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How to Strengthen Hungarian Small Enterprises that Face the Challenges of Neo-globalization

SUMMARY: In our article we have analysed the problem, how can the small enterprises (SME-s) survive in the shadow of the transnational companies (TNCs). Besides analysing the historical process of globalization, and its latest form, the 'neo-globalization', we were mainly focusing on wage levels. Local small enterprises generally are not able to increase their prices and their wages, but on the other hand, transnational companies – in case of necessities, for e.g. labour shortage –, can easily pay higher wages for their workers, as transnational companies are realizing extra profits due to their specific business model. TNCs have their products produced in poorer, low wage periphery countries, and then these products are sold in the rich centrum countries at higher prices, creating huge and easy extra profits. In this globalized model, TNCs are interested to maintain income differences between periphery and centrum regions. That is why we are convinced that governments should help small and medium companies, which are producing for the local markets. Naturally, later those SME-s may be able to move to international markets as well. Our final conclusion is that social security payments and special SME credits, which are tied to company sizes are not distorting the market, but rather are rebalancing an already distorted market structure.

KEYWORDS: size-dependent corporate taxation, special SME credits

JEL CODES: F23, H20, H50, L53, O43, R58

The article focuses on how domestically-owned small and medium-sized enterprises producing mostly for the local market can be strengthened in this neo-global world order that developed in the late 20th and early 21st centuries and is dominated by large transnational companies. An overview of neo-globalization is followed by the analysis of the problems of SMEs producing for the domestic market, and we take a look at why the mandatory rise of the minimum wage puts domestic SMEs in a difficult position. Then we attempt to present

feasible ideas how domestic SMEs could be supported by the government, hoping that our recommendations can provide solutions to SMEs in Hungary, and in periphery countries in general. Our recommendations include size-dependent corporate taxation, social security taxes/contributions and special SME credits.

METHODOLOGY

A theoretical overview is provided, based on literature, of the rise of neo-globalization, its causes and its factors. The situation of the Hungarian SME sector is approached

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from several angles. First we examine what factors put SMEs automatically at a competitive disadvantage compared to large corporations, and we describe the importance and significance of SMEs in the economy. This is followed by an analysis of the wage tensions between company categories in Hungary, relying on international comparison and statistical data. In case of wages, we analyse data by company size. We believe that it provides a good initial picture of the tensions.¹ The analysis of the data is followed by a recommendation on potential corrective measures and their budgetary impacts.

THE PRECURSOR OF NEO-GLOBALIZATION: IMPORT SUBSTITUTION INDUSTRIALIZATION (ISI) IN THE MID-20TH CENTURY

The first wave of globalization came in the 1500s and the 1600s, and was followed by a significant slowdown.² Globalization gained speed again in the 19th century, which was followed by another ebb between 1914 and the 1970s. The globalization tide we still experience today started in the 1970s and has brought new phenomena.³ We can safely say it is a completely new stage of globalization as its distinctive processes are based on transnational companies. From now on we will call this new stage 'neo-globalization' to indicate that new rules appeared in globalization this time.

In the early 20th century, there was a special division of labour among periphery countries and core countries: periphery countries (Latin-America, Asia and some African countries) exported mostly raw materials, such as food items and other raw materials and energy carriers to core countries, i.e. North America and Western Europe. Periphery countries used these revenues to pay for the imported industrial goods, both consumer and capital goods. This division of labour worked well in times

of peace and economic upturn, but these relations were severed after the first world war, partly because of the world wars and partly because of the Great Depression between 1929 and 1933. Even after 1945 they took a long time to recover. Some economist from Latin-America⁴ suggested substituting imported products with local production. This was 'import substitution industrialization'.

Stagflation in the late '70s and early '80s and the economic responses to that led to the fall of import substitution. In traditional Keynesian macroeconomics, inflation and stagnation can't happen at the same time, and monetarism and several other alternative approaches in economics (such as supply-side economics) were now gaining acceptance over the Keynesian system. Obviously it was supply disruptions that really triggered stagflation, more specifically the oil embargo after 1973 and the Iran-Iraq war, which hit oil exports hard.⁵ In response to stagflation, the central banks of core countries pursued restrictive credit policies in the '80s, and as a result credit interest rates increased, but of course inflation, which was basically cost-induced, did not slow down significantly. However, periphery countries that previously pursued import substitution industrialization found themselves in a very difficult situation, and not only were they not provided new, affordable credit, the interest rates of previous credits also skyrocketed.

'NEO-GLOBALIZATION', THE THIRD, MOST RECENT WAVE OF GLOBALIZATION IN THE LATE 20TH CENTURY

The so-called Washington Consensus was recommended to deal with the credit crisis and to address the additional financing needs of developing countries (see Williamson, 1989). It said that periphery countries should open

up their markets to foreign working capital investments. As a result, a new, previously almost non-existent system of globalization developed, based on the dominance of international companies. Even though the seedlings of large multinational companies had been there earlier, they only became this dominant at the end of the 20th century. It is important to emphasize that in this period international companies started to operate as integrated economic units, which hadn't been the case before. From the late 20th century, international companies were run from the core countries, serving the interests of the core countries. The old principle of 'buy low, sell high' was implemented, goods were produced at a low cost in periphery countries with cheap labour, and then sold in rich core countries at a high price (see the issues of the UNCTAD WIR).

By moving semi-finished products, materials, knowledge or other products or services among their branches, multinational companies get significant corporate tax advantages (this is called transfer pricing), which also increases their extra profits. In contrast with the previous aspects of international trade, international migration and cultural unification, the system described can be called the neo-globalization of multinational⁶ companies.

THE PERSISTENCE OF WAGE DIFFERENTIALS BETWEEN CORE AND PERIPHERY COUNTRIES SINCE THE LATE 20TH CENTURY

The distinctive feature of 'neo-globalization' was that large international companies had subsidies all over the world, and, as a result, at the end of the 20th century, intra-company trade accounted for at least half of world trade.⁷ This system was highly beneficial for international companies, as production was cheap in their

assembly plants in underdeveloped countries and they could sell their products at a high price to rich customers in core countries. The opposite of this system, the business model of Fordism should be mentioned for comparison. Ford paid higher wages to workers in his car factory so that they could afford Ford cars.

While international companies reaped the benefits, local small and medium-sized enterprises in semi-periphery countries faced grave difficulties. Multinational companies, thanks to their high prices, could easily pay the taxes and contributions on wages and workers. Whereas small and medium-sized enterprises couldn't sell their products and services at a higher price. They mostly produced for the domestic market and could not increase their prices because customers were highly 'price-sensitive'.

Large international companies caused significant market distortions and social tension in periphery countries where wages were much lower than in developed and rich core countries.⁸ This is most detectable in migration caused by low wages. In Eastern European countries (mostly in the Baltic states, Romania, Bulgaria, Poland and Hungary) a significant part of the population found employment in Western Europe, and most of them don't intend to return home in the foreseeable future.⁹ This poses a problem to these countries, mostly because it is young, qualified people who leave, and they would be the backbone of the economy in the future. By increasing the minimum wage, these countries can improve their situation to a limited extent, as SMEs producing for the local market can only partly pass through the cost increase to their customers. The strategic problem is that in this age when competition requires knowledge and innovation, creative and qualified people are more important than capital or equipment if you are looking to improve your competitiveness. This means that

countries that lose their knowledge capital have less of chance of catching up. It is especially true now that in the age of the digital revolution well-prepared professionals are needed even more.

Globalization affects price structure on the semi-periphery, so the prices

- of products produced by TNCs are getting closer to prices in Western Europe. Today, their pushy advertising generates sufficient demand – and alternative local producers were destroyed when markets were hastily opened without sufficient customs protection;
- low-quality Asian import goods were sold at somewhat dumped prices, which ruined enterprises producing similar goods on the semi-periphery;
- in-between these two are the markets supplied by local businesses that provide products and services. Those with an inclination towards entrepreneurship have all been forced to operate in this limited area, which means competition is strong here and prices are depressed.

Relationships between core and periphery countries were first described by *Immanuel Wallerstein* (1983, 2010) in the 20th century, and from more recent articles the analyses by *Pásztor and Szijártó* (2016), and *Pásztor and Pyatanova* (2017) should be highlighted.

QUESTIONS OF WAGE CONVERGENCE: HUNGARY

In the current situation, periphery countries, especially Eastern European countries, cannot eliminate wage differentials on their own and cannot increase local wages to a level where for young people it is not worth leaving for Western Europe. This is a result of several factors, and the oft-cited reason that Eastern European workers are less efficient (diligent,

qualified or innovative) than western workers is not the main one. In reality, it is more because large international companies usually move their low value added assembly activities that require cheap, unskilled labour to Eastern European periphery countries, so keeping wages low is in their interest. This decreases local gross value added (GVA), which is the measure of productivity. Naturally it is probably another factor that companies in periphery countries generally use less modern organisational and governance methods. This is substantiated by Eurostat data that suggest that in underdeveloped countries productivity is lower not only in the SME sector but also among multinational companies than in developed countries. This being said, the productivity of small enterprises is still lower.

In this situation, however good it might seem at first, a mandatory increase in the minimum wage is not an effective solution if the goal is for wages in periphery countries to get closer to wages in core countries. Unlike transnational companies, domestic SMEs producing for the local market can't make enough money to pay higher wages. A long-term and significant increase in mandatory minimum wage would directly lead to a large number of SMEs that produce for the local market going under. In periphery countries, including Hungary, the local subsidiaries of international companies export to the rich markets of core countries, while domestically owned small enterprises mostly supply the local market. This has been shown by a number of studies. Regarding the period before the EU accession by *Kállay and Lengyel* (2008), for example, and regarding the period after the EU accession it was found by *Békesi, Halpern and Muraközi* (2013) that '*Hungarian foreign trade, like in other countries, is very concentrated; over 80 percent of export and import is done by 5 percent of the companies.*' From articles on the export activity of Hungarian

companies, the following analyses should be highlighted: *Deli-Gray* and *Bernsütz* (2006), and *Kazainé Ónódi* (2016).

If a significant part of taxes and contributions (e.g. social security) payable by the companies were to be linked to corporate size, it would be an effective step towards wage convergence in periphery countries.¹⁰ This would help local small and medium-sized enterprises retain their best employees.

The higher wages offered by multinational companies and the open labour market of the EU together led to a distorted corporate structure in Hungary in the past 4 years, with an increasing dominance of large companies.

The employment shares of the non-financial business sector in Hungary are shown in *Table 1*.

From 2016 to 2018, the employment share of SMEs is expected to decrease in two member states, Italy and Hungary. The projection for Hungary shows a 2.5 percent decrease, while the EU average is expected to grow by 1.9 percent.¹¹ This is obviously bad news. It is also worth noticing that while in the political discourse it is often said that value added generated in the Hungarian SME sector is low, this is not substantiated by statistics. In 2016, for instance, the annual growth of value added was 1.0 percent in Germany while it

was 1.8 percent in Hungary, which is even better than the EU average. (EU average: 1.4 percent). We should note that when data broken down by company size is considered, the situation in Hungary isn't bad, either. Micro, small and medium-sized enterprises contributed to value added generated in the SME sector by 18.0 percent, 16.7 percent and 18.2 percent, respectively. In Germany and Austria, which are often cited as examples, the share of micro-enterprises is not higher: 16.3 and 18.7 percent. This means there is no reason why we shouldn't continue to see micro and small enterprises as opportunities and why we shouldn't help them so that they can obtain adequate workforce and innovate.

THE ROLE AND SIGNIFICANCE OF THE SME SECTOR, WITH A SPECIAL FOCUS ON HUNGARY

Small enterprises are considered important market actors all over the world. There are several reasons for this. Firstly, they are important in terms of value and job creation, and secondly, they are the wellspring of innovation and economic dynamism. It is not a coincidence that in several countries there is special focus on these companies, with a

Table 1

| EMPLOYMENT SHARES IN HUNGARY | | |
|--|--------|--------|
| Non-financial business sector, percent | | |
| Size class | 2011 | 2016 |
| Micro | 36.1 | 33.9 |
| Small | 18.5 | 18.9 |
| Medium | 16.7 | 15.7 |
| Large | 28.7 | 31.5 |
| Total | 100.00 | 100.00 |

Source: Eurostat website and the Annual Report on European SMEs 2016/2017 p 15

separate ministry responsible for creating a favourable business environment for them. Such countries include Great Britain, and in the US the SBA,¹² established in 1953, works with the federal government to provide small enterprises with access to financing and to the public sector market, and it also provides free, ongoing trainings and consultancy.

In 2016, there were 23.85 million active small enterprises in the EU. SMEs accounted for 99.8 percent of all enterprises, and 93 percent of that were micro-enterprises.¹³ The SME sector's share in total employment was 66.6 percent, with micro enterprises contributing with 29.8 percent. Finally, 56.8 percent of total value added is generated in the SME sector, and the share of micro SMEs is 20.9 percent. The number of SMEs in Hungary was 547 thousand in 2016, which is 99.8 percent of the total enterprise population. This is the same as the EU data. However, micro SMEs account for 94.1 percent, which is 1.1 percentage points above the EU average. The percentage of medium-sized enterprises is broadly equal (Hungary: 0.8 percent, EU average: 0.9 percent), but the percentage of small enterprises is higher in the EU. In Hungary, the SME sector's contribution to total employment is 68.5 percent, which is 1.9 percentage

points above the EU average. In terms of value added, their contribution is 52.9 percent, which is 3.9 percent below the EU average. We should note, however, that the contribution of German micro SMEs to value added, for instance, is only 16.3 percent, which is less than the Hungarian figure. Still, the total contribution of the German SME sector is higher than that of Hungarian SMEs, because of the great performance of medium-sized enterprises.¹⁴

Table 2 shows the features of Hungarian SMEs compared to EU data. It is clear from the table that in the Hungarian SME sector the number of employees is higher and value added is lower than the EU average. However, before we start generalising, we should note that the SME category is quite misleading as this group consists of enterprises of different sizes, with activities in different areas, with regionally different levels of development and infrastructure.

IT companies obviously target international markets from the start, while a local service provider micro enterprise cannot be expected to have export activities. The main function of these companies is to supply the local market and improve quality of life locally. What is really important however, is the business environment, as the smaller the company and the less developed the region is, the more it is

Table 2

FEATURES OF HUNGARIAN SMES AS COMPARED TO EU DATA

| Class size | Number of enterprises (%) | | Number of persons employed (%) | | Value added (%) | | |
|--------------|---------------------------|---------|--------------------------------|---------|-----------------|---------|---------|
| | EU | Hungary | EU | Hungary | EU | Hungary | Germany |
| Micro | 93.0 | 94.1 | 29.8 | 33.9 | 20.9 | 18.0 | 16.3 |
| Small | 5.8 | 4.9 | 20.0 | 18.9 | 17.8 | 16.7 | 18.1 |
| Medium-sized | 0.9 | 0.8 | 16.8 | 15.7 | 18.2 | 18.2 | 19.7 |
| SMEs | 99.8 | 99.8 | 66.6 | 68.5 | 56.8 | 52.9 | 54.0 |
| Large | 0.2 | 0.2 | 33.4 | 31.5 | 43.2 | 47.1 | 46.0 |

Source: EU SBA Fact Sheet & Scoreboard 2017

affected and the more its productivity is influenced by the business environment. It was said at an event¹⁵ that the productivity of a Dutch small enterprise is twice that of a Hungarian one. We should take a look at the business environment in the Netherlands as compared to Hungary: how much less red tape small enterprises have to deal with there, and what operational costs are incurred at small enterprises by the state. The Dutch example is put into perspective if we consider that in the WEF¹⁶ competitiveness ranking, the Netherlands is the 19th and Hungary is the 106th regarding the burden of government regulation component. There are huge differences in terms of venture capital availability to foster innovation at small enterprises as well: the Netherlands is ranked 21st, while Hungary is 43rd. The rankings implicate that the environment where a Hungarian small enterprise operates is different from the environment in the Netherlands. This is also pointed out by the so-called responsive administration performance introduced in the EU study referenced above, which measures how responsive governments are to the special problems of small enterprises and what efforts they make to resolve them through partnerships. According to this index, the Netherlands is ranked 4th and Hungary is ranked 25th among the 28 EU member states. These give a measure of the difficulties the Hungarian SME sector, especially micro and small enterprises face, as opposed to Dutch SMEs with their much more favourable environment.¹⁷

Considering the significant role they play in employment and in the generation of value added, it is in the interest of the state that a friendly environment for SMEs be created and costs caused by the state itself be decreased. But this is not enough. The state should also help SMEs so that they can obtain adequate workforce, train their staff and provide appropriate wages to retain them. With this jobs can be created and preserved, regional de-

velopment disparities can be decreased, and underdeveloped regions may be saved from depopulation.

GENERAL DIFFICULTIES OF SMES AS COMPARED TO LARGE COMPANIES

Small enterprises are at a disadvantage compared to larger companies everywhere in the world.¹⁸ These disadvantages are basically caused by the fact that, as compared to large companies, SMEs

- are undercapitalized and don't have easy access to credit like larger companies do;¹⁹
- are understaffed,²⁰ and, as a result, for them it is much more difficult to adapt to the changes in the regulatory system than for large companies with huge legal and accounting departments; understaffing contributes significantly to the weaker export activities of SMEs;
- consequently, SMEs are insufficiently informed and don't see the whole picture as much as large companies do;²¹
- have serious difficulties when they want to increase their prices on the local market, as opposed to international companies that operate both on the periphery and in the centre.

These difficulties are fundamental barriers to the successful operation of SMEs all over the world, and, as mentioned earlier, even in the US a federal agency was established to support SMEs, which provides comprehensive support to small businesses.

SME POLICY IN HUNGARY AFTER THE POLITICAL TRANSITION

The country has an economic interest in diversity in terms of the size, ownership and activities of the companies. This means that enhanced

support for medium-sized companies while marginalising small enterprises is not the way to go. Another reason is that in rural areas, it is usually small enterprises that provide stability to the economy and society of the region. They help keeping the workforce from moving away, and the services they provide contribute to the satisfactory quality of life of local residents. There are at least 10–20 small enterprises in every micro-region and district. These companies usually rely on local resources.

After the political transition in Hungary, the development of SMEs was part of the government discourse, but later it waned. Unfortunately, SMEs are still not represented in government work, as opposed to the US, France, Taiwan and several other developed countries.

Developments in economic policy that fundamentally influenced the activities of the SME sector in Hungary after 1990 are described in the annex.

THE SITUATION OF SMALL AND MEDIUM-SIZED ENTERPRISES IN HUNGARY, THEIR COEXISTENCE WITH INTERNATIONAL COMPANIES

We assume that the majority of the performance of small enterprises comes from companies that have been in operation for at least 5 years.²² If a large number of small enterprises go under now as a result of the wage competition, and corrective processes start in 3 years, it will take over a decade to replace the companies lost.

*Life-cycle research has found that launch usually takes 3 years and organisations spend even more in the specific growth stages.*²³ As from the stages of launch, creativity, direction and delegation small companies are typically in the 3rd stage and medium-sized companies

are in the 4th, it usually takes at least 6–7 years to become a small company, and 8–10 years to become a medium-sized one.

The situation is aggravated by the fact that the majority of those who established their companies in the '90s are about to reach or have just reached retirement age, and a lot of them don't have anyone to take over the firm. According to recent business demography data by Eurostat, the so-called net business population growth rate (percentage change of business population due to enterprise deaths and births) in Hungary is already unfavourable. It is also interesting that in Hungary the percentage of 3-year-old companies which are new but no longer at risk of folding is also low in the industry. The mobility of international companies, on the other hand, is high: when a decision is made, production may be launched within 6 months, and they may leave in 2–3 months, leaving, because of their size, a huge and lasting vacuum in the region.

The human resource policy of TNCs is built on offering higher wages to attract a large number of workers in the town or county from other companies and from the public sector. Obviously this is only possible if there is a large enough qualified workforce in the region. Migration to core countries, however, has dramatically decreased the available appropriate workforce in Hungary. It is probable that the percentage of those in a generation who are active, more talented or so much in need of money (e.g. those saving for a flat) that they take a job with a multinational company is no more than 30–35 percent. If foreign companies employ more than this 30–35 percent, there will be some less qualified workers, which will slow the others down as well. We are probably not mistaken when we say that in 3–4 counties in the Transdanubia region the employment share of multinational companies is around this limit. If multinational companies were to increase their staff from the employees of

small companies that are going under as a result of wage increases, their (previous) specific productivity level could discernibly decrease. It should be noted that international productivity statistics – as mentioned before – already substantiate this: labour productivity is lower in Hungary than in more developed countries, not only among small enterprises, but among large companies as well. We must add, however, that the main reason for this is not the inferior knowledge or motivation of the workforce, but the low added value of the activities and the less advanced management and organisational methods used here.

When it comes to wage increases, smaller companies are at a disadvantage, because wages there take up a greater share of value added. While a 20 percent wage increase results in a moderate decrease in a large company’s profits, at a smaller enterprise this can take away up to one third of the operating surplus. This means a large part of such companies may lose their profits, and their revenues may not even cover all depreciation costs.

Table 3 shows labour share by company size in Hungary.

In areas with high labour costs the current asset needs of financial management may significantly increase. For this, smaller companies should increase their circulating capital –

just as their profits are significantly declining because of the surge in their costs.

We believe that in the current situation, the EUR 850/person/month average wage in the SME sector²⁵ expected for 2018 should increase to EUR 1,150/person/month in the next 2 years.

This would have the following advantages:

- with a few wage increase steps (e.g. additional increase of the minimum wage) this group could earn around EUR 1,350/month,
- smaller companies could retain their employees more than they can now,
- tensions caused by the wage increase steps planned for the next 3–4 years would be much lower at smaller companies,
- with a higher wage dynamics in the SME sector, the wage increase in the whole private sector would steadily exceed 10 percent in the next 3 years. With that (calculating in euro), the wage gap (between Hungary and the other Visegrad countries, and between Hungary and German-speaking countries) could be decreased by at least 2 percentage points a year,²⁶
- wage increases at smaller enterprises would probably trigger wage increases at larger companies as well. This would generate additional revenues for the state.

Table 3

**LABOUR SHARE BY COMPANY SIZE IN HUNGARY, 2016,
PERCENT**

| Company size | Labour share |
|---------------------|--------------|
| Micro ²⁴ | 65.6 |
| Small | 64.2 |
| Medium | 59.6 |
| Large | 45.0 |
| Total | 52.8 |

Source: Own calculation based on Hungarian Central Statistical Office (KSH) data. Data source: 2016 wage survey, and A kis- és középvállalkozások helyzete hazánkban [The situation of small and medium-sized enterprises in Hungary], 2016 KSH

RECOMMENDATION FOR A SYSTEM OF TAXES/CONTRIBUTIONS DIFFERENTIATED ACCORDING TO COMPANY SIZE

We believe the following two measures should be considered in our tax and financial system:

① One is an adjustment that eases the tension that has developed at small enterprises as a result of migration and dramatic wage increases in recent years.

② The other is the introduction of regulatory elements that can decrease the competitive disadvantage of smaller enterprises as compared to multinational companies at system level.

AD 1: The automatic wage credit outlined below and its remission in the future can alleviate the difficulties small enterprises have had so far.

AD 2: In their article in Polgári Szemle, *László Árva* and *András Giday* described the core elements of a size-dependent social security system. According to that, a lower social contribution tax rate should apply to the first HUF 50 million of the companies' wage bill. The authors believed that a tax/contribution rate 7 percentage points lower than the prevailing rate should be considered. *'This reduction would apply to wages paid by every company. The difference between smaller and larger companies would be that in case of a company with 10–12 employees, the reduced rate would apply to wages paid throughout the year, while in case of a company with 200 employees, it would only apply to wages paid in January. As the wage bill reaches HUF 50 million, the standard rate would apply to the exceeding amount.'*

*According to our estimate, this system would result in a loss of state revenue of HUF 210 billion annually.*²⁷ (Giday-Árva, 2018).

Katalin Botos mentions that the Minister of Finance in the 1990 government had a concept about a price and wage reform where wages would have been increased and social

security contributions would have been decreased in such a way that it would not have blown the budget apart.²⁸

THE OUTLINE OF THE RECOMMENDED CREDIT SCHEME TO FACILITATE WAGE INCREASE IN THE SME SECTOR

Unfortunately, for Hungarian SMEs a substantial wage increase may pose serious problems even if taxes/contributions on wages are lower for these enterprises. This means that a state-supported credit scheme may be necessary to facilitate wage increase at SMEs.

We recommend that the government provide automatic, interest free wage credit to companies with 5–149 employees – approx HUF 1 million per employee. On the other hand, the government could say that it considers it desirable that wage dynamics among the companies concerned exceed the wage increase in other areas in the private sector. The government could encourage this by the remission of the wage credit of companies where the increase in the average wage exceeds the wage increase dynamics of companies with 150+ employees by the announced rate. Naturally the government could do so within the limits of the *de minimis* aid regulations.

One objective could be, for instance, to achieve a wage increase at companies with 5–149 employees that exceeds the otherwise expected wage dynamics by approx. 15 percent over two years.²⁹ The additional amount would be the 'desirable wage increase'.

THE EFFECTS OF THE MEASURES ON PUBLIC FINANCES

The potential effects of the outlined size-dependent wage increase credit scheme on the budget need to be examined.

State revenues

Table 4 shows the effects of the desirable wage increase.

Public expenditures

Table 5 shows the expected *de minimis* aid. Data in the table show that if we take a 3-year period, public expenditures are recovered mostly, since the higher wage levels at the companies concerned result in significant additional revenues.

As we believe that contributions need to be decreased, for a comprehensive view it must be added that if our recommendations are accepted, employees working at such companies today would not receive a lower pension when they turn 65.³⁰ It must be noted, however, that regardless of our recommendations, the Hungarian pension financing scheme is in need of reform,³¹ as, according to EUROSTAT, Hungary had one of the highest aggregate replacement rates in the EU in 2016.³² This is one reason why it is difficult to deal with the effects of ageing. State pension expenditure is

Table 4

| EFFECTS OF THE 'DESIRABLE WAGE INCREASE' | | | | | |
|--|------------------|------------|------------|------------|--------------|
| <i>billion HUF</i> | | | | | |
| | | Year 1 | Year 2 | Year 3 | 3-year total |
| Additional amount paid in wages | 5–19 employees | 208 | 208 | 208 | |
| | 20–149 employees | 110 | 353 | 353 | |
| | <i>Total</i> | <i>319</i> | <i>561</i> | <i>561</i> | |
| Taxes/contributions on additional amount paid in wages | | 167 | 283 | 272 | |
| Additional amount of sales tax* | | 53 | 93 | 93 | |
| Total additional amount of state revenue | | 220 | 377 | 377 | 974 |

Note: with a 15 percent additional amount paid in wages in 2018

*since net wages are spent

Source: own calculation

Table 5

| ESTIMATED <i>DE MINIMIS</i> AID | | | | |
|---------------------------------|--------------------------------------|--|--------------------------------|-----------------------|
| Company size | <i>De minimis</i> aid billion HUF | No. of employees thousand employees | No. of enterprises thousand | Credit billion HUF |
| 5–49 employees | 757 | 757 | 68.6 | 757 |
| 50–65 employees | 70 | 70 | 1* | 70 |
| 66–149 employees | 188 | 246 | 2.9* | 246 |
| Total | 1,015 | 1,030 | | 1,030 |
| *Estimate | 964 | | | |

*with 95% wage increase implementation

Source: own calculation from KSH data.

going to increase to 11.2 percent of the GDP by 2070 (from 9 percent in 2020).³³ Although in theory other budgetary sources may also be used for this purpose, it is less likely as (again, because of ageing) health and care expenditure will also rise (by 1 percentage point of GDP over this period).

CONCLUSIONS, THE INTERPRETATION OF OUR RESULTS

Previously we described, relying on literature and Hungarian data, that the essence of late 20th century 'neo-globalization' is that large transnational companies (TNCs) with sites in several countries efficiently exploit price and wage differences between countries. As a result, TNCs can organize production spatially in an optimal way and can make significant extra profits, which they usually send home.

Domestic SMEs are in a much more difficult situation, as they usually do not produce for the global market, and they must sell

their products and services locally, on a highly price-sensitive market. This means that in periphery countries, the almost only way for workers towards advancement is migration to core countries with higher wages and this, as we have pointed out, delivers a severe blow to the society in periphery countries.

The wage credit scheme we proposed and the size-dependent corporate taxation and social security system

- would decrease the competitive disadvantage small companies have had in recent years,
- or would at least slow down workforce migration.

The recommended measures would not upset the budgetary equilibrium. Moreover, and it is a key issue regarding future competitiveness, the Hungarian economy would not become even more one-sided and dependent, its national segment would get stronger, and, as a result, the Hungarian economy could join the present technological revolution innovatively and could contribute knowledge, while also relying on an effective and strong SME sector.

APPENDICES

Appendix 1

FORMATIVE ECONOMIC AND POLITICAL DEVELOPMENTS FOR HUNGARIAN SMES FROM 1998 TO DATE

MINIMUM WAGE INCREASE IN 2000–2001: the minimum wage was increased more than twofold in two steps. The government intended to provide compensatory aid over a 2–3 year period to counteract a major part of the effects in the most affected areas. However, as the socialist (MSZP) government took office in 2002, it immediately removed these,

which resulted in the loss of at least a hundred thousand jobs, a lot of them at medium-sized enterprises.

ARRIVAL OF MULTINATIONAL PRODUCTION COMPANIES (1999–2003): previously, capital that was moving to the so-called free zones only because of cheap labour created bases that were not or were only loosely connected to the Hungarian economy. As a result of the coming EU membership, the inflow increased even further, even though it was known that free zones would cease to exist in 2004.

A negative impact of multinational production companies was that they drained the labour force from Hungarian SMEs exactly where there was qualified labour (e.g. in Győr and Székesfehérvár, where they got sites at low costs) and their presence slowly destroyed even the majority of large Hungarian companies that were still standing. This was a severe blow to the sector of medium-sized companies, as larger local companies had many medium-sized industrial companies as suppliers.

THE APPRECIATION OF HUF (FROM 2001): the currency band of the Forint was widened in March 2001, which, unfortunately, allowed for speculative capital movements leading to the appreciation of the Forint. Import products appeared in the domestic market at somewhat dumped prices, which led to the decline of domestic production. Tens of thousands of jobs were lost.

BANK LENDING TO SMEs START: From 2001–2003, banks that had only been providing credit to medium-sized and large companies started to lend to micro and small enterprises as well.

THE EFFECTS OF OVERGENEROUS GOVERNMENT POLICIES ON THE ECONOMY AFTER 2002: the coalition government, trying to live up to its populist promises, provided generous 13th month benefits from external loans after 2002. A new tax (EVA) was introduced for the smallest (1 person) enterprises, with very low tax/contribution rate. For the SMEs this was beneficial in the short term (due to the recovery of the domestic market), but in a few years, things took a turn for the worse with the Öszöd twist and the speculative attack in 2008, followed by an EU excessive deficit procedure.

ÖSZÖD TWIST (2006): the goal was to increase tax revenues instead of reducing expenditure. It was mostly SMEs that were hit the worst by tax increases, and wealth gain inspections were conducted at a large number of small enterprises.

CONSEQUENCES OF THE 2004 EU ACCESSION: aggressive FDI inflow started in several service sectors, aiming to push Hungarian-owned SMEs from the market. At the same time, as the Hungarian customs system was dismantled and the Forint was strong, huge quantities of products were dumped on the market (from Brazil, China, and partly the EU) through western-owned retail chains. The losers in this process were the food industry, the clothing and footwear industry, etc.

THE FIRST PHASE OF THE CRISIS IN 2008–2009: in taxation, the crisis resulted in the reversal of the steps taken 3 years earlier (decreasing taxes/contributions on wages, substantial VAT increase). The contraction of the domestic market and the increasing interest rates triggered a wave of liquidations in the SME sector. Substantial aid to safeguard jobs was provided to large and medium-sized companies, but not to micro and small enterprises.

The second phase of the crisis in 2010–2012: special taxes introduced after 2010 for deficit reduction did not apply to SMEs, but in the second phase of the W curve of the crisis, the government further increased VAT as well. A discussion of the crisis must include that drawing the 2007–2013 EU funds did not alleviate the scope of the crisis and only had significant stimulus effect from 2012–2013.

ECONOMIC POLICY MEASURES TO TACKLE THE CRISIS: PARENT BANK DELEVERAGING AND THE NHP (FUNDING FOR GROWTH SCHEME): During the crisis, western parent banks, especially in Austria, tried to improve their position in their home country by scaling down their lending in Central Eastern Europe. So much so that the IMF itself initiated that this process should be stopped (Vienna Initiative 2009 and 2011). Later, the NHP (2013–2016) launched by the new president of the MNB provided effective help in renewing credit flows to the SME sector.

FURTHER ECONOMIC POLICY MEASURES TO DEAL WITH THE CRISIS: THE TRANSFORMATION OF VAT: For SMEs it had a twofold effect. The shift to flat rate left income with the population and, in theory, facilitated the expansion of the market. On the other hand, the elimination of the employee tax credit led to a decrease in incomes, which was neutralized by a so-called expected wage increase by the government (it was mandatory for employers to increase below-average wages)³⁴. Because of the still subdued domestic demand, many SMEs could hardly afford that.

MEASURES TO INCREASE THE TRANSPARENCY OF THE ECONOMY: Since 2013, new measures have been introduced to increase the transparency of the economy, and, we must add, these have been effective (VAT cut in certain areas, online cash registers, EKR [Electronic Public Procurement System], online invoicing). However, the effects of this programme and the tax cut it 'financed' are not balanced. Most of the additional state revenues came from the SME sector due to the extraordinarily high VAT rate in Hungary, but almost half of the tax cuts helped large and multinational companies (due to the decrease in social security tax and corporate income tax).

These include a special measure, the 'replacement' of EVA with KATA. First the tax

rate of EVA was increased in several steps, and later 2 new taxes were announced (KATA, with extremely low taxes/contributions and KIVA). The real winners of the change were mostly micro enterprises.

THE EFFECTS OF THE MASS MIGRATION OF THE WORK FORCE: Once the restrictions protecting the German and Austrian labour market were lifted, a mass migration of Hungarian workers, many of them skilled workers, to Western Europe started in 2011. Over 6 years (since 2012), the number of Hungarian citizens living in German speaking countries has increased by 150 thousand, and the majority of these people work there. The first significant response came only 5 years later.

MEASURES TO OVERCOME SHORTAGE OF LABOUR: A significant wage growth trend started in 2016, bolstered by an agreement between the government and its partners in November 2016. However, no measures have been taken to improve the poor market position of the majority of SMEs, so prices are still depressed. This means the SME sector can only partially pass through its increasing wage costs.

THE EFFECTS OF EU FUNDS ON THE HUNGARIAN ECONOMY IN THE 2013–2020 PROGRAMMING PERIOD: From 2017, this has significantly improved the opportunities of the SME sector as well.

Appendix 2

DESCRIPTION OF THE CREDIT SCHEME AIMED AT FACILITATING WAGE INCREASE

Unfortunately, for Hungarian SMEs a substantial wage increase may pose serious problems even if taxes/contributions on wages are lower for these enterprises. This means that a state-supported credit scheme may be necessary to facilitate wage increase at SMEs.

We recommend that the government provide automatic, interest free wage credit to companies with 5–149 employees – approx. HUF 1 million per employee. On the other hand, the government could remit the wage credit of companies where the increase in the average wage exceeds the wage increase dynamics of companies with 150+ employees by the announced rate.

This could be achieved in the following way.

▶The government announces that it expects an additional wage increase for specific size categories that exceeds the 'recommended' (say 8 percent) wage dynamics by 15 percent for the next year(s) for the majority of the SME sector (this additional amount is the 'desirable wage increase').

▶The state provides an automatic wage

credit of HUF 1 million per employee to every company with 5–149 employees.³⁵

▶The state takes over the automatic wage credit from companies that have increased wages at least at the desired (additional) rate. This could be done in the spring of the year following the year concerned, in the form of aid, more specifically the so-called *de minimis* aid, within which EUR two thousand (over 3 years, in total) can be granted to individual companies.³⁶

Appendix 3

RECOMMENDED RATE OF WAGE INCREASE

Recommended rate and scheduling of wage increase by size categories, see *Table 6*.

Table 6

| RECOMMENDED RATE AND SCHEDULING OF WAGE INCREASE | | | | |
|--|--------------|--------------|--------------|--------------------------------|
| Companies with 5–49 employees | Year 1, % | Year 2, % | Year 3, % | 3-year effect, cumulated, % |
| Wage increase expected otherwise | 8 | 8 | 8 | 126,0 |
| Desirable wage increase | 15 | | | 115,0 |
| Total wage increase | 23 | 8 | 8 | 132,8 |

| Companies with 50–149 employees | | | | |
|----------------------------------|--------------|--------------|--------------|--------------------------------|
| Companies with 50–149 employees | Year 1, % | Year 2, % | Year 3, % | 3-year effect, cumulated, % |
| Wage increase expected otherwise | 8 | 8 | 8 | 126,0 |
| Desirable wage increase | 5 | 10 | | 116,0 |
| Total wage increase | 13 | 18 | 8 | 144,0 |

NOTES

¹ We are well aware that further analysis of the ratio of wages by ownership within the size categories would provide more information. This is because there are definitely some companies classified as SMEs that substantially

have an identity of interest with TNCs (e.g. certain foreign-owned project companies in the construction sector).

² See also Maddison (2007)

- ³ For the latest system of globalization based on transnational companies see the papers by Árva (2018), and Giday and Árva (2018) in Polgári Szemle.
- ⁴ E.g. Celso Furtado (1956) and Raul Prebisch (1950)
- ⁵ For this, see the article by Giday-Árva (2018) in Polgári Szemle.
- ⁶ Another term used is transnational companies
- ⁷ For this, see UNCTAD, 1996, p. 103
- ⁸ Social tension was especially high in countries where workers could legally settle and seek employment in rich core countries, but illegal migration also intensified.
- ⁹ For details see reports by the Hungarian Demographic Research Institute
- ¹⁰ In addition to taxes/contributions on wages (personal income tax, social security contributions), of course linking corporate income tax to corporate size could also be considered. Size-linked corporate income tax has been successfully implemented in several member states of the EU (see EU Commission, 2015), and in Hungary such a system existed until 2017.
- ¹¹ See: European Commission, 2017, p 44
- ¹² Small Business Administration
- ¹³ Micro enterprise: up to 9 employees, small enterprise: 10–49 employees, medium-sized enterprise: 50–249 employees.
- ¹⁴ These are the famous German Mittelstand companies with successful innovation and export activities, also referred to as 'Hidden Champions'.
- ¹⁵ Tusványos Open University and Student Camp 24–28.07.2018
- ¹⁶ World Economic Forum
- ¹⁷ They also indicate that excessive administrative obligations should be limited and frequent changes in legal regulations should be avoided. A better communication of the SME sector's interests to the government should also be considered.
- ¹⁸ These difficulties are the arguments for establishing and maintaining SME development agencies all over the world.
- ¹⁹ Katalin Botos presented this on the German example in detail, see Botos (2005)
- ²⁰ No similarly short Hungarian expression exists for describing the phenomenon of being understaffed
- ²¹ This lack of information is a major hurdle when it comes to SMEs accessing grants. This means it is usually more useful to support SMEs with automatic solutions that do not require grant watch and grant application writing.
- ²² 'In 2016 in Poland, 84 percent of the employees of small enterprises were (with 87 percent of revenues) at small enterprises that had been operating for at least 5 years' (Giday-Árva, 2018). In Hungary there is no business demography data available to calculate such rates.
- ²³ Salamonné, H. Anna, p 19
- ²⁴ Own estimate
- ²⁵ Employees' wages at companies with a staff of at least 5.
- ²⁶ In 2017–18, an annual 6–8 percent nominal wage increase is expected in the private sector in the Visegrad countries with an autonomous currency policy, and because of wage inertia, it will, at most, decrease only gradually. Growth exceeding this would require a 10 percent rate in Hungary (con-

sidering a potential significant weakening of the forint).

²⁷ Own calculation. The source of data for that, <https://nfsz.munka.hu/bertarifa/adattar2017/index.html>, and <https://www.ksh.hu/docs/hun/xftp/idoszaki/valldemog/valldemog15.pdf>

²⁸ Botos (2015) p 501

²⁹ If, for example, the expected wage increase dynamics is 8 percent both in 2019 and 2020 in the private sector, wage increase among these companies would be exceeding this by 15 percent, i.e. it would be 31 percent (over two years).

³⁰ According to the current rules of pension calculation, the amount of the pension set does not depend on the amount of contributions paid by the employer.

³¹ Since an amendment of retirement regulations with a retrospective effect is not acceptable, measures

need to be taken in the coming years to avoid excessive pension expenditure after 2040.

³² Aggregate replacement rate is calculated as follows: gross pension of the 57–74 age group divided by the gross income of the 50–59 age group. See: EUROSTAT (2018)

³³ Convergence Programme of Hungary 2018–2022, p 82, table

³⁴ See Giday (2017) p 135

³⁵ With the help of guarantee and MNB refinancing credit.

³⁶ *De minimis* aid is special aid tolerated by the EU. Due to the small amount, it is not subject to notification procedures. Currently an enterprise can be granted EUR two thousand over a 3-year period without being subject to notification procedures. For details, see <http://tvi.kormany.hu/de-minimis>.

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