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HOW TO HELP HUNGARIAN COMPANIES STRENGTHEN?

Policy proposals of the Equilibrium Institute on the renewal of the system of state subsidies

Equilibrium Institute

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on the renewal of the system of state subsidies

2023-03

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Future for Hungary

Equilibrium Institute

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EXECUTIVE SUMMARY

01

Hungary's accession to the European Union offered an unparalleled breakthrough opportunity for Hungarian businesses and, through them, the strengthening of the entire Hungarian economy. In the past nearly two decades, Hungary has been one of the main beneficiaries of EU funds, while the state has spent a lot (double the EU average in recent years) on business development. However, the data so far show that Hungary has not managed to take advantage of this historical opportunity. Although catching up has undoubtedly taken place, the productivity of small and medium-sized enterprises, which are typically domestically owned, is still far behind that of the multinational companies operating in Hungary, and even that of similar-sized enterprises in other Visegrad countries. In addition, in regional comparison, very few domestically owned enterprises have succeeded in becoming international champions, i.e. dominant companies in the international market.

02

Therefore, it is necessary to examine what we can learn from the experience so far: have we properly used the resources flowing into the Hungarian economy? In what form and which companies should be supported? Can we learn from the example of successful countries? What should we do differently if we want to effectively contribute to the strengthening of Hungarian companies and increase our competitiveness?

03

The four main characteristics of Hungarian development policy up to now are: 1. it focuses on attracting capital operating abroad; 2. it is strongly redistributive and internalised in many elements; 3. SMEs receive relatively little state support; 4. subsidies are focused on the manufacturing industry. The Hungarian method differs from previous successful developing states in that it primarily relies on foreign direct investment (FDI). At the same time, we do not know of a successful country in history that in a similar way led its economy out of the trap of the middle-income trap through foreign capital concentrated in the manufacturing industry.

04

Within the EU, Hungary spends the most on state subsidies: 2.4 percent of GDP per year in the previous EU budget cycle, compared to the EU average of 1.2 percent. This leads to a strong redistribution of income, as even EU resources require significant co-financing from the domestic budget.

05

Today, after Ireland, Hungary is the country in the EU most dependent on foreign companies. In Hungary roughly half of the added value produced by the private sector is produced by foreign-owned companies, which is well over the EU average standing around 30 percent.

06

Foreign direct investment is both an opportunity and a risk. Its advantage is that it improves macroeconomic indicators in the short term, and the benefits of this are also enjoyed by domestic enterprises. At the same time, its disadvantage is the typically low value-added production and the low level of spillover effect - that is, it hardly helps to improve the productivity of domestic enterprises compared to its costs. Another disadvantage is that, due to the remittance of the owner's income, it is an expensive form of financing overall compared to other alternatives. In addition, the presence of multinational companies absorbs labour from domestic companies in a labour shortage situation. Overall, economic development based mainly on foreign capital is not a convergence path. The main lesson of the positive European examples starting from a similar historical and economic situation (such as Estonia) is that the state enterprise financing strategy can only be successful if the state does its homework in the fields of education, tax system and public administration.

07

The subsidies, which are primarily aimed at domestic SMEs and are not distributed on an individual basis, have not been able to result in meaningful catch-up in the past decades: although the subsidies paid through operational programs improve the main business indicators of companies (fixed assets, number of employees, sales revenue), they generally do not increase efficiency, for example, labour productivity. In addition, in years when EU funds flow intensively into the country, companies receive roughly twice as much support as they contributed in corporate tax.

08

Therefore, according to the proposal of the Equilibrium Institute, the most important and at the same time the most effective way of business development policy is not the financial support of businesses from state resources, but the consistent, intensive investment in the knowledge of Hungarians - the most important structural problems of the corporate sphere (the lack of skilled labour, the low added value, outdated production technologies, etc.) the profound reform of public education is the most beneficial solution.

09

We should use large amounts of individual grants for social and patriotic purposes, exclusively In Free Enterprise Zones (FZZs)! In this way, we can support the retention of the population and the creation of jobs in the declining regions. We should only support multinational companies if there is no Hungarian company that could exercise a similar effect in the region!

10

Research and development support should only be disbursed if domestic players also benefit from it! Only consortia and clusters including research institutes or domestic companies shall receive R&D support! Instead of focusing on the manufacturing industry, let's support services and creative sectors! In addition, we should only support investments that do not impose a significant additional burden on the state infrastructure and are energetically self-sufficient!

11

Let's support the companies that are relatively small in size today, but are already classified as large companies (250-1000 employees)! Let's regroup from the frames intended for individual grants to our elite programs - help the creation of international champions!

12

Lower state aid rates! In other words, the state or the EU should support projects with smaller amounts - this way, more beneficiaries could benefit from more effective and less distortive help.

13

Let's involve the banks in the disbursement of state subsidies! Banks should also add their own money in addition to the state subsidies! By involving the banks more intensively, let's relieve the overloaded Managing Authorities, thereby speeding up the evaluation of applications!

14

Generous financial aid conditions should be awarded at the cost of training employees!

15

Instead of supporting one priority production sector, the development policy should focus on long-term social needs such as the green transition, climate adaptation, digital transformation or the ageing of society!

1. WHAT IS THE PROBLEM?

Our accession to the European Union offered an unparalleled opportunity for Hungarian businesses to break out. **In the past nearly two decades, Hungary has been one of the main beneficiaries of EU funds, while the state has spent a lot of its own funds on business development, even in a European comparison.** The possibility has opened up in principle to break the dualised structure of the Hungarian economy, i.e. to reduce the gap between the productive multinational companies that are prominent in international competition, and the less competitive domestically owned enterprises that have difficulty breaking out of the domestic market.

However, the data so far show that we have not managed to take advantage of the historical opportunity. Although there has undoubtedly been some catching up, the productivity of domestically owned small and medium-sized enterprises is still far behind that of multinationals operating here or regional enterprises of similar size, while in regional comparison, very few domestically owned enterprises have succeeded in becoming international champions. This is especially surprising if we take into account how much EU and budget resources we spent on corporate subsidies, or if we compare the extent of Hungary's catch-up with the progress our closest regional competitors were able to show.

In doing so, of course, the question arises as to **how to determine the purpose of business development grants.** In the case of small, capital-poor post-socialist countries like Hungary, the development policy must always take into account the structural obstacle of a lack of capital, as well as the fact that we started at a significant disadvantage in the opening towards European markets, both in terms of the number of already existing domestic companies, the structure of the economy, and the culture of innovation and work considering. It is no coincidence that all the governments that followed the regime change treated foreign capital and the ability to attract foreign investments to Hungary as one of the key factors of our competitiveness. **According to the dominant argument since the very beginning of the nineties, the "pulling effect" of multinational companies settling in Hungary is indispensable for the strengthening of the domestic corporate sphere** - they argued that the spillover effect associated with the activities of multinationals (supplier chains, technology and innovation, work culture) is ultimately the key to the strengthening of domestic companies due to the interrupted traditions of the market economy.

More than three decades after the regime change and almost two decades after Hungary's accession to the EU, it is worth examining the lessons that can be drawn from experience and data. We are looking for answers to the following questions below:

- What characterises the past twenty years of Hungarian business development policy?
- What results emerge from the data – has the abundance of resources given to the corporate sector turned out to be a blessing or a curse?
- Does the form of subsidies matter? Which is better: non-refundable aid or loan subsidies and tax incentives?
- Can the direction of the development policy based on foreign direct investment (FDI) be sustained?
- Can we learn lessons from the examples of more successful countries?
- What should we do differently if we set ourselves the goal of being able to substantially help the strengthening of domestic companies in the next decade?

Below **we will only examine the utilisation of business development subsidies, as they fundamentally influence the productivity of the Hungarian economy and, consequently, the evolution of our ability to converge.** In doing so, we will not differentiate between support programs financed exclusively from domestic sources and support programs of EU origin. Although the operation of the two is determined by different regulations in many aspects, in terms of their results they typically do not differ from each other, since they must comply with the same EU legal framework. That is **when we are talking about state aid, it is not the origin of the funds that is important, but the fact that the state distributes them among enterprises.** Since the agricultural sector is supported in a system with a fundamentally different logic, we limit our investigation to companies in the non-agricultural sector. We also do not deal here with the public procurement system, in which case the state does not act as an investor, but as a direct customer, and the procedure itself follows a fundamentally different logic.

First, **we examine the advantages and disadvantages of the FDI-based Hungarian economic model.** After that, we will examine the data measuring the effectiveness of the subsidies, and we will complement this picture with the results of our consultations with the entrepreneurs and experts involved.[1] Finally, we **formulate proposals for the renewal of the state grant system.**

"The productivity of domestically owned small and medium-sized enterprises is still far behind that of multinationals operating here or regional enterprises of similar size, while in regional comparison, very few domestically owned enterprises have succeeded in becoming international champions."

1 In the course of 2022, the experts of the Equilibrium Institute discussed the business development system with the representatives of the participating businesses in 10 rural and 3 Budapest locations, in the framework of personal group consultations. Quantitative and qualitative results were filtered from the responses of the approximately 170 respondents. In addition, we conducted in-depth interviews with 6 experts. We asked experts who are involved in policy, executive or mediation, or who have insight into more than one of these areas, to present their expert opinion.

1. A BLESSING OR A CURSE? – LESSONS FROM HUNGARIAN BUSINESS DEVELOPMENT

From the point of view of the development of every company, it is crucial to have the necessary resources at its disposal. The latter can basically be divided into two larger groups:

- **resources from normal market operations (mostly sales);**
- **practically "free" resources: such as abundant natural resources (e.g. oil, diamonds) and state subsidies.**

In the case of "free" resources, **the state deviates from the usual logic of the market economy to correct some of its failures.** The most important dilemma is whether the deviation from the market logic is not sometimes specifically harmful to the functioning of the market.

For the permanent influx of significant business development transfers into the national economy – if we disregard the development aid of the developing world –**we find examples primarily in Europe. The subsidies can be used effectively, the development of some East-Central European states (Estonia, Slovenia, Czech Republic) and Ireland also demonstrates this spectacularly**.[2] On the other hand, southern states, primarily Greece and Portugal, are typically included in the list of countries that could not live with the opportunity given by the EU funds. Although they have been net beneficiaries of the EU budget since their accession more than forty years ago, they have not been able to take advantage of the opportunities provided by the "treasures". In fact, the "free" money that is poorly used, but almost guaranteed to arrive year after year, has sometimes directly hindered competitiveness in a similar way to natural resources increase. All this proves that **"free" resources can be as much a curse as a blessing - which, of course, depends on how individual states use them.**

What is the situation in Hungary? **Does the "free money" given to companies help the development of the Hungarian economy?** Does it really strengthen Hungarian companies, contributing to breaking out of the middle-income trap? Or, on the contrary, does it directly harm the competitiveness of the Hungarian economy due to its market-distorting effect and inadequate targeting? The raising of the question is particularly relevant from the point of view of Hungary, because compared to other countries **corporate capital transfers have played an extremely important role in Hungary for a long time. In Hungary, the ratio of both broader state subsidies and business development subsidies to GDP far exceeded both the regional and the EU average even before we joined the EU.** ***(Figures 1-2)*****.**

> ..."free" resources can be as much a curse as a blessing - which, of course, depends on how individual states use them.

2 Of course, the development of countries cannot be limited to a single factor. In addition to capital inflows, joining the EU also offers the opportunity to catch up through many other channels, such as legal harmonization and the free flow of goods, capital, people and services.

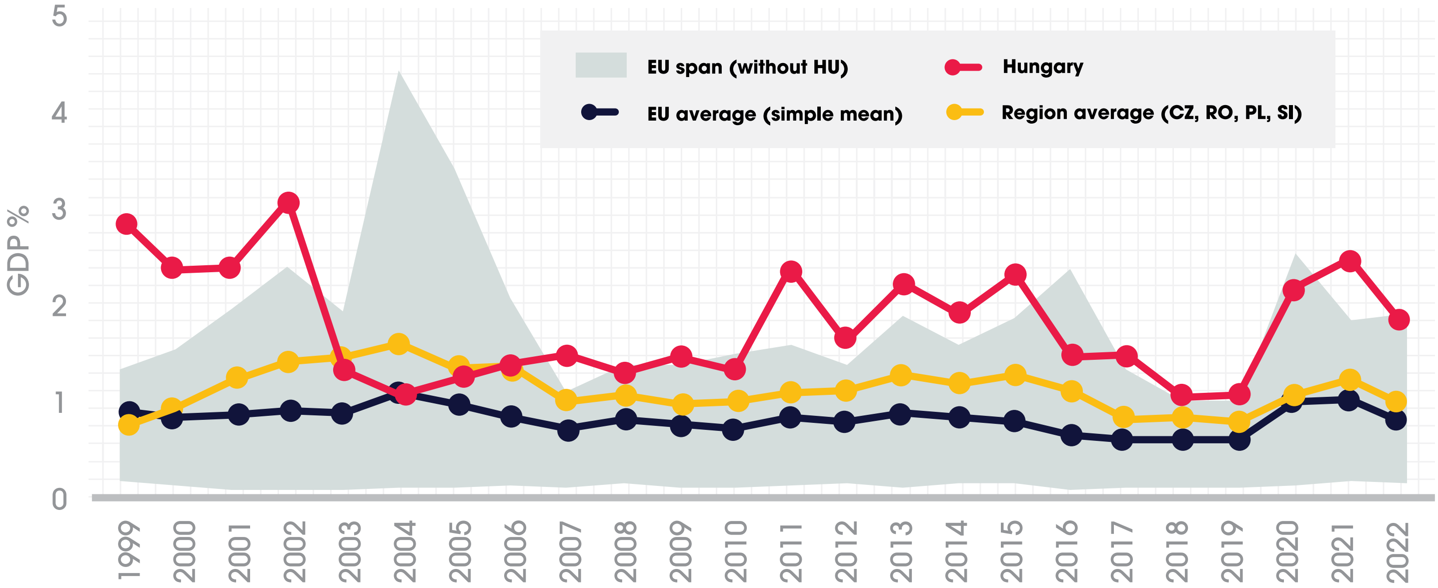

Figure 1: Capital transfers received by non-financial companies (source: calculations by Equilibrium Institute based on Eurostat data)

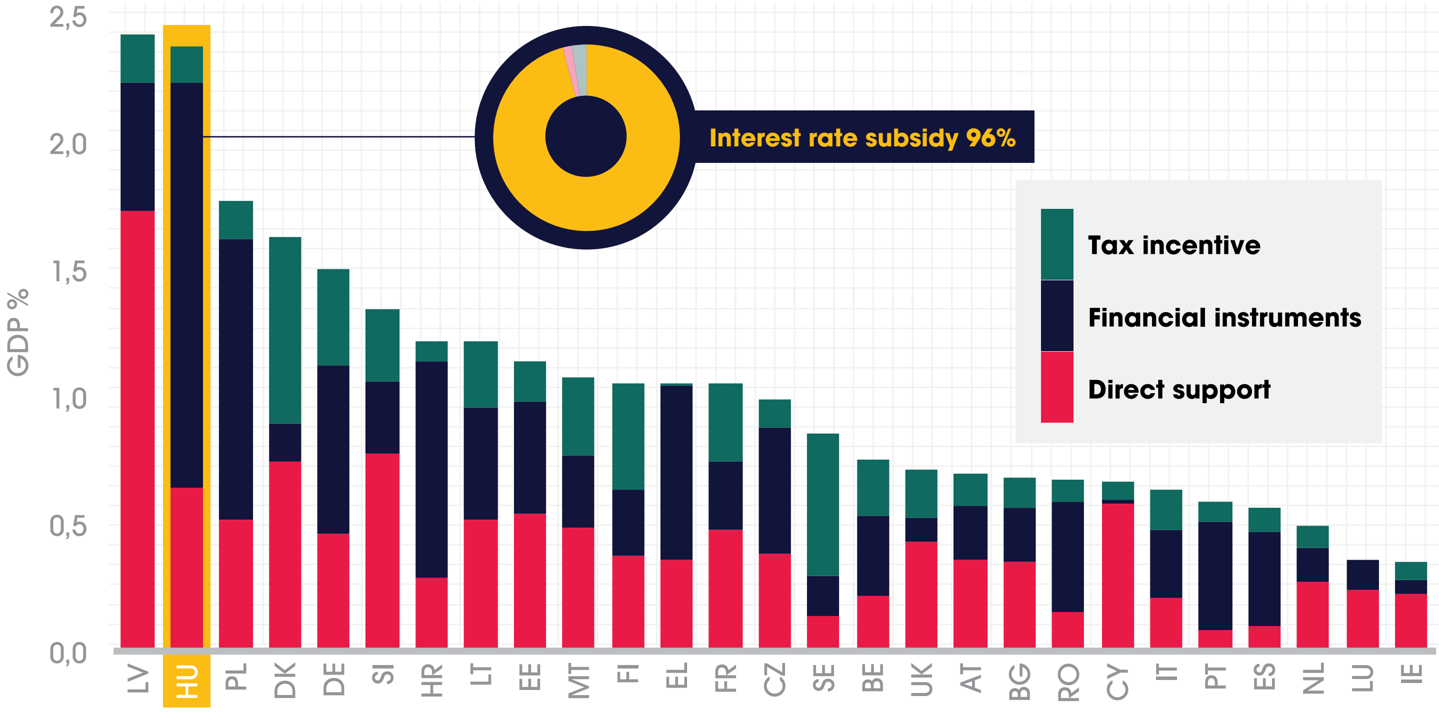

Figure 2: The average GDP-proportional value of the state subsidies notified to the European Commission by between 2015 and 2020[3], mean of the period (source: calculations by Equilibrium Institute based on data from Eurostat and the European Commission)

3 Note: Direct subsidies are non-refundable funds, while financial instruments are typically loans, interest subsidies, guarantees or venture capital investments. Figures 1 and 2 cover different circles, so they cannot be compared.

2.1. FOUR CHARACTERISTICS OF THE HUNGARIAN DEVELOPMENT POLICY

Hungary's industrial policy **is implemented in a more globalised production structure** compared to historical examples. **Moreover, Hungary is a member of the EU and WTO, which limit all forms of protectionism.** However, the Hungarian development policy shows different emphases compared to historical examples in at least four additional aspects.

2.1.1. FOREIGN CAPITAL FOCUS

While **intensive reliance on domestic property** was common in previous Western and Asian industrial policies, **since the 1990s, Hungarian economic policy has increasingly relied on foreign working capital (*foreign direct investment*, hereinafter: FDI). Today, after Ireland, Hungary is the country in the EU most dependent on foreign companies** *(Figure 3)*.

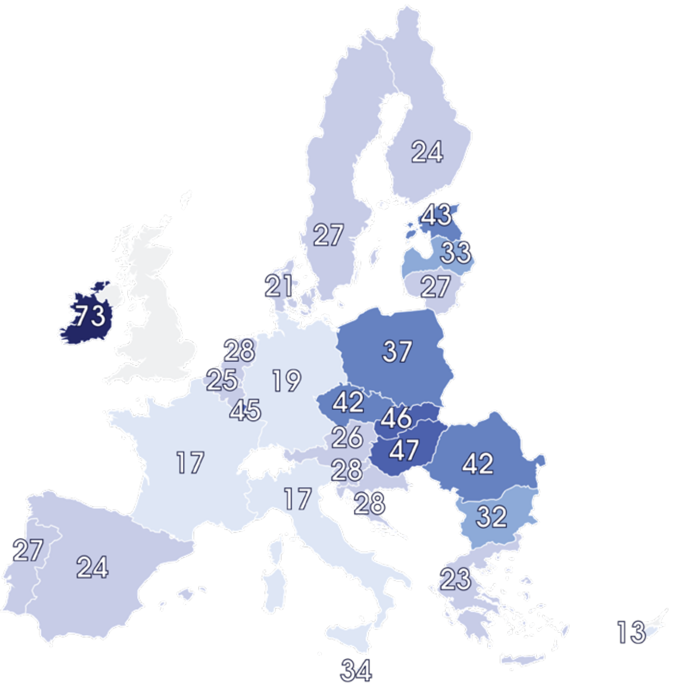

Figure 3: The added value produced by foreign-owned companies as a proportion of the total added value of the private sector, 2019 (source: Eurostat)

In Hungary **roughly half of the added value produced by the private sector is produced by foreign-owned companies, which is well over the EU-average figure of 30 percent.**

Among the beneficiaries of the largest amount of subsidies were several foreign companies – which, by the way, is more the case, the further east we go on the map of Europe *(Figure 4)*. Hungary still follows this development policy. **Even compared to Slovakia, Hungary favours to a great extent foreign capital in its investment support decisions.**

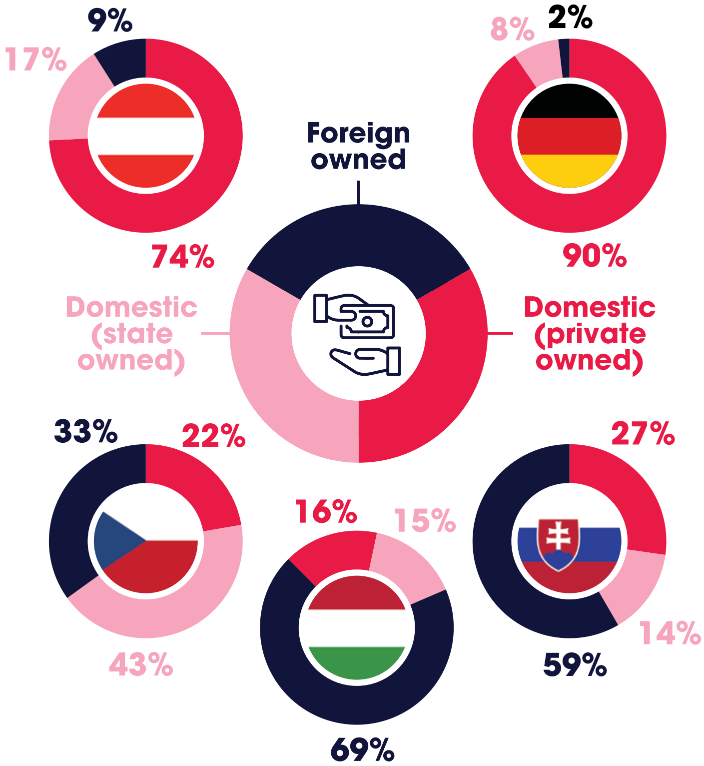

Figure 4: The 20 largest state aids between 2016 and 2022, according to the ultimate owner of the subsidised company (source: calculations of the Equilibrium Institute based on data from the European Commission)

2.1.2. STRONG REDISTRIBUTION AND CLOSED STRUCTURE

In addition to FDI, the Hungarian state provides increased support for capital concentration in priority sectors, as well as for SMEs in general -however, compared to the size of the target group, SMEs get much less emphasis. Capital concentration, i.e. the formation of a narrow circle of prominent players, started primarily in the fields of agriculture, the financial sector, info-communication services and the construction industry.

In the case of corporate capital transfers (i.e. where there is no public procurement, acquisition, etc.), a typical pattern is that when EU funds flowed more intensively into the country (2010–2015 and 2018–2021) **companies roughly received twice as much support as they contributed in corporate tax to the central budget** *(Figure 5)*. Of course, businesses do not only pay corporate tax, but if we include all corporate withholding taxes in the corporate payments, the redistribution in the competitive sector is still very significant.

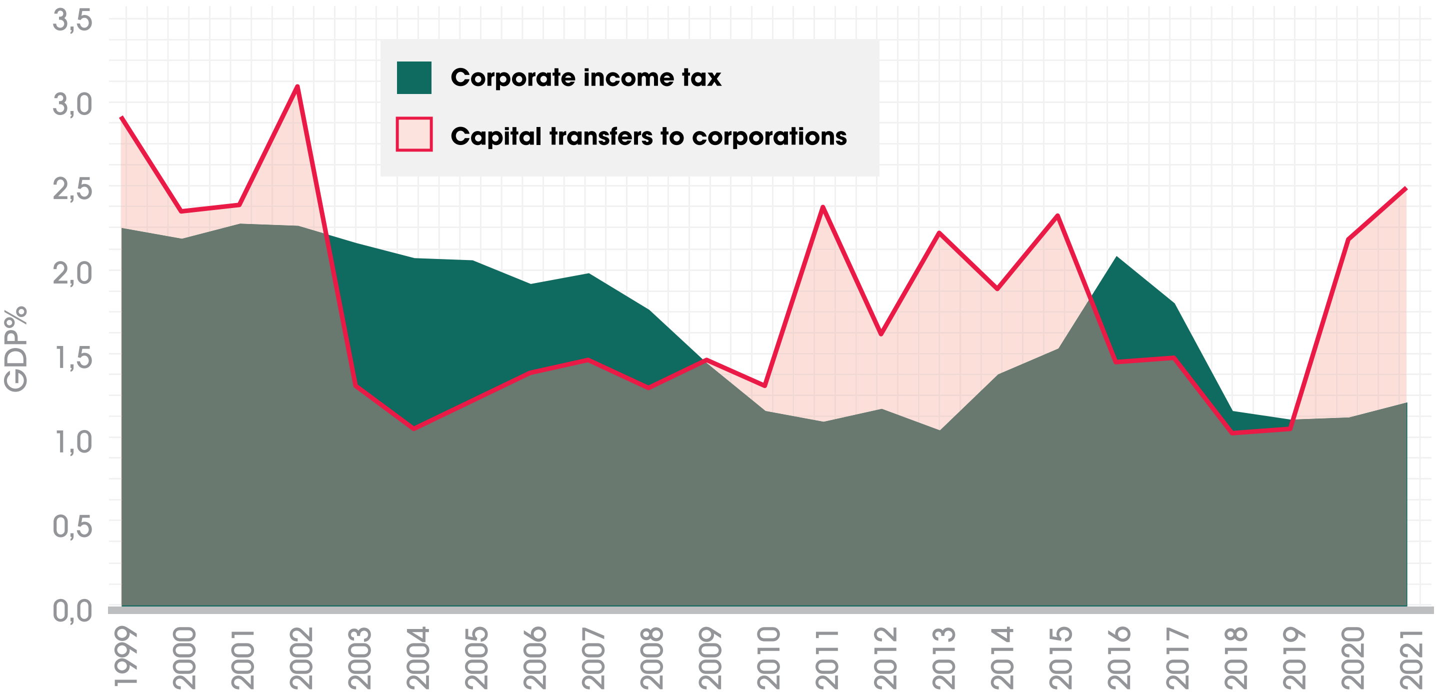

Figure 5: Subsidy redistribution within GDP: corporate capital transfers and corporate income tax revenues (source: calculations by the Equilibrium Institute based on KSH data)

The redistribution can also be observed within EU funds, and is even significant if we take into account that in the case of EU funds, part of the subsidies were not produced domestically - in other words, we are not talking about redistribution in relation to some of the subsidies, but partly about Brussels-origin “free money”. **The concentration can be seen in the fact that 52 percent of the grant amounts awarded (financed from EU sources) in the last decade went to routine applicants who had at least 5 projects during this period.**

2.1.3. SMEs RECEIVE RELATIVELY LITTLE STATE SUPPORT

The most important financial source of support for SMEs in the EU are **cohesion funds**. The so-called operative programmes, covering the vast majority of SME grants, support **target areas only slightly related to SME development goals,** instead, infrastructure development was the dominant area *(Figure 6)*. The fact that SME goals are present with little weight in Hungary does not stand out from the European pattern, that is, the Hungarian experience is not special in this respect. (Presumably, it would not significantly change the overall picture if we also had information on the funds allocated through non-operational programs.)

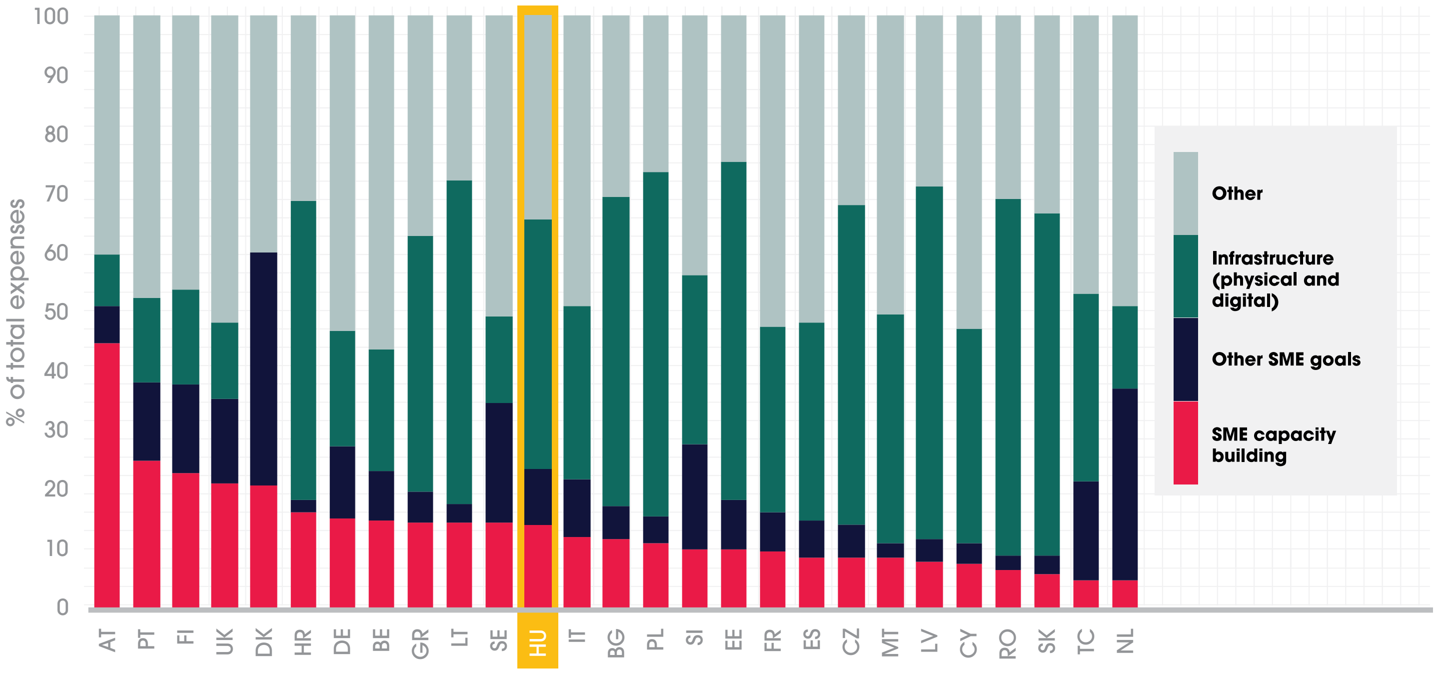

Figure 6: The resources allocated through operational programs for the 2014-2020 EU budget period thematic distribution (source: calculations by the Equilibrium Institute based on data from the European Commission)

When comparing the split of grants allocated between multinational companies and other companies (typically SMEs), it is important to see that corporate subsidies take place through two main channels:

01 INDIVIDUAL GRANTS INTENDED FOR LARGE COMPANIES

These sources, which mainly go to multinational companies, amounted to about HUF 200 billion in 2020.

02 SUPPORT RESOURCES FOR A WIDER AUDIENCE

Including tax benefits, the Széchenyi Card and funds allocated through operational programs - funds, which significantly benefit domestic small and medium-sized enterprises, amounted to about HUF 1,750 billion in 2020.

> Overall, the cost (and return) of luring a multi here can be orders of magnitude higher than the direct subsidy amount.

The relative ratio of these two forms of support shows that **almost ten times as much support goes to non-large companies as to large (international) companies**. At first glance, this may suggest a strong SME preponderance – but if we take into account that, in terms of their absolute number, SMEs make up much more than 90 percent of the corporate sector, and that more development is needed in the case of SMEs in the first place, **the proportion of individual support programs can be considered particularly high**.

Besides, **it is impossible to accurately estimate the total cost of supporting multinational companies.** The reason for this is that in the case of investments in the manufacturing industry (mainly greenfield) the state often **implements costly infrastructure improvements**: builds an access road, works on public works, and sells plots at a discount. That way overall, the cost (and return) of luring a multi here can be orders of magnitude higher than the direct subsidy amount.

2.1.4. MANUFACTURING INDUSTRY FOCUS

During the last EU budget cycle, the main target group of subsidies intended for a wider audience in Hungary was the manufacturing industry. Compared not only to Austria but also to the Czech Republic, Hungary spent a lot on supporting manufacturing companies - only Slovakia can compare with us in this regard *(Figure 7)*.

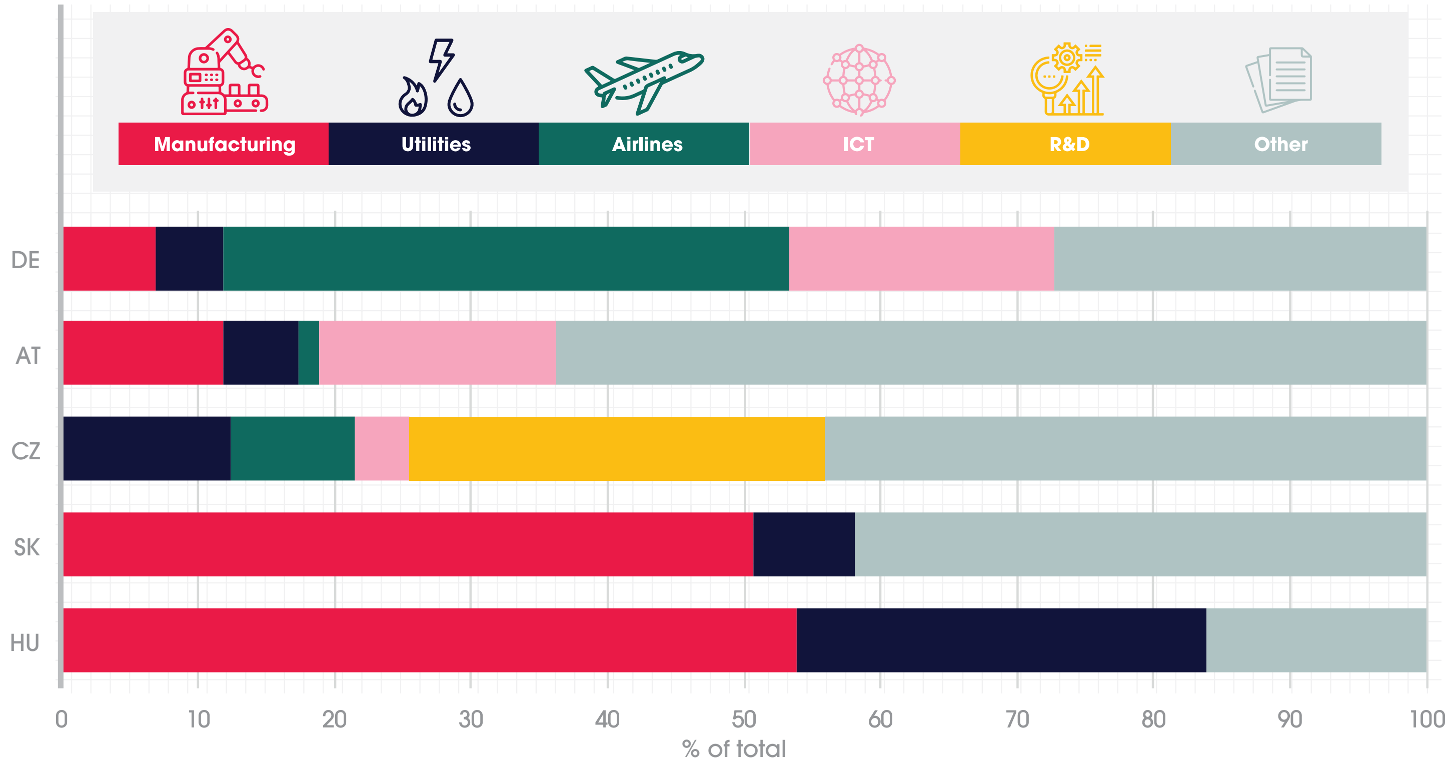

Figure 7: The 20 largest state aids sanctioned between 2016 and 2022, according to the sector of the company supported (source: calculations of the Equilibrium Institute based on data from the European Commission)[4]

4 The extraordinary subsidies due to COVID may slightly distort the comparability between countries, but the overall picture is unlikely to be modified in terms of magnitude.

Based on what has been said so far, we can summarise the characteristics of the Hungarian business development policy in two simple statements:

01 **FDI-based development, with a focus on the manufacturing industry: we are building our convergence on foreign direct investments, despite the fact that successful developing countries of Asia or Western Europe followed the opposite path.**

02 **Strong redistribution: within the EU, Hungary spends the most on state subsidies: 2.4 percent of GDP per year in the previous EU budget cycle, compared to the EU average of 1.2 percent. This leads to a strong redistribution of income, as even EU resources require significant co-financing from the domestic budget.**

2.2. ADVANTAGES AND DISADVANTAGES OF FOREIGN CAPITAL

The presence of foreign direct investment (FDI) holds both opportunities and risks. The two most important advantages are:

- As these companies usually generate an export surplus, our macroeconomic situation also improves (more foreign exchange earnings, positive foreign trade balance, and increase in GDP).
- The results of this can be indirectly enjoyed by other companies, for example through the stability of the exchange rate or low interest rates.

The main disadvantages of FDI:

- **The typically low added value production**, i.e. a high proportion of so-called assembly activities.
- **The spillover effect to the Hungarian economy is too small** (island-like operation, there are no spinoff Hungarian companies).
- **Working capital is a more expensive source compared to debt financing or EU subsidies.** Although in the short term a foreign investment is undoubtedly cheaper than financing a development of a similar scale with public debt, due to the fact that the foreign owners remit a significant part of the generated income, in the long term we can speak of an overall more expensive source.

FDI may bring a growth-surplus up to a certain level of development, but after that is reached, it becomes a particularly expensive form of financing. Thus, FDI alone is not enough to get out of the trap of medium development.

"FDI may bring a growth-surplus up to a certain level of development, but after that is reached, it becomes a particularly expensive form of financing. Thus, FDI alone is not enough to get out of the trap of medium development."

Several factors simultaneously prevent the glass ceiling from being broken through for the FDI-driven Hungarian economy:

- **As foreign direct investment typically thinks in terms of global value chains, it hardly relies on local resources, so there is not a sufficient spillover effect towards domestic companies.** Together with Slovakia, Hungary adds the lowest domestic added value to a unit of export product in the entire EU. **By supporting import-intensive activity, we are actually generating demand for a unit (and its workforce) in another country.**

- **Compared to state subsidies and the labour force absorbed, only little income is generated from FDI.** Detailed analysis showed that foreign-owned companies are able to significantly reduce their tax burden using various methods. In addition, the wage share within the added value is lower than in the case of domestically owned companies. **To put it more simply: in the case of a domestic company, both profit and wages are used at home, but in the case of multinationals, only the wages remain in the domestic economy.**

- **Grants aimed at financing supplier activities cannot be a successful strategy either.** The reason for this is that the profit rate decreases proportionally as you move down the production chain, i.e. even if we support a Hungarian company in the supply chain, we are actually supporting the multinational company since it is in a bargaining position with its (Hungarian) supplier. This is also indicated by the fact that the production margin is the lowest in vehicle manufacturing. All of this also means that Hungarian companies can only play a supplementary role, and the subsidies poured in here are actually a transfer to the multi-customer.

- **Foreign companies typically allocate support tasks, from which, due to their nature, additional businesses cannot grow**. If new technology, know-how and more efficient management spreads among domestic companies thanks to the appearance of foreign companies or additional capital inflows, it does not depend on the financing method (FDI or another method), but only on the operation and quality of the companies.

- Economic development based on FDI can also contribute to labour market frictions: based on the results of our microdata analysis, **the presence of foreign companies absorbs labour from other companies in a labour-scarce environment.**

It is therefore doubtful that the FDI-driven Hungarian development policy can lay the foundation for our economic catch-up. Although this model is able to ensure almost full employment, it does not offer a recipe for breaking out of the middle-income trap. In recent decades, we have not been able to make the expected progress either in terms of productivity indicators or indicators approximating the standard of living (for example, real consumption per capita). **Domestic innovation expenditures of FDI are also not automatically utilised in the domestic SME sector**. Although foreign companies form the backbone of our national R&D expenditures, the domestic spillover is only limited due to the lack of an appropriate system of subsidies, i.e. it hardly contributes to increasing the productivity of Hungarian companies.

Overall, we can say that the Hungarian (and Slovak) economic development method based primarily on FDI is unlikely to result in convergence. **The main lesson from positive European examples (such as Estonia) is that the state aid strategy can only be successful if the state does its homework in the fields of education, tax system and public administration.**

"The state aid strategy can only be successful if the state does its homework in the fields of education, tax system and public administration."

NOT EVERYTHING CAN BE SOLVED WITH MONEY: ESTONIA'S SUCCESSFUL ENTERPRISE DEVELOPMENT POLICY

In recent decades, Estonia's convergence in the field of post-socialist states has been the most spectacular. The corporate sphere played a prominent role in this: based on international comparative studies, Estonia has the most innovative corporate ecosystem in the Central and Eastern European region. Although the FDI stock plays an important role in the case of both Estonia and Hungary, the innovation performance of SMEs is not in pair with each other:

- An average Estonian SME is one and a half times more productive than a Hungarian SME, and while half of Estonian SMEs have already introduced innovation, in Hungary only one in five.
- Within the Central and Eastern European region, Estonia has the largest number of companies with a value of more than one billion euros (6 in number), while Hungary, which has a population six times larger, does not have a single such company.

The main reason for the difference is the emphasis on education and digitised public administration in economic development, but the general economic environment, the tax system and public administration supporting businesses are also important elements. A Hungarian SME spends five times more time on tax matters than an Estonian one, but in Estonia the costs and turnaround times for establishing a company are also lower. In addition, Estonian entrepreneurs consider the burden of complying with official regulations more favourable, as well as the preparedness of civil servants for the special needs of young companies are superior to Hungary.

The higher level of population skills also contributes to the innovation gap between the two countries. In addition to the generally higher standard of public education, Estonia is far ahead of Hungary or even the entire continent in the field of entrepreneurship education at all levels of the system. It is probably due to the good skills that Estonia has a low fear of entrepreneurial failure, which clearly helps innovation.

Overall, although the entrepreneurial support system in Hungary is much more generous, this cannot translate into innovation. **The Estonian example highlights that the development of human capabilities is much more important than financial support, to which a well-calibrated, supportive regulatory environment can contribute as a catalyst. Otherwise, supporting companies is essentially just money thrown down the drain.**

2.3. DO WE EFFECTIVELY SUPPORT DOMESTIC COMPANIES?

What was the effect of the funds that were primarily aimed at domestic SMEs and were not allocated on an individual basis?[5] **Although the productivity of SMEs has undoubtedly increased a lot in the last five or six years, the rate of catch-up is still modest** *(Figure 8)*. In 2008, one Hungarian SME produced 22,000 euros calculated at purchasing power parity, and by 2020 this figure had risen to 32,000. Meanwhile, in the case of Estonia, which started from a more developed level anyway, this figure increased from 26 thousand to 41 thousand euros. In our case, growth remained low despite the efforts to restrain hidden revenues (with online cash registers, EKÁER freight registration system, etc.) also strongly distorted the indicators measuring the productivity of SMEs in an upward way. That is **a significant part of the catch-up was probably not linked to EU subsidies, but to the whitening of the economy.** In addition, this period coincides with the era of easing of monetary conditions, which created a favourable financing environment for previously credit-constrained companies, while global processes were also more favourable. From all this, it seems that even with a strong tailwind, a spectacular jump in terms of productivity was not achieved. In fact, **since 2018, we have essentially seen stagnation** *(Figure 8)*.

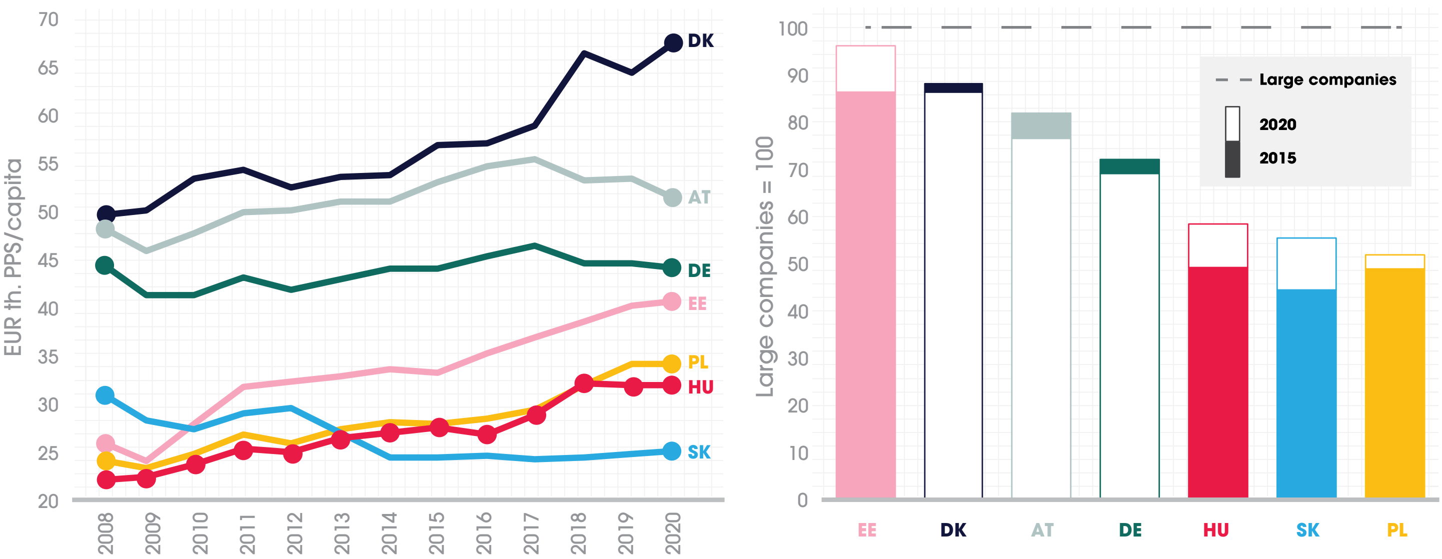

Figure 8: left: labour productivity of SMEs at purchasing power parity; right: labour productivity of SMEs compared to that of large companies (=100%) (source: calculations of the Equilibrium Institute based on DIW-ECON and Eurostat data)

5 For example, Széchenyi 2020, Széchenyi Card, MFB loans. These grants account for 70-80 percent of Hungarian business development resources.

Based on research literature, it can be concluded that although subsidies paid through operational programs improve the main business indicators of companies (fixed assets, number of employees, sales revenue), they generally do not increase efficiency, for example labour productivity. In Hungary, subsidies have a positive effect on all business indicators, but the efficiency of companies could not improve. If an increase in efficiency is observable, it is typically only temporary. Moreover, it is challenging to separate the positive results from the general effects of the economic cycles. Overall **most of the literature could not demonstrate the direct efficiency-enhancing effect of state subsidies. This is at the same time not a specifically Hungarian phenomenon.** Even in Europe, only a few cases showed an increase in productivity at the supported companies.

In terms of the success of the programs usually **not the strategy, but the way of implementation** matters most: for example, the selection criteria, evaluation criteria, and support intensity. Based on the analyses, we can make four further conclusions:

01 **Subsidised companies are typically more likely to stay afloat for a longer period of time than non-subsidized companies of similar size.** This finding is important because even the mere survival of businesses can be a socially stabilising force in lagging regions.

02 **Supporting smaller companies has a greater impact,** while the chance of better utilisation also increases with the age of the company.

03 **Subsidies that are too small or too large are both less effective than a well-targeted** support intensity.

04 Companies located geographically close to the beneficiaries, but not subsidised, may be at a disadvantage due to the state support. **State support can therefore also have a market-distorting effect, which mainly applies through the labour market.**

> In terms of the success of the programs usually not the strategy, but the way of implementation matters most.

In short: business development grants can only be useful in certain cases - **their main advantage is not economic, but socio-political, as long as employment can be ensured in lagging regions with their help.**

The limited usefulness of state subsidies is partly confirmed by the stakeholders themselves. The results of the discussions between entrepreneurs and experts of the Equilibrium Institute can be briefly summarised as saying that state subsidies are necessary, but - in accordance with the Estonian recipe - **much more should be spent on the general development of human resources,** especially for education and training. The main lessons of the stakeholder consultations:

- The majority of the surveyed enterprises **would have implemented the investment financed from it even without the support, however, they often carried out greater development than the original plan, and brought forward their expenses in this direction.** In other words, the subsidies did not have a significant additional effect (the investment would have been realised even without the subsidy), but they had a favourable influence on the magnitude and timing of the investments.

- The main problem for businesses is the lack of skilled labour, which is also related to the generally poor quality of education. **One of the most important factors standing in the way of competitiveness, in addition to the labour shortage, is the unpredictability of state measures.**

- **A possible problem with the application system is the unpredictable start and end of applications.** The key to success is often that some applicants devote more time to establishing the right relationships, and because they can give work to non-value-creating actors (application writers).

- **Domestic SMEs are typically at great disadvantage compared to the European average primarily in terms of human capital, not physical capital.** That's why the support system must focus on improving the workforce.

- **Not the form of subsidies (reimbursable financial assets versus non-reimbursable grants) is essential, but rather the targeted result and the operation of the disbursing institution.** In either form of support, enterprises definitely take a risk by putting equity behind their project. The disbursement channel and the assessment method are almost certainly more important in terms of efficiency than the form of disbursement.

- Grant amounts must be determined so that **the grant is worth the administrative costs, but they should add sufficient equity** so that the beneficiaries do not perceive the support as free money.

3. THE EQUILIBRIUM INSTITUTE'S POLICY PROPOSALS ON THE RENEWAL OF THE SYSTEM OF STATE AID TO COMPANIES

Before formulating specific policy proposals on making individual subsidies and corporate subsidies granted to a wider circle more effective, we must state as first step: **the most important and at the same time the most effective way of business development is a consistent, intensive investment in the knowledge of Hungarians. In the period of the radical transformation of the knowledge-based economy and the labour market, we can only put Hungary on a rising path by strengthening our own capabilities.**

All relevant indicators of economic development indicate a close correlation with the quality of education, and in the economy of the future, this relationship will only strengthen. If we list the most important structural problems of the corporate sphere (lack of skilled labour, low added value, outdated production technologies, etc.), in each case we quickly arrive at the same basic problem: the quality of the public education system. Therefore, it is crucial to learn from the main lesson of successful economic recipes: development does not bring good education, but vice versa! **We cannot expect the development of human resources either from multinational companies settling here, or from domestic companies – the primary task and responsibility of the Hungarian state is to lay the foundation for our break out of the middle-income trap through a radical transformation of public education.** *(The Equilibrium Institute dealt in detail with the renewal of public education in the package of policy proposals under the title of "How to be a smart nation?")*

> The most important and at the same time the most effective way of business development is a consistent, intensive investment in the knowledge of Hungarians.

3.1. INDIVIDUAL GRANTS

LET'S USE LARGE AMOUNTS OF INDIVIDUAL GRANTS FOR SOCIAL AND PATRIOTIC PURPOSES EXCLUSIVELY IN "FREE ENTERPRISE ZONES"!

The system of individual or large corporate subsidies should henceforth be determined by patriotic economic policy and a social policy approach! The latter can be served by supporting businesses with large grants only in Free Enterprise Zones (FEZs). These are deprived areas, where support for large companies (even multinationals) is particularly justified to maintain population and create jobs.

Outside of these zones, support programs should only be maintained if the applicant undertakes to employ the unemployed or previously inactive! This is the only way to ensure that the labour shortage, which is expected to remain, does not cause a competitive disadvantage to the companies excluded from the support by the subsidised companies absorbing the limited workforce. **Preference for domestic enterprises is justified from the point of view of income spillover**, since in addition to the wages, the entrepreneurial income would also remain in Hungary.

RESEARCH AND DEVELOPMENT SUPPORT SHOULD ONLY BE DISBURSED IF DOMESTIC PLAYERS ALSO BENEFIT FROM IT!

The Hungarian R&D support system is very generous,[6] however, in most cases R&D support is only used within the walls of the company. In this case, only a capital transfer takes place, while knowledge transfer does not take place between the companies and other domestic actors. It is in vain to have a relatively high national ratio of R&D expenditures to GDP in the regional context, if its fruits do not become widely available. Therefore, instead of the current subsidies and other benefits that can be applied for/requested on an individual basis, **only consortia and clusters including the research institute or domestic companies can receive R&D support!** Due to the rules limiting state subsidies, it is worthwhile to put domestic enterprises in a position by introducing SME criteria instead of domestic ownership.

INSTEAD OF THE MANUFACTURING INDUSTRY, LET'S SUPPORT THE SERVICES AND CREATIVE SECTORS!

In the practice of both individual and sectoral subsidies, the primary beneficiary is the manufacturing industry, especially the machine industry (electronics, machine manufacturing, automobile manufacturing), while in the current, latest era of FDI, battery manufacturing is becoming the new protagonist. **However, Hungary's demographic, energetic and natural characteristics do not allow these sectors to be successful in the long term.** Although assembly plants do not require special natural features, such factories increase our energy exposure and also carry a significant environmental risk (these investments are coupled with a high demand for water and energy). **Hungarian added value appears primarily in the field of services and in the creative sectors - state subsidies must treat these sectors as a priority target group!**

“Hungarian added value appears primarily in the field of services and in the creative sectors - state subsidies must treat these sectors as a priority target group!”

INSTEAD OF CREATING NEW DEPENDENCIES, LET'S SUPPORT THE GREEN TRANSITION!

As a general rule, we should only support investments that do not impose a significant additional burden on the state infrastructure and are energetically self-sufficient! In this way, it is possible to avoid having to support the activities of companies with little spill-over effect at the expense of public debt.

6 R&D support is available as a reduction of the tax base by a total of about 11.3 percent (9% corporate income tax, 2% local corporate tax, 0.3 innovation contribution). Based on the Corporate Income Tax Law, 25-70 percent support is available for investment. The obligation to pay the contribution can be reduced to half of the contribution for the researcher's salary costs. In addition, a number of non-reimbursable funds have been available to corporate applicants over the past 20 years.

3.2. SUPPORT FOR A WIDER RANGE OF APPLICANTS TO STRENGTHEN HUNGARIAN SMEs

LET'S REGROUP FROM THE BUDGET LOTS INTENDED FOR INDIVIDUAL GRANTS TOWARDS OUR ELITE PROGRAMS TO FOSTER THE CREATION OF INTERNATIONAL CHAMPIONS!

Every year in the Hungarian budget, a significant amount of direct and indirect money is available, mainly for individual support of multinational companies, while **the budget of our own corporate elite training programs is much more modest.** Instead of the emphasis on multinationals, **let's support the relatively small companies (250-1000 employees) that can be considered large companies!** With phased development programs tailored to their unique needs, we can benefit the economy more in the long term than with subsidies granted to multinational companies. To avoid rent seeking, **we must designate foreign market acquisition as a criterion for success!**

LOWER SUPPORT INTENSITIES - COMPANIES SHOULD BE INTERESTED IN THEIR OWN SUCCESS!

State and EU subsidies should support projects with a larger own equity and thus smaller grant intensity! This is necessary for several reasons. Due to the guaranteed demand, suppliers often work with higher margins for EU subsidies, which means that they do not use the resources efficiently. In response to this challenge, the authority now usually requests documents to support the market price, which is an extremely time-consuming process. **The risk of overpricing would be more effectively reduced if the state (or the EU) contributed to each project to a lesser extent and, in parallel, demanded a larger own contribution - thus the applicants would manage the incoming offers better.** In addition, the funds would run out more slowly, the confidence deficit due to the sudden closure of tenders could be eased, while more previously unsupported actors could receive support. At the same time, care must also be taken to ensure that the incentive effect mentioned above is not too small.

LET'S INVOLVE THE BANKS IN THE DISBURSEMENT OF SUBSIDIES!

Based on research, **subsidies disbursed through banks are typically better utilised than resources distributed in the traditional way.** One of the main reasons for this is that the bank is able to collect relevant information from applicants more efficiently. Support through the banking system is opposed by the fact that credit-limited companies (those companies that would not be able to obtain market credit) are left out of the support - at the same time, in their case, easing the credit limit through support does not, based on experience, cause a lasting improvement anyway. For credit-limited companies, it is worth developing special schemes that should serve to strengthen creditworthiness (for example, training and consulting). This step should by all means precede the grant.

IN ADDITION TO THE AMOUNTS DISBURSED THROUGH THE BANKS, THE BANK SHOULD ALSO PUT ITS MONEY THERE!

A number of state aid schemes are currently also being disbursed through financial institutions. **The common feature of these is that the bank is typically entitled to a credit intermediation fee and therefore does not take on any significant risk** (especially if the aid is accompanied by a state guarantee). While this practice may relax the credit constraint, it may still lead to weaker overall outcomes. **A better outcome would be for banks to take more risk in a subsidised scheme, making them more interested in selecting good projects.**

MORE ASSESSMENT STUDIES SHOULD BE MADE AVAILABLE TO THE PUBLIC TO ENABLE READJUSTING!

There is a consensus among experts that **intermediate evaluations and the possibility of continuous redesign and correction are particularly important.** The number of official evaluation studies (i.e. ordered by the state) is extremely limited today, and they are only completed at the end of the 7-year funding period, while the academic sphere can only typically make valid findings based on a database from a period that has long been closed. **At the same time, individual applicant's data are available, so when combined with company reports and other information, they enable continuous evaluation. Let's make this database public in an anonymized way!** With this in mind, the transparency of the system could be improved, and the necessary fine-tuning could be carried out more quickly.

FASTER APPLICATION EVALUATION!

Due to the high workload, the Managing Authority supporting the EU tendering process is forced to exceed the statutory deadlines in many cases. In practice, this results in delays in investments, uncertainty and, consequently, forced accruals for companies. In other words, the Managing Authorities are currently unable to perform their tasks properly. In addition to the obvious possibility of capacity expansion to speed up the evaluation, **we encourage greater participation of financial actors in supporting the tender!** Several banks already provide similar services to corporate clients, from tender preparation advice to budget planning to the administration of project closure - in other words, the necessary knowledge is also available in this sector.

LET'S USE RESOURCES TO TIMELY PLAN OVER THE EXPIRING EU CYCLES FOR THE NEXT PERIOD!

The transition between seven-year EU budgets is not instantaneous but often takes several years. The development funds for the new period are not available during these transition periods, so Member States have to make uncomfortable decisions about whether to take over the pre-financing from their national budgets until the legal and financial framework in Brussels is in place. In practice, in many cases this does not happen, so funding for tenders is frozen.

Therefore, the domestic economic planners and the Commission must start the planning process much earlier to avoid major breaks during the transition between the seven-year periods! These forced periods, in addition to causing significant wasted time, strengthen the cyclicality of the economy if, for example, resources are not available during a crisis period, while they can overheat the economy in rising phases. Because of this, **let's strive to maintain the continuity of the financing system!**

> "Let's strive to maintain the continuity of the financing system!"

LET'S STRENGTHEN TRUST IN THE APPLICATION SYSTEM WITH PHASED EVALUATION!

One of the most common complaints against the current application system is the unpredictability of the assessment, as well as the fact that the application frameworks are often exhausted too quickly. Therefore, **let's announce the calls in a more general way, with larger budgets, evaluating the incoming applications in several stages!** Ultimately, this would mean that, although there would be fewer calls for proposals, the larger budgets and the continuous reopening of the funds would make these schemes available in the longer term.

THE TRAINING OF THE EMPLOYEES SHOULD BE A CONDITION FOR A LARGER AMOUNT OF STATE SUPPORT COMMENSURATE WITH THE DEVELOPMENT NEEDS!

Although the development of human resources is perhaps the biggest debt and task of domestic business development, too much of the non-reimbursable funds still go to businesses without a meaningful human capital development criterion. **Favourable support intensity state aid shall only be awarded at the cost of training employees!**

LET'S SUPPORT COMPANIES IN OBTAINING INTERNATIONAL CERTIFICATIONS!

One of the main reasons for the low productivity of SMEs in European terms is that they rarely use modern company management solutions. Through the application of international production and quality assurance systems (ISO certifications), it is possible to kill two birds with one stone: the internal functioning of companies improves, and the company would also benefit from acquiring new customers. **Let's support the implementation of the company developments necessary to obtain the certifications by assuming part of the associated costs!** The condition for disbursement of the support would be the acquisition of the targeted ISO certification.

> One of the main reasons for the low productivity of SMEs in European terms is that they rarely use modern company management solutions.

STATE AID EXEMPTIONS ADAPTED TO ELITE PROGRAMS!

As a result of state aid rules and the intention to mitigate audit risk, many complex corporate development needs cannot be met effectively. The **most successful development programs of the past period were programs focusing on a narrow circle of companies with the phased principle in mind.** Some of the obstacles can be domestic (for example, coming from the managing authority or NAV) and foreign (European Commission rules). The Commission's approach to EU subsidies is that these funds serve to catch up, not to create elite companies (with the exception of R&D subsidies, which always aim for excellence). At the same time, in the case of programs where there is no significant competitive market disadvantage, and the range of beneficiaries and the nature of supported activities are limited and transparent, **a new support title included in the General Block Exemption rules would serve the country's development. These can be programs to help innovative small businesses or initiatives aimed at creating international champions.**

INSTEAD OF A SECTORAL FOCUS, LET'S FOCUS ON LONG-TERM SOCIAL NEEDS!

Both the EU and the national planning documents select priority support sectors. Some of these can be interpreted as EU marginal conditions (agricultural subsidies), others stem from historical factors (tourism subsidies), while still other sectors were put in a privileged position after the change of regime (machine industry, battery production). **At the same time, when choosing the right sectors, there is little chance that the state will have a sufficient amount of information about current and future market trends, so that the investment will definitely be profitable - in other words, there is a high risk of simply choosing the wrong target area. Instead, it should focus its resources on social needs that can be easily identified even in the present. These include the green transition, climate adaptation, digital transformation or the ageing of society.** The development of these areas requires a strong state role, since in many cases there are no adequate market incentives. On the other hand, a mass of knowledge accumulated for global challenges is exportable in itself, that is, it can also be used for the foreign trade balance in the longer term.

LET'S CREATE SPECIALISED ECONOMIC DEVELOPMENT INSTITUTIONS!

Specialised institutions set up specifically for development policy purposes can produce better projects, as effective development policy can be pursued with cumulative institutional knowledge. Examples of such specialised institutions in Hungary are the Tourism Agency or the National Research Development and Innovation Office, which was set up for R&D tasks. In contrast, ministries that pool general knowledge are less able to deal with the needs in terms of organisation, and the logic of the ministry does not allow sufficient room for experimentation. **Therefore, the most important economic development activities of ministries should be entrusted to specialised institutions.**

THE EQUILIBRIUM INSTITUTE'S RECOMMENDATIONS

FOUNDATION OF BUSINESS DEVELOPMENT	**Make a consistent, intensive investment in the knowledge of Hungarians a priority national strategic goal!** ***(The Equilibrium Institute previously dealt with the topic in a separate package of policy proposals).***
INDIVIDUAL SUBSIDIES	**Use large individual grants for social and patriotic purposes - support businesses only in Free Enterprise Zones (FEZs)!**
	Research and development support should only be paid if domestic players also benefit from these benefits!
	Instead of the manufacturing industry, let's support the services and creative sectors more!
	Instead of creating new dependencies, let's support the green transition!
SUBSIDIES INTENDED FOR A WIDER CIRCLE OF APPLICANTS THAT SERVE THE STRENGTHENING OF HUNGARIAN SMEs	**Let's regroup from the budgets intended for individual grants towards our elite programmes! Let's help the creation of international champions!**
	Lower support intensities - companies should be interested in their own success!
	Let's involve the banks in the disbursement of subsidies!
	In addition to the amounts disbursed through the banks, the bank should also put its money at stake!

ON THE STRENGTHENING OF HUNGARIAN COMPANIES

AREA	PROPOSAL
SUBSIDIES INTENDED FOR A WIDER CIRCLE OF APPLICANTS THAT SERVE THE STRENGTHENING OF HUNGARIAN SMEs	More assessment studies should be made available to the public to enable readjusting!
	Faster application evaluation!
	We use the resources of the expiring EU cycles to plan the next period!
	Let's strengthen trust in the application system with phased evaluation!
	The training of the employees should be a condition for a larger amount of state support commensurate with the development needs!
	Let's support companies in obtaining international certifications!
	State aid exemptions adapted to elite programs!
	Instead of a sectoral focus, let's focus on long-term social needs!
	Let's create specialised economic development institutions!

ABOUT US

The Equilibrium Institute is Hungary's largest independent, future-oriented policy think tank.

In line with the vision of Hungary's future presented in our publication entitled Hungary 2030, the Equilibrium Institute works on creating a smart and environmentally cleaner nation rooted in a strong community. To this end, we write widely appealing and practical policy proposals that serve the development of our country, and we discuss these jointly with the best domestic and international experts.

Our goal is to ensure that the current and future political, economic, and cultural decision-makers learn about our recommendations, come to agree with them and implement them.

The staff members of the Equilibrium Institute and the members of its Advisory Board are renowned experts in Hungary who are considered to be among the best researchers and analysts in their respective fields. The work of the Institute is helped by more than 30 experts, including economists, sociologists, political scientists, lawyers, urbanists, and climate researchers.

OUR EXPERTS

TAMÁS BOROS

Executive director and co-founder of the Equilibrium Institute

He serves as a member of the Scientific Council of a leading European think tank, the Brussels-based Foundation for European Progressive Studies (FEPS). He is the co-founder and co-owner of Policy Solutions, a consultancy and research institute. He is a recurring guest on a variety of political talk shows and often comments about public affairs for leading international media. He previously worked for the European Commission and the Hungarian Ministry of Foreign Affairs as an expert on communication and EU affairs. His research focuses on Hungarian and EU political communication and populism.

GÁBOR FILIPPOV

Director of Research

Previously he worked as an expert advisor in the Hungarian National Assembly and then as a political analyst and senior analyst at the Hungarian Progressive Institute. His analyses and op-eds have been published by numerous domestic and international media outlets, and he is frequently invited to talk about politics on television and radio shows. His research focuses on the European and the Hungarian far-right, on the histories of anti-Semitism and Islamophobia and their present-day manifestations, as well as the workings of contemporary authoritarian regimes.

DÓRA CSERNUS

Senior Climate and Environmental Policy Expert

As an expert in environmental issues, she has worked for the Ministry of Environment and Water, the Office of the Parliamentary Commissioner for Future Generations and the Ministry of Public Administration and Justice, representing the Hungarian position in different EU, UN, and OECD fora. She later worked as Director for International Policy Development at Klímapolitika Research and Consultancy Ltd, and as an independent expert in climate and environmental issues. Her main focus is on climate policy, air-quality control and water policy.

ZSOLT BECSEY

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Zsolt Becsey started his career as an economic planner at the Ministry for National Economy, then worked as an economic analyst and later as a modeller at the Central Bank of Hungary. His areas of interest are industrial policy, input-output analysis, macroeconomics, SME policy, and competitiveness.

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