Ms/44

T. Laky
The role of the small firms in the local development of East-Europe; the case of Hungary

Paper presented in the 4th International Meeting of Sociology of Work

Bologna-Forli
10-12 Nov 1992

Bologna and Forli, the venue of this meeting, belong to the Emilia-Romana region. This region is known all over the world as the homeland of the "industrial district" system based on the cooperation of small business creating new forms of economic and social relations and the cradle of "Third Italy" prosperity generated in these nearby regions.

Similar local social and economic formations have been invented in several advanced countries worldwide. Analysts have tried to define the specific features of these forms.[1]

H. Schmitz (1990) proposes that the district model is defined by more than geographical proximity and sectoral specialisation. Additional attributes are: the predominance of small firms, close inter-firm collaboration, inter-firm competition through innovation rather than through wage squeeze, high degree of trust between employers and skilled workers, provision of collective services through self-help organization and active regional and municipal government strengthening the innovative capacity of local industry.

In Hungary there is scarcely any region let alone settlement where small business and their interfaces could meet a small fraction of these criteria.

In terms of economic development Hungary is still lagging behind the advanced industrial countries. The beginning of Hungarian industrial development is dated back by economic historians only to 1967, that is, the last third of the 19th century, at a delay of 50 to 100 years compared to the leading countries of industrial development. At the end of the 19th century only one tenth of earners were employed in the industrial sector. (Berend-Szuhay, 1973.) Although the lag of a century has been reduced, in 1991 the rate of earners was recorded to be 34,7% in industry, 13,5% in agriculture and 51,8% in services. (Central Statistical Office, Macroeconomic labour statement, 1992.)

---

[1] From the growing literature of the industrial district symptom the first mention must be made of several Italian authors who were the first to discover this phenomenon, namely, S. Brusco (1986), G. Becattini (1989), A Bagnasco (1977) and M. Paci (1982). The first Hungarian reviews of their findings have been released by Á. Simonyi, among others in a study in (1989). Researchers have probably understood the social newness and importance of this system from the work of Piore-Sabel entitled The second industrial divide (1984).
This issue has remained in the focus of international attention. A conference was held by ILO in 1990 in this theme where several Hungarian research workers including the author of this paper also had the opportunity to attend. The international experiences pooled to date were summarized at the conference by W. Sengenberger. (1990)

After the second war the natural process of economic evolution was adjusted by centrally controlled planned economy. As it was termed byu J. Kornai (1983), the natural forms and relations of business were replaced by bureaucratic coordination by administrative authorities. However, market coordination requires autonomous actors establishing their relations between themselves.

The initial stage of market economy building

The establishment of market economy is currently at issue in Hungary.[2] The first precondition is to replace state ownership by the creation of business on private ownership basis. At the same time, as it is shown by experience, the building of private business results in the fragmentation of gargantuan state owned companies and gargantuan cooperatives into much smaller organization.

On the other hand, private business emerging in a natural process is also shown by experience to be inherently small and typically based on self employment or teams of a few members.

The process of market economy building has been found to be slower than anticipated.

It takes the following three forms:

(1) natural growth of the traditional (small) private sector, i.e., at the discretion of entrepreneurs;

(2) sale of state owned assets of production;

(3) allocation of shares to cooperative members and employees. The shares allocated through the formal distribution of cooperative assets are personally owned by the members and employees and they are free to decide to quit the cooperative and work as self-employed farmers; or to form some sort of a business partnership; or to select the continuing of the cooperative form.[3]

---

[2] The conditions of transformation are reviewed more broadly in the presentation of L. Héthy (1992).

[3] Imre Kovách in his presentation (1992) reviewed the transformation of agricultural cooperatives. In Hungary several hundreds of large cooperatives were operating in the industrial or service sector. These are also liable to identify their assets. The recompensation also covered

These three key forms of development are outlined in the following.

First: Natural growth of private business

As it is generally known, in the socialist planned economies private business was merely tolerated and their activities were limited by countless restrictions.

Up till the early 80s the Hungarian private sector consisted of typical personal or family undertakings, mainly small manufacturers, retailers or farmers.

According to the statistics reflecting the January 1, 1982 conditions, from the five million of active earners only 3,5% or 176.600 people were employed in the private sector.

As a result of the gradually liberalized small business policy of the 1980s, the number of employees of small scale industry and trade steadily increased and partnerships (without entity) as well as private entrepreneurs leasing and operating state owned outlets and especially restaurants entered into the scene. Some slight growth of private farmers was also recorded. The number of employees was surging after the abolition of a penalizing tax of employment. At the same time more and more family members became full-time assistants of such private enterprises.

In the year 1989, the private sector employed about 265 thousand full-timers (including self-employed, employees and family members).

The natural growth of the private sector in the eighties entailed polarization. Some successful ventures developed into large private business. From 1982 on many of them continued to develop in alternating forms into big and wealthy organizations. After 1989 a few dozens of them were transformed into public companies.

Act V of private business came into effect in 1990 lifting the historical discriminating restrictions and opening the way to the natural growth of private business. Since this time there has been a robust increase in the number of artisans, dealers, independent farmers and other "private businessmen". The

---

by Imre Kovách is paid in consideration of nationalized property. Holders are free to trade it partly in kind up to a certain limit in case of land or as investment securities (or convert it to annuity).

number of full-time private entrepreneurs increased by about 87 thousand while this rate was 22 thousand of employees and about 213 thousand of helping family members.

In the smallest scale private business the number of retailers heavily increased. Thousands of people went independent partly by the sale (or leasing) of the smallest outlets of state owned distribution networks. A part of retailing has once again became a family business. However, the number of retailers has been grown by mushrooming hucksters who have been forced to select this "business" to escape unemployment.

Voluntary and forced entrepreneurs are massively included in industry as well as services. Included in the latter category are, for example, the big number of passenger and cargo transporters. Many taxi drivers have entered into the streets and try to compete with growing supply using family cars sometimes as old as ten years. Entrepreneurs working in the cargo delivery services are often using vans bought or leased from liquidated companies. A big variety of activities once performed by state owned companies are now pursued as private business, such as there are hundreds of small tourist agencies or exchange services.

As the number of entrepreneurs is still low in several sectors, many of the smallest ones are doing quite well (although this is also attributable to incomes concealed from the tax authorities).

It is noted here that growth notwithstanding, the number of artisans and retailers is still below the pre-war level.

A considerable growth of business <u>associations</u> has been also recorded, however, data are not available. Statistics show aggregates of partnerships without distinction of owners. According to end-19911 figures there were more than 45 thousand partnerships without an entity and about 43 thousand entities. (Note that about 80% of the members of partnerships without entity participate in the business as an additional occupation.) Again, the sudden growth of different company forms is the outcome of changing taxation. As to entities, the still state owned decentralized organizations like public companies or limited companies represent a substantial share.

Second: **Privatization of state owned assets**

The Economist published an international comparison showing the rate of state ownership in the capital assets of several countries. In the mid-eighties the share of state owned capital assets amounted to 17% in France, 14% in Italy, 11% each in Germany and the UK, 6% in Denmark and a paltry of 11% in the USA, as against a range of 82 to 97% in the former socialist countries. (The Economist, Sept.21.1991. Survey, p.10.)

According to this estimate the share of the Hungarian state amounted to 86%. This enormous share should be privatized as soon as possible. Local demand is thin because there isn't any appreciable local propensity to pay. The hopes were attached to instant and massive involvement of international buyers. However, the achievements of privatization are limited in spite of considerable interest.

The available statistics of fully or partly privatized organizations including companies with international participation indicate a low number and ratio of organizations fully or majority owned by international partners.

Share of organizations with international participation
at the end of 1991

No. of companies with entity: 42.697
Including

- Fully international owned	1.499	3.5%
- Majority international owned	1.578	3.7%
- Majority local owned	8.258	19.3%
TOTAL:	11.335	26.5%

Data Source: Macroeconomic organization structure
Central Statistical Office, April 1992 (PP 13 and 15)

Only a few bigger state owned companies have been acquired by domestic buyers using substantial borrowed funds in most case. The local buyer base has begun to include employees who can buy shares in their place of work in a special scheme (adopting the American ESOP model). Moreover, another two alternative loan facilities are also available to employees.

However, as already discussed, the sale of state owned assets is a much more prolonged process than expected.

Third: The identification of cooperative assets must be completed by the end of this year. Naturally there are only partial details available of this process. Most industrial and service cooperatives seem to survive, although there are some spin-offs at several places. According to a survey of the Ministry of Agriculture, 300 of the total of 1500 agricultural cooperatives held the general meeting to decide about the future of the cooperative. Overall, in most farms the members prefer to keep the cooperative together. (Népszabadság, November 6, 1992.)

The newly formed cooperatives can operate according to the international standards of cooperatives as business organizations.

The so-called small cooperatives are actually included in the cooperative sector. Small cooperatives are specific Hungarian formations. Small organizations were implemented in the early 1980s in an effort to reform the system of planned economy, enabling the separation of viable units of less than 100 staff. Hundreds of small cooperatives were created and pursued their autonomous activities using the old location and inherited equipment.

These small cooperatives enjoyed a big variety of benefits (they paid the lowest tax of all other forms of small business, substandard social insurance contributions, etc.), a multitude of new partnerships were created in this form. Some of them with substantial equity and some others without any, these cooperatives have been virtually operating as private business from the inception and up till now they have maintained the cooperative form.

Consequently in 1991 there were nearly 3 thousand active small cooperatives, although it is already impossible to tell how many of them are old spin-off organizations and how many of them were formed voluntarily by the members on the grounds of private ownership.

All in all, since 1982 or about 10 years a large number of small size organizations have been created, however, only the smallest ones can be safely considered to be privately owned.

Number of business at the end of 1991

	(thousand units)
Business organizations without an entity	
- private entrepreneurs (artisans, retailers, other)	532,9
- business partnerships	45,5
Entities	42.7
from this;	
- PC	1.1
- Ltd.	41.2

Data source: Macroeconomic organization structure, Central Statistical Office 1992.

Full data of staff categories are not available.

According to estimates, in about 80-85% of private business an entrepreneur is working alone with not more than one employee or two, but rather with family members. The business organizations without an entity are also small ones and, as already noted before, only 22% of their members are full-timers while the balance participate in the business while maintaining their original jobs (with state owned or cooperative organizations).

According to available data on business organizations with an entity, most of the limited liability companies have a staff of less than 20 people.

Staff categories of entities
March 1992

	Less than 20		21-51		51-300		More than 300		Total	
	#	%	#	%	#	%	#	%	#	%
Ltd.	40.655	86	4.341	9	1.990	4	216	..	47.292	100
PC.	347	27	189	15	385	30	348	27	1.269	100

Source: Macroeconomic organization structure
Central Statistical Office, April 1992

However, as it was also noted before, the assets are assumed to be still owned mostly by the state. Naturally there isn't any justification of this state ownership, however, these organizations may be privatized more easily just because of their small size.

The total number of business recorded in 1991 statistics was 466 thousand (including private entrepreneurs and members of business partnerships without an entity) representing 4,8 million employees or less than 10%. (Macroeconomic labour statement, January 1, 1992. CSO, 1992.) Altogether 707 people or 15% of employees were working in the private sector including employees and helping family members. (As noted above, there are no available data on the distribution of members and employees of entities in terms of holding; employees of organizations fully or majority owned by international partners are also excluded from this figure. The latter category is estimated at about 80 to 100 thousand people.)

It may be sufficiently evidenced by the aforesaid that Hungary is still in an infant stage of market economy creation. Moreover, transformation is thwarted by austere economic conditions, international recession, heavy international indebtedness, loss of the former Comecon market and subsequent unemployment, and so forth.[4]

---

[4] It may be revealing to review some typical features of the actual business environment. As a result of international debts amassed for several decades, Hungary has the highest per capita debt rate of the world ($ 2060 per cap, Figyelő, October 1, 1992) and the Hungarian administration is determined to maintain the repayment schedule. This requires the heaviest possible draining of earnings generated in this country (during the last years only the Swedish tax rates have been higher and while the tax revenue of the Italian government amounts to about 40% of the GDP, in Hungary the tax revenue of the state is in the range of 50% of the GDP and taxation is increased year after year).
Like many other countries, in a matter of a few years Hungary has lost its key international market in the former Comecon countries and especially in the former Soviet Union. (A decisive share of Hungarian export was sold in these countries.) Mainly as a result of this dramatic loss of market umemployment has been steadily growing since the middle of 1990. The first massive lay-offs were resulting from the drop of production of organizations directly involved in eastern export. The loss of supply orders has had its implicationall over the economy entailing more and more redundancies and liquidations. (In the first half of 1992, industrial production was not more than 64,3% of the comparable period of the year 1985.) By August 1992 the rate of unemployment was over 11% and it is forecast to go as high up as to 15-20% along with the persisting decline of the economy. Though at a diminishing rate, inflation is still 25-28% high and the end-year fiscal deficit will be nearly three times higher than budgeted.

All these facts are heavy impediments in the way of faster growth and stimulation of business.

Small business in the local economy

J. Schumpeter described the classic local market in his illustration of considering the potentials of the market known from empirical experience: "The volume of meat sold by the butcher depends on how much and for how much his customer the tailor is willing to buy. In turn, this depends on the success of the business of the tailor and this again depends on the needs and buying propensity of his customer the bootmaker. Again, the buying capacity of the bootmaker depends on the needs and buying capacities of the people for whom he is making the boots and so on, until a person is found who earns his income from selling goods to the butcher": [Schumpeter (1980).]

As a rule, the actors of a local market are aware of their close interdependence. They have their assertive bodies, traditional unions or clubs. While the Hungarian local market was functioning more or less in the same way as anywhere in the world, the limited number of actors in itself set the limit to the creation of broad social relations. Moreover, through the last fourty years the regime resisted to any spontaneous social agreement and tried to put any state activity under state control. The pre-war organizations of artisans and retailers survived, however, they were recast by the regime according to its own requirements.

Membership was made compulsory, however, the representation of particular interests was replaced by transforming the local organizations into components of a centrally controlled hierarchy and into executive bodies of governmental will.

After the change of the political system these organizations have been reorganized, their names changed, their membership made voluntary - and thinned. The hierarchy has fallen into pieces. Although there are some national centres, the local organizations cannot afford but their own activities but most of them do not contribute funds to keep the regional organizations because they do not feel the importance of regional cooperation.

Moreover, since the political system change and the creation of parties many areas are politically divided and belonging to this party or another has become more critical than to represent the common local interests. [One of the still few local studies is a review of this rather general situation by István Jávor and Tamás Rozgonyi after research work carried out in a small city. In addition to this predictably lasting conflict they also experienced aversions between the native local entrepreneurs and newcomer "aliens" starting business in the city. (1992)]

Local governments can become active supporters of local business. In the last 40 years the local councils contacted businessmen mainly as tax officers. However, the taxes collected and often deliberately increased were delivered to the central government as the biggest part of the operating costs of local councils was allocated from the central budget. This fact together with all-out central control meant a strong limitation of any local activity, although the people tried to make a lot of development partly by finance contributed by the community and partly by voluntary work.

The financial position of the local governments has not shown any appreciable improvement. Allocations from a heavily burdened central budget still represent a substantial part of their revenues. The local governments could levy local taxes, however, they refrain to do so because they would like to protect local business (from several thousands of local governments local taxes were levied only by about 200).

Local governments also try to help by initiating or sponsoring business development projects. During the last few months several local and regional business development agencies were set up under the Phare program and with the assistance of the national business development organization and a foundation of similar objectives and new LEDAs (Local Economic Development Agencies) and LEAs have been formed.

It is a remarkable experience that the regions with the lowest unemployment rate have the highest rate of business and vice versa, business is limited in counties inflicted by high unemployment. (Naturally this has several interfaces beyond the scope of this presentation. For example, geographic location, such as Western or Eastern border area or the standard of schooling show close relations with good or bad positions.)

This has been a sketchy outline of the first initial steps of local development. Several additional features may be revealed soon by current research activities.[5]

Even if some similar attributes are found, it will probably take a long time for the Hungarian economy to follow the example of Third Italy. A model where small business organizations pursue their own interests while their synergy supports the development of the entire community.

---

[5] E.g. the study of inter-entrepreneur relations by Csaba Makó; the study of arrangement of new organizations by Tibor Kuczi; or the study of the development of textile manufacturing activities and inter-business relations in a small city by László Neumann.

REFERENCES

Bagnasco, A.:	Tre Italie Mulino, Bologna, 1977
Becattini, G.:	/Sectors and/or districts: some remarks on the conceptual foundations of industrial economies', in Goodman, E. and Bamford, F. (eds.) 1989
Berend, T., Szuhay, M.:	A tőkés gazdaság története Magyarországon (The history of capitalist economy in Hungary) 1848-1944. Kossuth, 1973
Brusco, S.:	'Small Firms and Industrial Districts: The Experience of Italy', in Keeble, D. and Wever, E. (eds.) New Firms and Regional Development in Europe, Croom Helm, London 1986.
Jávor, I., Rozgonyi, T.:	Kisvárosi tapasztalatok rendszerváltás idején. (Experiences of a small city in times of system change.) Szociológiai szemle, 1992/2. 85-92.
Héthy, L.:	I cambiamenti socio-economici nell'Europa dell\Est: una sintesi introduttiva (Contribution at the 4th International Meeting of Sociology of Work, Bologna-Forli 10-12 November 1992)
Schumpeter, J.A.:	The theory of economic development. KJK, 1980. p.46.
Kornai, J.:	Bürokratikus és piaci koordináció (Bureaucratic and market coordination) Közgazdasági Szemle, 1983/9. pp.1026-38.
Kovách, I.:	Mercato, privatizzatione ed imprese in Ungheria (Contribution at the 4th International Meeting of Sociology of Work, Bologna-Forli 10-12 November 1992)
Central Statistical Office:	A nemzetgazdaság szervezeti struktúrája (Macroeconomic organization structure) 1992.
Central Statistical Office:	A nemzetgazdaság munkaerőmérlege (Macroeconomic labour statement) January 1, 1992. (1992)
Sengenberger, U.:	An overview of research and practice. International Conference on Industrial Districts and Local Economic Regeneration. ILO, Geneva, 18-19 October 1990
Simonyi, Á.:	Társadalmi, politikai összefüggések a kisvállalkozások fellendülésének hátterében: egy olasz példa. (Underlying social and political factors of small

business growth : An Italian example). Közgazdasági Szmle, 1989/5.

Paci, M.: La struttura sociale italiane Mulino, Bologna, 1982.

Piore, M.J.+ Sabel, C.F.: The second Industrial Divide: Possibilities for Propserity. New York, Basic Books, 1984.