In spite of the EU methodological guidelines emphasising the 'bottom-up' approach (subsidiarity), neither regional development concepts nor the National Development Plan take important opportunities for local businesses into account, including small- and medium-sized enterprises. They do not identify in concrete terms the most promising, competitive or potentially competitive sectors, companies, products and production cross sections in the concerned regions. They do not tackle the profiles which still exist but need to be eliminated. They do not contain precise recommendations on priorities (the users of potential development aid from the government, EU, etc.). Consequently, local organisations and small- and medium-sized enterprises who never play insignificant roles as regards implementation are not interested in achieving the set objectives and the financial resources available for the developments become fragmented during use. Accordingly regional strategies must be revised and the priorities contained therein be specified.

Conclusion

Two-thirds of the active labour force work at SMEs and they create fifty percent of the GDP in the EU and in Hungary alike. However, the other half of the GDP and the majority of exports are produced by large companies, which in Hungary are mostly multinationals. The chances of the SME sector in the next year will improve, in spite of the temporarily unfavourable macroeconomic conditions that result in worsening business climate. The competition between banks for new clients, the drastically increasing EU funds for enterprise development and the transformation of the Hungarian SME development institutional system together can effectively contribute to evolve a much stronger and competitive SME sector.

References

- Action Plan: The European Agenda for Entrepreneurship. EC, Brussels, 2004.
- A kis- és középvállalkozások helyzete 2003-2004-2005. Éves jelentés. Gazdasági és Közlekedési Minisztérium, (The situation of SMEs 2003-2004-2005. Annual Report. Ministry of Economy and Transport.) 2005.
- A Lisszaboni folyamat és Magyarország. (The Lisbon Process and Hungary.) Társadalom és Gazdaság. 27/1-2., 2005.
- Cohesion Policy in Support of Growth and Jobs: Community Strategic Guidelines, 2007-2013. EC. Brussels, 2005.
- Community actions for Growth and Employment: The Community Lisbon Programme. COM(2005) 330 final.
- Doing Business in 2006: Creating Jobs. World Bank, 2005.
- European Innovation Scoreboard 2005. EC, Brussels, 2005.
- Flash Eurobarometer 160 Entrepreneurship 2004. EC, Brussels, 2005.

Fostering Entrepreneurship and Firm Creation as a Driver of Growth in a Global Economy. OECD, Paris, 2004.

Global Entrepreneurship Monitor. Executive Summary 2005.

Green Paper Entrepreneurship in Europe. EC, Brussels, 2003.

Presidency Conclusions – 23/24 March 2006. EC, Brussels, 2006.

Presidency Conclusions – 15/16 June 2006. EC, Brussels, 2006.

Román, Zoltán (2006): The Small and Medium-sized Enterprises and the Lisbon Objectives in Hungary, Development and Finance 2006/3, Budapest

The Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs. OECD, 2004.

Time to move up a gear. Annex to the Communication from the Commission to the Spring European Council. EC, Brussels, 2006.

Vállalkozások demográfiája, 1999-2003. (Demography of Enterprises.) Central Statistical Office, 2006.