Chapter 7

SME Promotion: Increasing Competitiveness and Fostering Successful Entrepreneurship

Small and medium-sized enterprises (SMEs) in Hungary have great potential that still needs to be realised. Their weight in the economy (nearly 69% of employment and over half of sales and value added), their job creation and their capacity for innovation make their improved performance essential for reaching the government's growth objectives. Their average size is unusually small and their productivity is weak. Few Hungarian SMEs are innovative or internationally competitive. Indeed, human resources in Hungarian SMEs are often under-qualified, have weak training and technical education, and inadequate R&D skills. Structural differences among SMEs across regions in Hungary are significant. This chapter analyses how effectively the government's Strategy for the Development of Small and Medium-sized Enterprises (2007-13) can contribute to increasing SME competitiveness in Hungary. The specific issues discussed are: (i) *Why and in which sense is the situation and performance of Hungarian SMEs unsatisfactory, in particular with regard to their competitiveness?* (ii) *What can be done to stimulate the contribution of SMEs to sustainable growth, given the constraints imposed by fiscal consolidation?* (iii) *Is the Strategy appropriate to address the current situation? Are the targets pursued realistic and relevant?*

Background and key policy recommendations

As in most economies, small and medium-sized enterprises (SMEs)[1] constitute a major part of the business sector in Hungary. They account for the overwhelming majority (99.9%) of enterprises, nearly 69% of employment and over half of sales and value added. Strengthening their performance is therefore crucial to achieving the goals of the national strategic reference framework of Hungary for the period 2007-13. Against this background, this chapter reviews the Strategy for the Development of Small and Medium-sized Enterprises (2007-13) (the "Strategy") (Government of the Republic of Hungary, 2007), which was approved on 10 October 2007 to improve SME development over the period 2007-13. The assessment suggests that policy action to improve SME performance should give priority to:

- **promotion of a business environment that encourages entrepreneurship and SME development**.
- **mobilisation of human resources for entrepreneurship and innovation**, especially through programmes for entrepreneurship education.
- **broadening SME access to finance and improving financing for entrepreneurship and SME growth**.
- **reducing barriers to access to international markets and encouraging international co-operative agreements**, especially in the area of innovation.
- **development of an "evaluation culture"** (involving all the necessary resources and tools) concerning entrepreneurship and SME policies and programmes.

Detailed components of these recommendations and their underlying rationale are developed below.

Overview of the SME sector in Hungary

As is evident from Table 7.1 most operating SMEs (96%) in Hungary are micro firms with less than 10 employees, a higher proportion than in most OECD countries. This high proportion primarily reflects the 0-1 size class (75.6%) and more than one-fourth of registered enterprises (depending on the methodology used) are not even operating.[2] SMEs are concentrated in low productivity industries such as the craft and retail sectors, with limited presence in manufacturing, especially in more advanced industries. Entrepreneurial capacity is limited, human resources are often unskilled, and the level of innovation is low. Furthermore, most performance indicators are low for Hungarian SMEs compared to EU19[3] averages, regardless of the size class (Table 7.2).

Table 7.1. **Main characteristics of the SME sector by size class**, **2005**

% of all enterprises

Size of enterprise workforce		0-1	2-9	10-49	50-249	SME total
Number of enterprises	1	75.6	20.2	3.6	0.6	99.9
Employees	1	6	21.9	21.6	19.5	68.9
Sales revenues		7.4	14.4	19.7	18.1	59.6
Export		5.9	5.5	10.3	13.5	35.3
Value added		6	10.9	16.4	18.7	52
Equity		8.9	11.9	14.6	15.8	51.2

1. Including the financial sector.

Source: Hungarian Central Statistical Office in the case of sales revenues and added value figures, Hungarian Ministry of Economy and Transport calculations for the rest.

Table 7.2. **Comparison of enterprises in the European Union (EU19[1]) (2003) and Hungary (2005)**

Averages

		Micro	Small	Medium	SMEs	Large	Total
Average size (persons)	EU-19	3	19	98	5	1 052	7
	HU	2	20	100	3	874	4
Sales revenues per enterprise (EUR thousands)	EU-19	440	3 610	25 680	890	319 020	1 550
	HU	73	1 689	8 083	183	95 952	293
Value added/enterprise (EUR thousands)	EU-19	120	1 180	8 860	280	126 030	540
	HU	12	226	1 359	28	21 244	52
Proportion of export in sales revenues (%)	EU-19	9	13	17	12	23	17
	HU	11	12	18	13	41	23
Value added per employee (EUR 1 000/person)	EU-19	40	60	90	55	120	75
	HU	7	11	14	9	24	13
Labour cost per value added (%)	EU-19	57	57	55	56	47	52
	HU	41	63	74	58	56	57

Note: EU19: 15 member states + Iceland, Liechtenstein, Norway and Switzerland.

Source: Observatory of European SMEs (2003), *SMEs in Europe 2003*, No. 7; calculations based on data provided by APEH; Hungarian Tax and Finance Control Administration, see MoET (2007a), "State of Small and Medium sized Business in Hungary 2005–06", Budapest.

On the basis of analyses and surveys, the Ministry of Economy and Transport (MoET) distinguishes three different groups of small enterprises in terms of performance, a pattern that has been stable since the late 1990s: *(i)* **fast-growing enterprises** (yearly growth exceeding 20%), which includes some 15% of SMEs, innovative, active on external markets, part of value chains and networks, which make extensive use of bank credit for their investments; *(ii)* **average situation enterprises**: they represent 65-70% of the SME population, do not expect improvements nor decline, have low performance and low qualification of their entrepreneurs/managers and employees, and produce mainly for the retail market, rarely using bank credit, but rather relying on support from family or friends;

(iii) **laggard enterprises** include the isolated 15-20% of small enterprises which are in the start-up or in the declining phase of their life cycles (declining sales revenues and working capacities), sell their products and services to the final consumers and make no use of external finance and services.

Differences across regions are also significant. In central Hungary, where Budapest is located, average productivity of SMEs is higher than that of large companies. In contrast, in Central Transdanubia and Western Transdanubia, where much foreign investment is located, large companies' productivity is, respectively, 2.7 and 2 times higher than that of SMEs . Furthermore, outside central Hungary, value added per capita is nearly 4 times higher for large firms in the most developed regions than in the least developed regions, while the difference is of 1.5 times in the case of medium-sized enterprises (MoET, 2007a). There is a direct relation between enterprise density and economic development and greater propensity to export in the Central Transdanubia and Western Transdanubia regions (Government of the Republic of Hungary, 2007).

There is an increasing trend towards networking that by now involves more than half of SMEs, (MoET, 2007a). About 54% of all enterprises participated in 2005 in some form of informal co-operation (counselling, borrowing tools, machines or money, acquiring business, etc.) and 17% in more formal co-operation (joint purchase, sales, production) with a total of 57% of enterprises that participate in either informal or formal co-operation. However, most of these are soft forms of networking since production (or "hard") networking is rather scarce. A promising development is the increase of ownership cross-holding, which is associated with cross-investment. This is leading to greater corporate concentration and may strengthen the enterprises resource base and performance. However, these developments remain rather limited.

Many factors have been cited by entrepreneurs as causes of the slow growth and poor performance of Hungarian SMEs (Table 7.3). Some of these causes are little more than reflections of poor performance, *e.g.* "Not enough orders received**"** and "Strong competition", and do not warrant a policy response. But others refer to problems that are generally beyond the control of most SMEs, and many appear to represent real problems that may have to be addressed by the government. The Strategy devotes considerable analysis to the problems of the sector and arrives at a "Summary of Problems" which highlights: *(i)* regulatory problems; *(ii)* difficulties in access to finance; *(iii)* knowledge-related problems; and *(iv)* infrastructural deficiencies.[4] While these priorities overlap with the impediments cited in Table 7.3, they do not fully align with them. In particular, high tax and social security burdens are ranked as the most important impediment by survey respondents but receive no mention in the Strategy Summary of Problems, even among the lower tier issues, while survey respondents rank "other financial needs", which is given great prominence in the Strategy, fairly low among the obstacles they face.

Table 7.3. **Perceived relevance of factors impeding enterprise growth in Hungary[1]**

From least (0) to most (100) important

Factors impeding growth	1997	1998	1999	2003	2005	2007
High tax and social security burdens	84	78	73	74	72	77
Unpredictability of economic regulation	62	58	53	58	55	63
Strong competition	53	57	61	61	61	56
Not enough orders received	48	45	52	45	48	45
Unfair competition	46	44	44	47	48	45
Clients defaulting on payments	30	31	30	32	34	35
Shortage of capital	40	37	37	34	32	31
Difficulties in purchasing	14	16	16	17	16	13
Outdated, not modern existing capacities	17	19	17	17	13	12
Lack of credit	27	26	26	20	15	12
Shortage of labour	9	9	9	12	8	9
Other impeding factors	19	20	17	16	13	19

1. Methodology: In a questionnaire-based survey of the Ministry of Economy and Transport, Hungarian small and medium-sized enterprises gave grades on a scale of 1 to 5 to factors having an impact on their growth. Factors "not impeding growth of the enterprises in any way" received a 1, while "significantly" impeding factors were given a 5. A figure of importance was calculated in a way that answers were transformed to a scale ranging from 0 to 4, having 5 grades. Each figure was multiplied by the number of respondents and divided by the maximum possible value of the figure. This way a percentage value was received the maximum of which is 100 if everybody gives the highest importance to a given factor, and the minimum of which is 0 if everybody gives the lowest importance to it (Government of the Republic of Hungary, 2007, p. 21).

Source: MoET (2007), "Representative MoET Entrepreneurial Survey".

Overall the Strategy focuses on support and services provided to SMEs, but it devotes less attention to fostering entrepreneurship, although it stresses "knowledge-related problems", which are at the core of many SME problems. For instance, as regards difficulties in access to finance, emphasis is put on the various instruments that might ease constraints, but much less on the critical issue of how to increase the willingness and opportunities of entrepreneurs to ask for and use efficiently financial resources. It would be important to assess whether this behaviour can be ascribed to entrepreneurs' ignorance, lack of information, lack of business opportunities, or fear of losing control of their enterprises. Another reason could be related to banks targeting more developed clients and the absence of significant programmes for potential entrepreneurs.[5] Yet, the relatively low number of "would-be" or potential entrepreneurs and the unwillingness or inability of entrepreneurs to invest to expand and innovate is one of the critical issues in Hungary.

Fostering SME competitiveness and entrepreneurship

The 2004 OECD Istanbul SME Ministerial Declaration[6] reaffirmed the need for the best set of public policies that will foster the creation and growth of innovative SMEs. In particular, it noted that this requires "policies and an institutional framework that contribute to a business environment conducive to entrepreneurship"; and "policies that contribute to mobilising human resources for entrepreneurship". Such policies should not be designed to favour enterprises of any particular size, but careful attention should be paid to "areas that impinge strongly on SMEs, such as competition, international trade and investment, financial markets, labour markets and education" (OECD, 2004, p. 3). The Istanbul Declaration also recognised a role for cost-effective SME assistance and development programmes "which are clear in terms of their rationale, objectives, and beneficiaries". In this regard, it attached priority to:

- "the need to reduce barriers to SME access to global markets";
- "the need to improve access to financing for SMEs on reasonable terms"; and
- "the need to develop a strong evaluation culture in ministries and agencies responsible for SME policies and programmes in order to ensure that they remain cost-effective and adapt to changing conditions in a dynamic world" (OECD, 2004 p. 4).[7]

This section analyses the Istanbul Declaration priority areas: *(i)* the business environment; *(ii)* human resources; *(iii)* SME assistance and development priorities: *(a)* access to financing; *(b)* access to international markets; and *(iv)* evaluation of SME programmes.

Promoting a business environment encouraging entrepreneurship and SME development

The single most important factor impeding firms' operations identified by entrepreneurs in Hungary is **high tax and social security burdens** (Table 7.3). The negative rating has improved somewhat since 1997 as the tax system has been reformed on several occasions. Improvements include lowering corporate tax (presently at 16% with additional easing for smaller tax bases) and the introduction of the simplified entrepreneurial tax. Fiscal pressure related to social security payments remains particularly high for labour-intensive SMEs, which find it more difficult to make use of tax allowances than large firms, in particular multi-national enterprises (MNEs), which can benefit from a favourable tax regime. The overall fiscal burden (expected in 2007) is lower than the EU25 average, but significantly higher than in "Visegrád" countries (Eurostat, 2007). Fiscal pressure places Hungary at a low 127th place in the overall ranking of the World Bank's study, *Doing Business 2008*, (World Bank, 2007) and in 17th place in the Eastern Europe & Central Asia (EECA) region (Table 7.4). The Strategy recognises this problem and calls for reducing the burden by an ambitious 1.5% of GDP by 2013. Also, according to the 2005 Act CXIX on Social Security, the overall rate of fiscal levies on wages (including social security, vocational training and employer's contributions) was scheduled to decrease from 33.5% in 2006 to 28.5% in 2009 (MoET, 2007a, p. 83).

Table 7.4. **Hungarian rankings in the "Ease of Doing Business" survey**, **2008**

	All countries (178)	Eastern Europe and Central Asia (28)
Ease of doing business	45	7
Starting a business	67	14
Dealing with licences	87	10
Employing workers	81	12
Registering property	96	20
Getting credit	26	7
Protecting investors	107	22
Paying taxes	127	17
Trading across borders	45	7
Enforcing contracts	12	2

Source: World Bank (2007), *Doing Business 2008*, World Bank, Washington, DC.

The second main obstacle to the operation of SMEs in the perception of the business community is the variability and unpredictability of economic regulation. While some of the need for change has resulted from EU membership and the need to respect the "*acquis communautaire*", most volatility has domestic origins. More generally, compliance costs and other regulatory problems are often particularly onerous for small enterprises, which lack internal capacities to deal with them and may have to use costly external support services. Some of these costs,[8] which the MoET estimates on the basis of the World Bank 2006 edition of *Doing Business* (WB-DB) to amount to 4.5-6.7% of gross domestic product (GDP) (well above the EU25 average of 3.5% of GDP), stem from EU obligations (about 1.5% of GDP). But the larger part is generated by the Hungarian regulatory and public administration environment. Internationally, WB-DB ranks Hungary 45th out of 178 countries as concerns "ease of doing business", and 7th in EECA.

Doing Business also identifies **starting a business** and **dealing with licences** as a serious obstacle to SME formation: Hungary's ranks are 67th and 87th respectively in the global comparison and 14th and 10th for the EECA region. Reforms have been initiated to improve this situation: the number of days required to start a business is targeted to decrease from 38 in 2007 to 16 in 2008. Closing a business is somewhat less problematic although not satisfactory (Hungary's respective global rankings are 53 and 7). Only if the pertinent reforms presented in the Strategy are effectively implemented and pursued consistently can Hungary reach the strategic target of having a supportive regulatory environment.

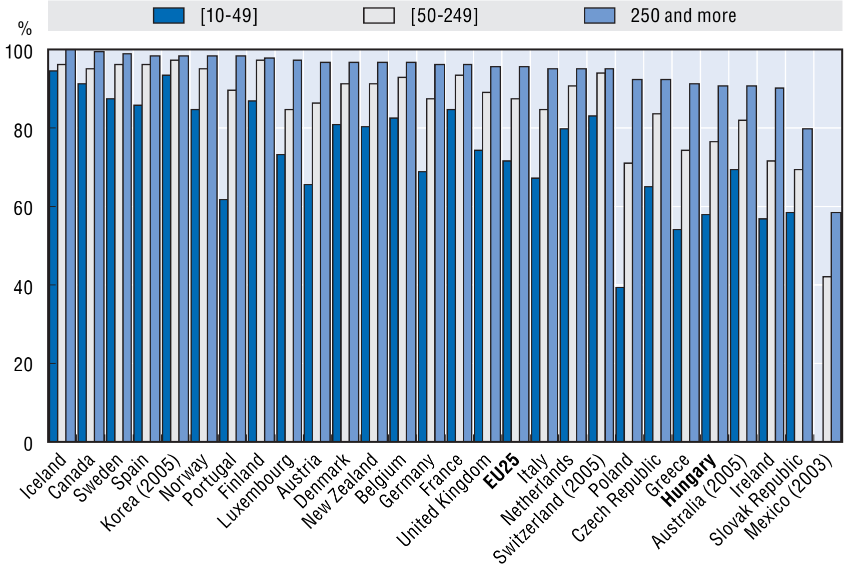
Efficient bankruptcy laws and procedures are important elements of a healthy business environment. Current bankruptcy procedures have several drawbacks: they do not facilitate business rehabilitation, particularly for small enterprises. Companies in trouble have maximum 150 days to negotiate with their creditors and recover. As a consequence, only 8 enterprises restructured in 2006 out of 14 933 enterprises which went through bankruptcy procedures, and 9 439 went into liquidation. This outcome can be ascribed to various factors including: increasing defaults on payments from clients and contractors; limited use of credit insurance; lack of professional management and evaluation culture in domestic SMEs. The new Bankruptcy Act should combine the presently separate bankruptcy and liquidation procedures and shorten the time needed for liquidation (Government of the Republic of Hungary, 2007). But further action is needed, *i.e.* a well-defined set of measures necessary to reduce the number of enterprises that have to go through bankruptcy procedures for reasons other than their own failures (*e.g.* strengthening a culture of *ex ante* evaluation and supporting the spread of credit insurance against payment shirking).

Property rights are in general well-defined and protected, but Hungary compares poorly internationally in areas such as registering property and investor protection. Of particular importance for SMEs if they are to compete successfully in the knowledge-based economy is ensuring that **intellectual property rights** legislation is coherent and easy to understand so that they can be used effectively. Only 65% of Hungarian enterprises are aware of industrial property rights protection issues even though 40% are directly concerned through means such as trademarks, patents, and licences. Promoting intellectual asset management by SMEs and developing systems to value intellectual assets adequately, creating and promoting online marketplaces for intellectual assets where SMEs can showcase their offerings easily and inexpensively, are examples of actions that could contribute to the improvement of this situation.[9] Overall, these are areas to which the Strategy should attach higher priority.

An important area where Hungary's SMEs would benefit from a strengthening of infrastructure is **information and communication technologies** (ICTs). These potentially offer SMEs the possibility of combining the advantages of their own small scale with economies of scale and scope through networking among firms, both in Hungary and internationally, and with other actors such as universities and research institutions. In recent years, the use of ICTs has increased considerably among Hungarian SMEs, but remains at relatively low levels of technical sophistication (*i.e.* using a computer and having an Internet connection) (Figure 7.1). Hungary falls behind the European average with respect to: *(i)* the use of more sophisticated technologies (broadband access), although not behind most new EU member countries; *(ii)* the rate of enterprises using secured transaction systems; *(iii)* the share of companies using digital signatures; and *(iv)* the use of electronic commerce by Hungarian enterprises (less than half the EU average, the last position in the EU).

Figure 7.1. **Broadband penetration by size class, 2006**[1]

As a percentage of businesses with 10 or more employees[2]



1. Most countries define broadband in terms of technology (*e.g.* ADSL, cable, etc.) rather than speed; industry coverage varies between countries.

2. For Canada, 50-299 employees instead of 50-249 and 300 and more instead of 250 and more. For Switzerland, 5-49 instead of 10-49 employees.

Source: OECD (2007), *Science, Technology and Industry Scoreboard 2007*, OECD, Paris.

A particular area where further development would benefit SMEs is **e-government** (see Chapter 11) since it has the potential to facilitate compliance with rules and decrease related transaction costs of enterprises significantly. The share of basic public services in Hungary accessible electronically for the general public (50%) is higher than the EU average (36%). However, for enterprises, Hungary ranks only 21st in the 25 EU member states, significantly behind the European average (MoET, 2007a; UN, 2005). The Strategy gives high priority to fostering access to and use of quality ICTs throughout the economy, in particular to SMEs which are likely to benefit disproportionately from advances in this area, (*e.g.* through ICT development schemes co-financed by the EU and measures for developing the broadband network infrastructure and logistic services).

Overall, simplifying the **tax system**, particularly easing the burden of social security contributions should be a policy priority to foster SME competitiveness and to facilitate moving the shadow economy into the formal sector. The Strategy objective concerning a simplified regulatory framework should be implemented consistently in order not to increase further the instability of regulation. The Strategy goes in the right direction, but the institutional co-ordination that it establishes (project director, sponsor board, etc.) could be complex to manage.

Mobilising human resources for entrepreneurship and innovation

Successful entrepreneurial and innovative behaviour requires dynamic and motivated people willing to take risks. In practice, much of such behaviour occurs in small firms able to move more quickly than large ones, and which can maintain rapid growth rates for a certain period. In recognition of this, the Hungarian government has tried repeatedly to foster and support entrepreneurship in various ways and with various means. But the outcome has been rather modest, as the willingness to start up companies has significantly deteriorated over time (CSO, 2006). Furthermore, Hungarian entrepreneurs appear to avoid high-risk, knowledge- and technology-based industries and to prefer those that require lower capital intensity, guarantee rapid returns and do not require particular skills.

Past failure of government programmes to foster entrepreneurship may be due to a number of reasons. First, programmes have usually been episodic and uncoordinated. Second, they have not fostered the entrepreneurs' interest (particularly that of young and educated persons) to specialise, modernise and promote the growth of their enterprise, in place of seeking employment with multinational subsidiaries. Third, nearly all programmes show time inconsistency and are discontinued after a relatively short time. Fourth, policy makers implementing the programmes have tended to be more interested in the implementation of their expenditure plan and other formal components, such as the number of applicants, and not in the outcome. Fifth, many programmes depend entirely on donors and do not involve the beneficiaries' responsibility, *e.g.* by means of co-financing. Sixth, the donor typically is not involved in following the outcome of the project after the support is terminated: the relation between the donor and the beneficiary is usually formal and short-lived.

The Istanbul Ministerial Declaration calls attention to the desirability of "the integration of entrepreneurship at all levels of the formal education system" as a means of mobilising human resources for entrepreneurship and complementing this by "learning-by-doing and other practical workshops" (OECD, 2004). This should be supplemented by the diffusion of training programmes, notably to address management weakness, which is a key cause of (small) business failure (OECD, 2002a), and life-long learning opportunities. These are best provided on a market basis where possible, but publicly funded where justified on the basis of identified market failures. Hungary needs to do more in these areas, particularly if it is to do well in high value-added, knowledge-based activities.

Hungary ranks below the European average regarding both life-long learning and the share of students in the technical and natural sciences (see Chapter 6). Furthermore, most research and development (R&D) personnel are employed in higher education institutions (CSO, 2006) or in large enterprises under foreign ownership, which carry out nearly 80% of total corporate research. Training, entrepreneurship education, e-learning, distance learning and R&D human resources are all scarce in SMEs.

The Strategy estimates that not more than 2-3% of SMEs are innovative pioneers and only another 20-22% are imitators; a Eurostat Survey presents similar findings. It puts the number of Hungarian enterprises with more than ten employees and pursuing any innovation-related activity at half the EU average. OECD data show also that SMEs in Hungary rank among the lowest in OECD countries in terms of in-house products and process innovations (Table 7.5; see also Chapter 8).

Overall, entrepreneurship policy has been rather neglected so far and should be given high priority in order to counteract the deterioration of entrepreneurial willingness and the risk and modernisation aversion of many entrepreneurs.

SME assistance and development programmes

Better financing for entrepreneurship and SME growth

The Hungarian experience – and that of other former transition countries – is that in the opinion of their owners, lack of financing is not an important obstacle to the creation of small firms, which rely on the resources of the founders, their families and friends or, for some firms, foreign capital. This is reflected in its comparatively low ranking of problems cited by survey respondents reported in Table 7.3. Indeed, since late 1999, when commercial banks and savings cooperatives started serving SMEs with new loan products and services at an increasing pace, financing for the enterprise sector as a whole has been reasonably easy. Over this period, domestic credit to the private sector compared to GDP improved from 30.9% to 54.6% leaving the other central European countries at a distance. In World Bank (2007), Hungary ranks 26th in the overall ranking and 7th in that referring to EECA for access to credit.

Although access to credit is not considered a major impediment to development Hungary still falls short of the ideal that the OECD Brasilia Action Statement proposed for SME financing: “access to appropriate types of financing structures and facilities that are especially required to allow SMEs and entrepreneurs to take advantage of the opportunities provided by innovation, notably through the diffusion of information and communications technology” (OECD, 2006a, 2006b). Indeed, the great improvement of the role of banks has solved the financing problems of only a subset of SMEs. Failure to access external finance can be a critical impediment to entrepreneurship and the further development of SMEs which otherwise have the potential to expand rapidly.

Table 7.5. **In-house product and process innovators by firm size in OECD countries, 2002-04**[1]

As percentage of all firms[2]

		Product innovators		Process innovators	
		SMEs	Large firms	SMEs	Large firms
Hungary		8.0	27.4	5.3	15.8
Slovak Republic		8.4	28.4	6.7	20.4
Norway		17.7	31.9	10.0	21.2
Australia		24.0	32.0	28.0	46.0
Poland		10.2	32.1	10.9	30.6
Netherlands		14.9	33.4	8.2	22.7
Italy		11.7	35.7	14.0	26.6
Spain		14.5	35.9	18.5	34.7
Portugal		14.9	36.0	17.6	28.9
Japan		14.0	37.0	8.0	25.0
Czech Republic		17.6	37.5	13.4	26.8
New Zealand		25.0	39.0	22.0	33.0
Finland		18.5	42.7	13.2	27.8
Sweden		25.2	44.1	16.3	32.0
Denmark		22.5	46.5	17.5	40.8
Ireland		32.1	47.5	32.4	54.8
France		14.8	50.1	17.8	44.5
Austria		24.8	51.2	19.1	34.4
Greece		20.2	51.4	25.5	51.4
Canada	3	44.4	52.4	46.3	60.2
Korea		21.9	52.6	6.5	12.2
Germany		27.3	53.7	15.4	32.4
Luxembourg		27.3	53.7	21.5	46.3
Belgium		25.7	54.0	22.8	46.4

1. Or nearest available years.

2. SMEs: 10-249 employees for European countries, Australia and Japan (persons employed); 10-99 for New Zealand, 10-299 for Korea, 20-249 for Canada.

3. Manufacturing only.

Source: OECD (2007), *Science, Technology and Industry Scoreboard 2007*, OECD, Paris.

There are various reasons for SMEs' limited participation in credit markets. First, there is an issue of ignorance or worry of many entrepreneurs concerning the existing credit possibilities and their features. Second, the credit guarantee and insurance system is insufficiently developed. Third, there still is a reputation and trust problem that prevents the matching of demand and supply and that can only be solved, for most small entrepreneurs, by financial institutions rooted locally. Fourth, as in other OECD countries, many small entrepreneurs avoid credit financing to avoid weakening or jeopardising their control over the enterprise. Fifth, there is also pure conservatism and fear or inability of growing. While some of these problems might be amenable to capacity building in the financial sector, others relate to attitudes and capacities of the entrepreneurs themselves.

The government took positive steps to ease the traditional aversion of large banks to SME credit, particularly with the multi-pillar special credit system set up in 2003 and jointly operated by various credit institutions and organisations.[10] However, small locally-based banks continue to play a very modest role in extending credit to enterprises, which can explain why smaller firms, as in many countries, avoid using bank credit and rely on their own and family resources.

Other financing instruments show a pattern similar to that of bank credit: rapid development, but inability to attract the large majority of enterprises and overall modest impact (JEREMIE, 2007; MoET, 2007b). The importance of microfinance has been rapidly decreasing in recent years, while banks have preferred to target more developed clients. In Hungary there is currently no significant finance programme targeting potential entrepreneurs. Perhaps the most successful innovation has been leasing, whose amount has increased threefold between 2000 and 2005, reaching 5.4% of GDP. However, 80% of transactions are related to vehicles. Factoring is still highly underdeveloped, similarly to business angels and venture capital (Figure 7.2). Where these instruments exist, they concentrate on expanding businesses and are nearly absent in the seed stage and weak in the start-up stage. The majority of government guarantee operations relate to loans extended to micro-enterprises. Credit guarantees for SMEs are administered by two major funds created by the state and the large public and private banks, savings cooperatives and associations of entrepreneurial interest representation.

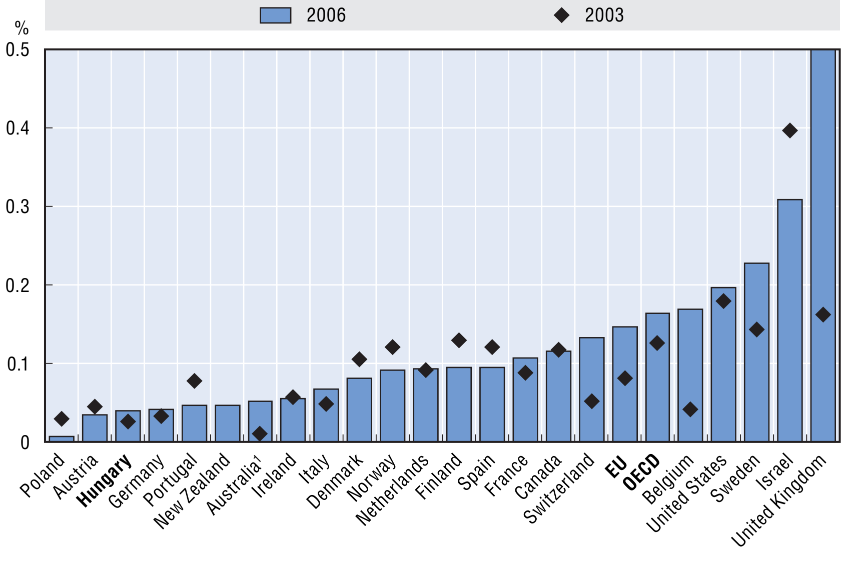
The Strategy pursues the important objective of increasing the share of SMEs making use of credit. However, the role of a wider range of financial actors and instruments (*e.g.* small locally-based banks, business angels; guarantees) could usefully receive more emphasis, as suggested by good practices in other OECD countries (OECD, 2006b, 2007b).

Reducing barriers to Hungarian SME access to international markets

Access to international markets can offer important opportunities to SMEs which, if exploited, can have positive overall effects for economic growth (OECD, 2006c). However, various real or perceived barriers exist that diminish the potential internationalisation of SMEs. In Hungary, as in most other OECD countries, a disproportionate share (nearly two-thirds) of exports come from large enterprises (Table 7.1), in particular from the subsidiaries of multinational companies, and large firms also have a much higher proportion of exports to employment than do SMEs. OECD and the Asia-Pacific Economic Cooperation (APEC) SME policy makers[11] considered the issue of barriers to SME access to international markets and commissioned a survey which identified the ten most important obstacles (OECD, forthcoming). Results are reported in Table 7.6.

Figure 7.2. **Venture capital investments, 2003 and 2006**

Percentage of GDP



1. Australia data corresponds to 2003-05 period.

Source: Thomson Financial, PwC, EVCA, NVCA, AVCAL, NZVCA and OECD calculation.

Of the top ten barriers to SME access to international markets, some are probably also prominent in Hungary. These include inadequate quantity of and/or untrained personnel for internationalisation, which is probably due also to the superior pay and work conditions that foreign subsidiaries offer to the most skilled people. Shortage of working capital to finance exports should not be particularly important for high-growth and open SMEs, while for more traditional enterprises this potential barrier is second to the lack or insufficient development of relevant capabilities.[12]

Barriers to foreign market access, including limited information to locate/analyse markets, identifying foreign business opportunities, and unfamiliar exporting procedures/paperwork, may be important since the services necessary for SMEs to overcome them are not particularly developed in Hungary. There is a rationale for policies overcoming this gap also by means of public supply of information on foreign markets and education and technical support regarding internationalisation procedures, particularly for SMEs.

Table 7.6. **The top ten barriers to SME access to international markets**

Rank-weighted factor	OECD 1995 classification	Description of barrier
1	Capabilities	Inadequate quantity of and/or untrained personnel for internationalisation
2	Finance	Shortage of working capital to finance exports
3	Access	Limited information to locate/analyse markets
4	Access	Identifying foreign business opportunities
5	Capabilities	Lack of managerial time to deal with internationalisation
6	Capabilities	Inability to contact potential overseas costumers
7	Capabilities	Developing new products for foreign markets
8	Business environment	Unfamiliar foreign business practices
9	Capabilities	Meeting export product quality/standards/specifications
10	Access	Unfamiliar exporting procedures/paperwork

Source: OECD (forthcoming), *Removing Barriers to SME Access to International Markets*, OECD, Paris.

The participation in international activities provides important growth and learning opportunities to SMEs (OECD, 2000, 2004, 2006c, forthcoming). Increasing exports is prominent among the Strategy objectives. However, other forms of internationalisation do not receive attention in the Strategy. Increasing SMEs international activity will be possible only if Hungary is able to remove part of the barriers to foreign trade that for the time being ranks the country only 45th in the World Bank (2007) index of trading across borders and 7th in the EECA index.[13]

Evaluating SME policies and programmes

The OECD Istanbul Ministerial Declaration underlines the need to strengthen the "culture of evaluation" of SME and entrepreneurship policies (see the section above on *Fostering SME competitiveness and entrepreneurship*). This is necessary in order to: establish the impact of policies and programmes; make informed decisions about the allocation of funds; show the taxpayer and business community whether the programme is a cost-effective use of public funds; stimulate informed debate; and achieve continued improvements in the design and administration of programmes (OECD, 2008).

Evaluation should follow a standardised approach in order to provide policy makers, experts and the public with technically grounded and comparable data. The "Six Steps to

Heaven" provide a method for assessing the impact of SME policy (OECD, 2008). The Six Steps procedure recognises that there are different levels of sophistication regarding the evaluation process, ranging from the initial taking up of evaluation schemes to the more demanding taking account of selection bias. The first three steps are monitoring activities relying exclusively upon the views of the recipients of the policy support and only the three last steps are proper evaluation activities, seeking to contrast the recipients' views with those of a control group of non-recipients in order to present the "counter factual". The difference between recipients' results and the "counter-factual" is an estimate of the impact of the policy – or its "additionality". The degree of increasing sophistication from Step 1 to Step 6 corresponds to the increasing confidence the policy maker can have in attributing changes in outcomes observed in businesses supported under the programme.

Evaluation in Hungary now is only moving through the first steps and an evaluation culture is still lacking. Evaluation at the level of policy makers is still more formal than substantial: only few programmes have been evaluated and this process has remained so far rather unsophisticated. In fact, existing evaluation is more an assessment done in terms of number of interventions (typically: how many enterprises – possibly distinguished into micro, small, and medium-sized enterprises – applied to and received funds from individual programmes), jobs created and funds spent (possibly broken down by size class of enterprises and aim of the application). Typically the results of the programmes are not analysed against what would have happened without the programme.

The lack of an "evaluation culture" is not the only reason for the absence of SME and entrepreneurship programme evaluation. Another cause is the lack of continuity in programme application: too little time is allowed to pass to identify the impact of the programmes on targets. Programmes are typically implemented with an insufficient time perspective and inadequate human and financial resources to monitor the outcome after the active components of the programme itself (typically financing) have terminated. When the programme is closed and replaced by another programme and no monitoring takes place, it becomes impossible to evaluate its impact both because relevant information and data are missing, and because the effects on the initial target depend also upon the new programme. Finally, interest in evaluation is weakened by lack of consequences from failure in meeting the objectives of the programme. As a consequence, evaluation practices are currently inadequate for assessing SME policies.

The Strategy promises to initiate a new phase of evaluation in SME policies in Hungary: it includes a plan for monitoring and takes responsibility for an interim assessment of the impact of the Strategy. In order to make this possible, it defines a set of targets and distinguishes them according to their nature and relevance (strategic targets, comprehensive objectives, horizontal targets). This approach is the necessary starting point for institutionalising the process of monitoring and evaluation. A number of conditions has to be met in order to make monitoring effective. First, objectives should be independent of each other: any mutual influence would prevent a proper evaluation of the impact of individual policy instruments on a given objective, since the impact could depend upon the performance of a different policy instrument used to pursue a different objective. Second, objectives should also be clearly and precisely specified. For instance, the Strategy's main strategic target of "**increasing the economic performance of small and medium-sized enterprises**" is expressed as the increase of the ratio of gross value added produced by SMEs from the current 52% to 55% by 2013. However, it does so without specifying whether this will be the outcome of growing numbers of SMEs or the expansion of existing SMEs.

While Hungary is still at the start of the "Six Steps to Heaven" path, a culture of evaluation is taking hold. What remains to be done urgently is to give sufficient time stability to entrepreneurship and SME-related policies and programmes.

Assessment and recommendations

SMEs in Hungary have great potential that still needs to be realised. Their weight in the economy, their job creation and their capacity for innovation give them a key role in achieving the country's growth objectives. To improve SME performance requires: *(i)* that broad framework policies affecting the business environment take account of the constraints facing SMEs, notably their cost constraints and limited capacity to deal with complexity in area such as tax, regulation and accessing international markets; and *(ii)* that policies and programmes targeted at SMEs specifically have a clear rationale in terms of correcting market failures, are capable of reaching their objectives, and do so in a cost-effective way. Considerable progress has been made in recent years, for instance as regards SME access to credit, and strengthening the contribution of SMEs to the economy has become a priority among policy goals. However, notwithstanding these improvements, SME policies have been neither cost-effective nor sufficiently stable over time and they still seem unlikely to foster Hungarian SMEs' competitiveness in the globalised knowledge-based economy.

A deficiency of many policies to date is that they have been primarily targeted to existing SMEs and have somehow failed to foster innovative and internationally competitive SMEs. Important issues such as awareness and capacity building, opportunity recognition and utilisation, may have been overlooked. As a consequence, most SMEs have created jobs but hardly innovated. This is the challenge for the years to come.

These considerations should determine the nature and content of the policy instruments chosen. The determinants of entrepreneurship, as defined by the OECD Entrepreneurship Indicators Project, relate to areas such as: regulatory framework, entrepreneurial capabilities, access to finance, R&D and technology, culture and market conditions. It appears that the effective articulation of an Entrepreneurship Policy, focused on these issues and targeted at potential and nascent entrepreneurs, and an SME Policy, supporting the development and growth of existing SMEs, is lacking in Hungary. Facilitating entry of new entrepreneurs with strong motivation and skills and alerted to catch opportunities, may be a promising way for Hungary to increase the number of fast-growing productive firms (OECD, 2002b).[14]

The new Strategy constitutes an important step toward overcoming the main problems afflicting the sector. It affords a detailed and realistic situation analysis and builds upon it the detailed formulation of a new strategy for the development of SMEs. It places SME policies in a perspective that is broader, more detailed and better defined than in the past. These policies also promise to be better co-ordinated, both internally and with other policy areas.

Yet the Strategy needs to also go further in the following areas, if it is to tackle the critical issues of entrepreneurship for innovation and SME competitiveness satisfactorily:

- **Strengthening existing networking** should be promoted by policy makers, since this would reinforce the market role of SMEs, improve their competitiveness and resilience, support their access to innovation and improve the circulation of information and ideas.

- **The regional dimension needs to be better integrated** in the Strategy and the design of policies, particularly assistance programmes. As noted earlier, regional differences in SME characteristics and issues are significant and justify a strong regional and local dimension in the design and implementation of programmes. Today, with the exception of EU-funded projects, SME policy remains centralised in Hungary.

- **Finally**, **the institutional framework in which the Strategy is going to be implemented should be reviewed**. While responsibility for SME policy and programmes is dispersed over various ministries (*e.g.* the Ministry of Economy and Transport, the Ministry of Agriculture, the Ministry of Finance) and other administrations, the responsibility for monitoring the Strategy has been centralised in the Ministry of Economy and Transport.[15] This centralisation has probably facilitated the elaboration of the Strategy, but co-ordination and implementation difficulties may nevertheless arise at a later stage. Solving these problems would require better co-ordination of SME policy and programmes at all stages, having a well-defined single co-ordination body.

The recommendations found in Box 7.1 are based on the perception of this incompleteness and bias of the Strategy. They follow the classification in conceptual and action areas used in this chapter.

Box 7.1. **Summary of policy recommendations for improving SME competitiveness and fostering successful entrepreneurship in Hungary**

1. Promote a business environment conducive to entrepreneurship and SME development.

1.1. Improve regulatory frameworks.

- Improve policy co-ordination and establish a stable and predictable regulatory framework, giving long-term perspective to policy making and enterprises.
- Decentralise selective entrepreneurship and SME policy competences and enhance the capacity of the state and local authorities to elaborate, co-ordinate and implement programmes.

1.2. Implement a tax system that entails low compliance costs.

- Simplify the tax system, broaden the tax base and further decrease the cost of social security.
- Avoid the distortion caused by tax allowances favouring large firms.

1.3. Ensure that intellectual property rights systems are coherent, easy to understand and used effectively.

- Increase SME awareness of intellectual property rights protection.
- Support SMEs in the development of the skills necessary for the management of their intellectual assets.

1.4. Promote access to and use of quality information and communication infrastructure.

- Improve the use through education and training of more sophisticated information technologies.

2. Mobilise human resources.

- Build entrepreneurial awareness and support its transformation into entrepreneurship with consistent, co-ordinated and sustainable long-term entrepreneurship and human resources programmes.
- Facilitate the upgrading of capacities of existing entrepreneurs and managers.
- Foster and support the co-operation of SMEs with education, information and knowledge centres and introduce courses in entrepreneurship and innovation into university education.

3. Provide better financing for entrepreneurship and SME growth.

- Give top priority and find solutions to financing potential entrepreneurs and start-ups.
- Increase financing resources for SMES by means of financial instruments better apt to local circumstances, including local banks and business angels.
- Build financing awareness and capacities of entrepreneurs.
- Develop the guarantee system and its use.
- Promote measures for investing in high-growth enterprises.

4. Reduce barriers to Hungarian SME access to international markets.

- Tune internationalisation instruments according to regions and size groups of SMEs.
- Use the OECD survey format to find out what Hungarian SMEs regard as the key barriers to internationalisation.
- Provide more complete comparative data on the different forms of international activity of SMEs and participate actively in international comparative programmes.

5. Evaluate SME and entrepreneurship-related programmes.

- Assess whether the governance structure proposed in the Strategy, and charged with achieving stated objectives is well suited to do so.
- Implement entrepreneurship and SME programmes in a timeframe sufficient to monitor outcomes and permits sound evaluation.
- Ensure that institutional arrangements are in place for evaluations to be carried out in an independent manner.

Notes

1. According to the Hungarian official definition (Government of the Republic of Hungary, 2007, p. 10) “an enterprise will qualify as SME if its total headcount is less than 250, and its annual net revenue does not exceed the equivalent of EUR 50 million in Hungarian Forint (HUF), or its balance sheet total does not exceed the HUF equivalent of EUR 43 million.” Within the SME category a small enterprise is defined as having less than 50 employees and an annual turnover or balance sheet equivalent or inferior to the HUF equivalent of EUR 10 million. A micro enterprise is defined as a firm with no more than 10 employees and annual net turnover or balance sheet under the HUF equivalent of EUR 2 million.

2. According to the Hungarian Central Statistical Office, an enterprise is considered to be operating in a given year if it had sales revenues or had at least one employee (MoET, 2007a, p. 130).

3. EU19 represents the EU15 member states plus Iceland, Liechtenstein, Norway and Switzerland.

4. See Figure 2.3.6, “A Summary of the Problems of the SME Sector”, in Government of the Republic of Hungary (2007), p. 42.

5. Currently there is no significant programme targeting potential enterprises (the net credit demand necessary to finance potential enterprises is estimated at EUR 110 million) (JEREMIE, 2007).

6. See the related recommendations of the 2004 OECD Istanbul Ministerial Declaration on “Fostering the Growth of Innovative and Internationally Competitive SMEs”. The Declaration was adopted by ministers and representatives of governments participating in the OECD conference held in Istanbul on 3-5 June 2004.

7. The Istanbul Ministerial Declaration also identified “the need to strengthen the factual and analytical basis for policy making so that policy decisions can be based on empirical evidence.” This issue is not specifically addressed in the Strategy, except for the Hungarian XXXIV Act of 2004 which “requires that in data provisions of the Hungarian Central Statistical Office and the Hungarian Tax and Finance Control Administration SMEs must be differentiated according to headcount” (Government of the Republic of Hungary, 2007, p. 10).

8. Direct burdens to Hungarian entrepreneurs (comprising data provision to the public administration and other burdens related to public administration procedures).

9. As recommended by the OECD Tokyo Action Statement on Strengthening the Role of SMEs in Global Value Chains (OECD, 2007a).

10. The programme included a Micro Credit Programme, a Midi Credit, the Europe Technological Catching-up Investment Credit Programme and the Széchenyi Card, by far the most successful programme offering access to a maximum of EUR 40 000 credit (increased to EUR 100 000 in QI 2006) for unlimited use, to manage liquidity problems, subject to a simplified procedure, with the state budget providing a 50% guarantee fee subsidy for every card issued and with a state interest subsidy of 2%.

11. OECD Working Party on SMEs and Entrepreneurship and APEC SME Working Group.

12. Only few responses were received from Hungarian SMEs to the questionnaire. It is recommended that Hungary continues this analysis in the future in order to have an internationally comparable picture of domestic conditions regarding this issue. It would be desirable that Hungary participates actively in the OECD WPSMEE study on "SME Internationalisation" that would generate internationally comparable data for Hungary. It would also be useful to have more complete data on the international activity of SMEs, including data on imports (only exports are mentioned in Government of the Republic of Hungary, 2007 and MoET, 2007a in conjunction with SMEs), comparative data on foreign direct investment, outsourcing, multinational networks and alliances, and on indirect internationalisation through the supply of components and services to domestic exporters.

13. This index is based on the compilation of "procedural requirements for trading a standard shipment of goods by ocean transport. Every official procedure – and the associated documents, time and cost – for importing and exporting the goods is recorded, starting with the contractual agreement between the two parties and ending with delivery of the goods. For importing the goods, the procedures measured range from the vessel's arrival at the port of entry to the shipment's delivery at the factory warehouse. For exporting the goods, the procedures measured range from the packing of the goods at the factory to their departure from the port of exit (World Bank, 2007, p. 39).

14. As a follow-up to the 2002 study, the OECD Working Party on SMEs and Entrepreneurship is carrying out a project on "High-Growth SMEs, Innovation, Intellectual Assets and Value Creation".

15. The Strategy was prepared by the Department for Enterprise Finance of the Ministry of Economy and Transport (MoET), with the technical support of other departments of the Ministry and of the EU and the Governance Group of KPMG Consulting Ltd.

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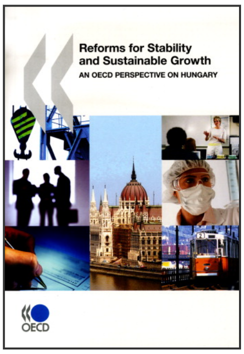
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