

Management has many aspects with many challenges. The goals remain but the solutions are improved. This is the third volume of the book that shows the diversity of topics and the interest of the authors. This volume highlights some actual and interesting results related to finance, labour market, corporate social responsibility and strategic management. The authors are: Zoltán Bartha (University of Miskolc), Dóra Berend (Corvinus University of Budapest), László Berényi (University of Miskolc), Sándor Bozsik (University of Miskolc), Anita Demény (University of Miskolc), Noémi Hajdú (University of Miskolc), Katalin Lipták (University of Miskolc), Róbert Marciniak (Corvinus University of Budapest), Katsiaryna Marmilava (Belarus State Economic University), András Rideg (University of Pécs), Andrea S. Gubik, Andrea (University of Miskolc), Eszter Siposné Nándori (University of Miskolc), Judit Szemán (University of Miskolc).

Management Challenges. Volume III



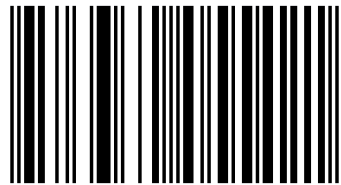
László Berényi (Ed.)

# Management Challenges in the 21st Century. Volume III

Diversity of Challenges



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## CHAPTER 11.

### THE FOI MODEL AND CORPORATE CHALLENGES OF THE OUTWARD FOCUSED DEVELOPMENT PATH

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#### INTRODUCTION

The transition period of the 1990s has brought a difficult economic policy dilemma for Hungary, as the country had to choose a new development path. Some elements of the transition were obvious (liberalisation of markets, deregulation etc.), but in many respects Hungary could have had the option to take her own path toward the market economy and development. As there are clear trade-offs among key development factors (e.g. low wages offer short term competitiveness edges in global markets, but they limit the possibility of consumers to invest in goods and services that help in creating value over the long run), Hungary had to make important long term commitments.

The aim of this paper is to show what path Hungary chose, and what challenges the Hungarian enterprises are faced with as a result of this choice. To describe the characteristics of the Hungarian development path, the FOI model was used. The FOI model was developed at the University of Miskolc. It offers a new typology of development factors, but it is also capable of structuring these factors along three clear development directions: F, i.e. the future potential of a country; O, i.e. the outside potential of a country; and I, i.e. the inside potential of a country. The three potentials fundamentally influence the business environment of an economy, and therefore have an effect on the way corporations can be managed.

This chapter gives a general overview of development factors on which the FOI model was based. Then the model itself is presented, which is used to conduct a factor and cluster analysis on the sample of the OECD countries. Hungary is part of the cluster that is best described with the dual or outward focused development path. The characteristics of this development path are shown, and finally the chapter is concluded with the corporate challenges the dual model creates.

## **DEVELOPMENT FACTORS**

The different schools of economics have had different views on the rules of the economy, and they do not agree on the basic assumptions either; hence, a wide variety of theories have been developed over the centuries. The identified development factors can be broken down into two main groups: factors available inside; and factors coming from the outside.

### **THE INSIDE FACTORS OF DEVELOPMENT**

Adam Smith (1776) saw the division of labour as the main source of wealth. The countries that are able to extend the division of labour among their firms and citizens can become wealthier, as they are able to produce a higher quantity with the same labour input. The main finding of the Harrod–Domar model (Domar, 1947; Harrod, 1948) is that investments are the key to economic growth. Investments on the other hand are mainly dependent on the savings rate. Around a decade later Solow (1956) pointed out that investments and savings cannot contribute to growth in the long run. In his view, long-term economic growth is driven by technical change.

Keynes (1936) suggested crises are generated by limits in demand, and the latter may be strengthened by large income differences. The speculative demand for money of those who are well off can be especially high, which prevents a substantial part of the income from turning into effective market demand. Inequalities in income distribution thus can be a setback for balanced growth.

Schumpeter (1934) stressed that cyclical fluctuations should be regarded as a natural part of the economy, as entrepreneurs may only draw profits if they break the status quo of equilibrium. The way to break the status quo is through innovation, which therefore becomes the primary driver of the cyclical development. McClelland (1957) also emphasised the importance of the entrepreneurial class. In his view entrepreneurs are the pioneers of development, and their biggest motivator is not profit, but the achievement of some special goals (N-achievement).

When the big colonial empires collapsed, several academics explained the situation of the underdeveloped former colonies with a value system and social structure that was different from the Western one. In underdeveloped countries the rural characteristics of the society are dominant, meaning that labour is inefficient, immobile, the social structure is rigid, and the general attitude rejects

individualism and risk taking (Meier, 1964). When local values confront the Western values, the society is split into two groups, and a dual social structure is formed (Boeke, 1953), which is completed with a dual economic structure as well (where the traditional and modern sectors are insulated from each other).

The role of human capital in growth and development is highlighted in various forms in the literature. Szentes (2011) quotes from A. Marshall: from a national perspective the capital invested in workers' children is just as productive as capital invested in horses or machinery. Newer theories unquestionably suggest that capital invested in children is far more productive than that invested in horses and machinery. Endogenous growth theories see increasing returns as a prime source of long- term growth, and they directly or indirectly explain increasing returns with human capital. Lucas (1988) treats human capital as a reproducible one, an element of capital that the society is able to broaden at a constant rate. The expansion of human capital, on the other hand, leads to a constant increase in the productivity of the physical capital. Romer (1986) also can be connected to human capital. In his model, investments made in research and development produce positive externalities that enable a constant increase in the productivity of physical capital.

Veblen (1919) points out that human behaviour is deeply affected by institutionalised rules of society. His views were taken over by new institutional economists (e.g. North, 1993, Williamson, 1998). According to them institutions affect the incentive system of an economy, while the incentive system on the other hand influences the behaviour, size and competition of firms, the level of investments and technological development, and so, ultimately the level of development of an economy. Underdevelopment thus is explained by institutional frameworks consisting of bad incentives, according to the new institutional school.

Partially connected to the institutional approach is the theory of government failures, which was mainly brought into the attention of development experts by Tullock (1993). It was back in the 1960es when Tullock suggested (1967) that the super profit that monopolistic structures offer can be an incentive for firms to lobby for government regulations granting monopolistic positions and monopoly profits. According to calculations made by Krueger (1974), the rent seeking behaviour of firms in the field of import licences caused a 7.3% GDP loss in India, and a 15% GDP loss In Turkey in 1964. The more corrupt a country is, the weaker

the state is, the heavier the costs of rent seeking are, and so rent seeking can be one of the major obstacles of economic development.

Porter's (1990) national competitiveness theory adds some highly complex factors to the literature of economic development. A somewhat similar idea is suggested by Freeman (1987), who developed the theory of national innovation systems. These systems are centred around cooperation among businesses, the education system and the research infrastructure.

### **THE OUTSIDE FACTORS OF DEVELOPMENT**

The theory of comparative advantage developed by Ricardo (1817) had become one of the cornerstones of the laissez-faire approach of international relations. According to Ricardo the highest welfare level can only be ensured if trade is conducted along the lines of comparative advantages, and there is a free flow of goods. This free trade principle was questioned by many. List (1841) argued against laissez-faire. He defended protectionism, and suggested protective tariffs for newly established industries (the infant industry argument). His suggestions echoed those of Alexander Hamilton (1791) made in the newly formed USA.

After the Second World War the focus of development economics shifted towards the power relations of different countries. Prebisch (1964) and Myrdal (1957) point out that underdeveloped states are dependent on richer countries, and so the current system of international division of labour is not based on comparative advantages. The internal economic structures of most of the developing countries are directly influenced by the developed ones through the colonial system (Myrdal: forced bilateralism). Balogh (1963) argues that as a result of power inequalities among parties, the economic structure of the developing countries has to be adjusted time after time to the changes generated by technical progress made in the developed economies, and the adjustment process prevents them from achieving long term growth. The dependency relations lead to one-track specialisation (Singer, 1964). The majority of exports of the developing countries are primary products and commodities, which leads to a decrease in the terms of trade over the long run. Bhagwati in his 1958 paper titled "Immiserizing growth" showed that the decrease in terms of trade can result in a decrease in the national income even if there is dynamic growth in the production of the export sector. One lesson learned from the literature of

interdependencies is that a diversified export structure can be an important development factor.

Emmanuel (1972) has gone as far as claiming that trade between developing and developed countries is an unequal exchange, which is a manifestation of the imperialism of trade. Unequal exchange was triggered by wage differences, and is sustained by the immobility of labour. Wallerstein (1974) also accepted the concept of unequal exchange, though he argued that it is a result of the different bargaining power of nations. The core-periphery relations and the geographical position basically predestine the fate of nations, according to Wallerstein.

<b>Inside factors</b>	<b>Outside factors</b>
Division of labour (Smith)	Free trade – international division of labour (Ricardo)
Savings rate (Harrod & Domar) Abundance-scarcity of capital	Protectionism Defence of infant industries (List)
Equal-unequal income distribution (Keynes)	Equal or unequal trade partners (Balogh) Pressure to fit to modern patterns (Balogh)
Drive to innovate (Schumpeter)	Unilateral dependency - diversification (Myrdal)
Entrepreneurial behaviour (McClelland)	One-sided specialisation (Singer)
Rigid-flexible social structure (Meier) Imported or organically developed social structures (Boeke)	Immiserising growth – terms of trade (Bhagwati) Forced bilateralism (Myrdal)
Dual-homogeneous economic structures (Meier)	International wage division- mobility of labour (Emmanuel)
Investments into human capital (Marshall) Human capital, as a renewable resource (Lucas) Positive externalities of R&D (Romer)	Geographical position – core and periphery (Wallerstein)
Institutional incentives (North) Path-dependent development	Investment strategies of multinational companies (Furtado)
Government failure (Tullock) Rent-seeking (Krueger)	Demonstration effect
National diamond (Porter) Innovation systems (Freeman)	
Rule of law, democracy (Barro)	

*Inside and outside development factors (own edition)*

As the role played by transnational companies in the international flow of goods and capital became more and more dominant, a great deal of attention was directed towards them. Furtado (1970) suggested that the most important development factor is not the interdependencies among countries any more, but the investment strategies of transnational companies. Transnational companies can bring capital to a country, creating jobs, but the newly formed subsidiaries may be isolated from the local economy (Singer 1964). The ability of a country to attract foreign capital, especially if the capital is invested in fields that can fit in well to the current economic structure of the economy, is another important development factor.

The demonstration effects of modern consumer societies are worth mentioning, too. Generally the consumers of the developing countries try to follow the consumption patterns of the developed nations. This usually has a cut-down effect on local growth, as the goods fitting to the most current consumption trends are generally produced overseas, so following the trends increases imports, and can contribute to the trade balance deficit.

## **FOI STRUCTURE AND THE MODEL**

The original idea behind the FOI model was to identify the crucial development factors of Hungary. The model is primarily based on the factors collected from the literature, but these factors are structured in a unique way which allows us to draw up characteristic development paths that can be clearly separated from each other. We used the following assumptions when the FOI model was set up:

- National economies are the unit of our analysis; international interdependencies are mostly disregarded.
- The key to development is not a single factor, but rather a combination of many factors. According to our assumption there are several important motors of development; sometimes these factors do influence each other, and it is very difficult to determine what causes what, still they can be equally important, and they all have to be used to draw up a potential development path for a country.
- Among the many factors considered in the model, the so-called institutional factors play a primary role. Institutional factors are detected using the hierarchy put forward by Williamson (1998). In fact the model

was developed with the aim of stressing the importance of institutional factors in development.

- Development can take more than one shape and form. There are several feasible development paths, and Hungary countries are not constrained to only one of them, but it may choose from a (limited) number of such paths.

The FOI model is based on a three-dimensional structure. These three dimensions are: F, i.e. the future potential of a country; O, i.e. the outside potential of a country; I, i.e. the inside potential of a country. All three dimensions are complex, composed of a large scale of factors. Yet they can still be clearly distinguished from each other, which is useful because the clear distinction can help in the formulation of distinctive development strategies.

The future potential includes factors that are regarded to be crucial for the sustainability and future competitiveness of an economy. As sustainability has become one of the main paradigms of all social sciences, we felt that the inclusion of it as a separate development dimension was essential. In our case sustainability translates to ensuring that the typical signs and indicators of a developed country characterise not only the current state of the economy but also the relatively distant future.

The outside potential includes factors that are crucial to the current world market position of an economy. This second dimension can be treated as an equivalent of the outside factors listed based on the literature. Some of the elements of the outside potential may not be influenced from the inside; others, like the conditions affecting the international flow of goods, services and factors of production, are a standard part of economic policy.

The inside potential is made up of factors that are regarded to be crucial to the current well-being and development of a developed economy. Most of the inside factors listed in the next table fall into this potential. The countries that offer favourable conditions for local entrepreneurs, and provide a high level for quality of life to their inhabitants, can have remarkable inside potential.

It is not difficult to spot that certain trade-offs exist among the three potentials. Higher wage levels, for example, are absolutely favourable from the perspective of the inside potential, but they can be dangerous for the outside potential of the country. They can also be threatening to the future potential, if the result of a high wage level is overconsumption. If a country is well endowed with natural resources, this can boost its inside and outside potentials, but the abundance of



resources usually leads to high proportions of waste, which again harms the future potential. The three potentials were drafted with these trade-offs in mind.

### FORMULATING THE MEASUREMENT METHOD

During a brainstorming session, a list of 50 indicators was compiled with the help of experts.

<b>Future potential</b>	<b>Outside potential</b>	<b>Inside potential</b>
Social responsibility (L1-3)	Trade to GDP ratio (L3-4)	Burden of government regulation (L2-3)
Industrial disputes (L1)	Country credit rating (L4)	Quality of life (L4)
Energy infrastructure (L3)	Exchange rate stability (L3)	Collected total tax revenues (L3)
Total public expenditure on education per capita (L3)	Financial institutions' transparency (L3)	Pension funding (L2-3)
Ageing of society (L1-2)	English proficiency (L4)	GDP (PPP) per capita (L4)
Renewable energies (L3)		Real GDP Growth (L4)
Healthy life expectancy (L3)		Ease of access to loans (L3)
Ecological footprint (L1-2)		Rigidity of employment (L3)
Total expenditure on R&D per capita (L3)		Labour force (L4)
Total R&D personnel nationwide per capita (L3)		Skilled labour (L3)
Educational assessment / Mathematics (L3)		

*The components of the future, outside and inside potentials (own edition)*

The 50 indicators were chosen to measure the relevant development factors, and they were all included in a questionnaire. Experts were asked to rank all 50 indicators on a 1-7 scale (1 = not relevant at all; 7 = of highest significance). Each indicator received three separate scores: one for future potential, one for outside potential and one for inside potential. The respondents had to give a high score to an indicator if they believed it greatly contributed to the sustainability and future competitiveness (F potential), current world market position (O potential) or current well-being (I potential) of Hungary. The questionnaire was completed by 28 experts. Most of them were active members of the Committee on Future Research of the Hungarian Academy of Sciences. Representing several academic

fields (arts, engineering, medicine, natural and social sciences), they offered a wide perspective and a strong future-oriented attitude, values that are highly useful in this kind of research.

During the processing of the questionnaires each indicator was placed in the group (F, O or I potential) where it scored highest, meaning that an indicator could only be part of one of the potentials. In order to eliminate some of the less important factors (which received low scores in all three dimensions), we disregarded everything that had a score below average. The final transformation left us with 27 factors: 12 of them influence the future potential, 10 the inside and 5 the outside potential.

### THE FOI ANALYSIS OF THE OECD COUNTRIES

To quantify the future, outside and inside potentials, the FOI-indices were calculated. The value of the 27 components were gathered for all 34 OECD members for the year 2010, and then all values were transformed to a 1-7 scale using the min-max method. By averaging the standardised values, we were able to calculate the F-, O- and I-indices of all 34 countries.

Country	F	O	I	Country	F	O	I
Australia	4.20	5.32	4.35	Japan	4.80	3.68	4.01
Austria	4.70	5.41	4.05	South Korea	4.00	4.26	3.33
Belgium	3.90	5.56	3.47	Luxembourg	5.30	6.56	4.45
Canada	3.90	5.41	4.50	Mexico	2.70	3.98	2.85
Chile	3.80	5.03	4.13	Netherlands	4.40	5.54	3.83
Czech Rep.	3.10	4.97	3.57	New Zealand	4.20	4.52	4.00
Denmark	4.80	5.77	4.30	Norway	5.20	5.70	4.13
Estonia	3.00	4.94	3.08	Poland	2.90	4.42	3.07
Finland	5.00	5.72	4.02	Portugal	3.50	4.33	2.91
France	4.40	4.46	3.04	Slovakia	3.00	4.82	3.25
Germany	4.30	5.26	3.73	Slovenia	3.40	5.08	2.70
Greece	2.90	3.66	2.50	Spain	3.40	4.23	2.99
Hungary	2.90	4.56	2.55	Sweden	5.10	5.22	4.13
Iceland	5.90	2.33	4.42	Switzerland	5.40	5.37	4.89
Ireland	3.90	4.17	3.91	Turkey	3.30	3.63	3.14
Israel	3.60	4.89	4.13	U. Kingdom	3.90	4.35	3.60
Italy	3.50	3.82	2.66	USA	3.80	4.27	4.47

*The F-, O- and I-indices of the OECD countries (own edition)*

## FACTOR ANALYSIS

In order to better understand, what background factors drive the value of the different F-, O- and I-indices, a factor analysis was conducted with SPSS 19. Almost 150 variables were tested during the analysis. In the first step, we checked how closely related those variables are to the three index values in the OECD countries, and what the direction of the relationship is. As a second step, all variables were only considered in the factor analysis of the index they had the highest correlation relationship with.

We were able to establish three main groups of indicators that showed a significant correlation with the index of the future potential of the OECD countries. They were labelled Human capital, Accountable corporations and Quality of the education system. The Human capital factor is a combination of indicators measuring the education and health sectors, and the productivity. The Accountable corporate factor combines such factors as the ethical and social responsibility of organisations and the credibility of managers, and so it represents the social, ethical and environmental considerations of businesses. The third factor, Quality of the education system, shows the returns on efforts made in the education system.

Two factors were found with the factor analysis of the O-index, namely National goodwill and Investment conditions. The main distinction between the two factors is the time frame within which their indicators may be influenced by the decision maker. The Investment conditions factor includes variables that can be influenced relatively easily, even over the short term; the National goodwill on the other hand may only be changed over the very long term.

Variables having a significant correlation with the I-index can be separated into three factors. These factors were labelled Business competitiveness, Government intervention and Availability of resources. The Business competitiveness factor measures the microeconomic position of all businesses (small and medium-sized enterprises and large corporations) along such dimensions as productivity, efficiency and R&D&I. The other two factors describe the macroeconomic environment of the businesses, where the Government interventions consists of the regulation part and the Availability of resources the allocation part.

## FORMING CLUSTERS

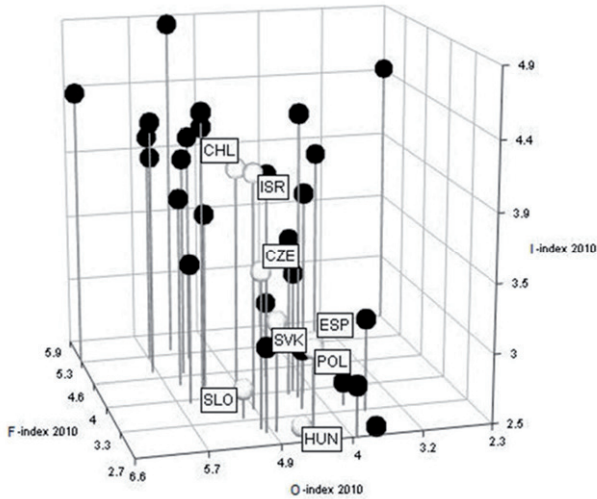
The FOI-indices and the factors determined during the factor analysis were used to identify typical clusters within the OECD countries. These artificial clusters were created based on the values of the F-, O-, and I-index, with the so-called half-scale method. As the indices can have a value between 1 and 7, 4 is the mid-value. So all three indices were split into two groups: the values from 1 to 4 went into the group labelled as “low” (1), while the values above 4 were labelled as “high” (2).

Theoretically, all 8 clusters could represent feasible combinations, but most of the 34 OECD members fall into 4 groups. In our interpretation, these four groups of countries represent the development models within the OECD.

The current chapter focuses on Group 3 (Chile, Czech Republic, Estonia, Hungary, Israel, Poland, Slovakia, Slovenia, Spain, and the United Kingdom), which is called the dual model, representing the outward focused development strategy. Countries of Group 3 perform above average in their outside potential. A closer inspection of the factors shows, however, that these countries are especially strong in ensuring favourable Investment conditions and their national goodwill (the other factor of the O-index) is below average. They are all characterised by liberalised capital flow regulations, exchange rate stability, accessible capital markets and incentive policies for investments. As far as the F-index is concerned, they perform poorly in the Quality of the education system and Human capital, while they are barely below average in the Accountable corporate factor. In the case of the I-index, the value of the Government intervention factor is slightly above average, although that cannot compensate for their weak performance in the other factors of Business competitiveness and Availability of resources.

It is not difficult to spot a strong focus on outside resources in the factor structure of Group 3. These countries create a favourable environment for the world market-oriented companies, and they adopt policies that lead to a more liberalised government regulation. For this reason, their economies may be characterised with the classical dual structure: a competitive, outside-oriented sector that relies substantially on outside resources, and a traditional sector applying local capital that is at least partially isolated from the other sector. The main characteristic of the dual model therefore is a strong focus on attracting

outside resources, with the help of which the economy can be modernised and a higher growth rate might be achieved.



*Position of the outward focused countries along the FOI dimensions (own edition)*

### **THE OUTWARD FOCUSED DEVELOPMENT STRATEGY**

The dual model implies a strategy that focusing on the attraction of outside resources. In other words, we argue that if the goal is to move towards the dual model, the economic policy should concentrate on a strategy centred on the attraction of outside resources. If we draw a parallel between the development model (deducted from the clusters of countries) and the economic policy strategy, we can also tell which factors are most important for the outward focused strategy. We have seen that the third cluster exceeds in one of the outside factors, called Investment conditions, and in one of the inside ones, called Government intervention. These two will be the areas that the economic policy needs to address when the strengthening of the dual model is the goal.

As a next step we checked which of the OECD members scored well in these two factors. In Investment conditions Ireland scores the highest, Austria is seventh, Finland and Denmark are eleventh and twelfth respectively; in Government intervention Finland is second, Denmark is fifth, Ireland is ninth and Austria is eleventh. Country studies were prepared for these four countries to

detect those best practices that allowed them to excel in the areas measured by the two factors above. The country studies are fairly extensive and therefore cannot be included in this chapter, but the lessons learned from them are featured in the final sections (the country studies are accessible in the Appendix of Bartha et al., 2013).

The main characteristics and strategic development directions of the outward focused policy are presented according to Williamson's (1998) hierarchy. As the lowest level (L4) summarises the current issues of resource allocation, the actions listed here theoretically can have an instant effect on the economy. Economic policy measures may belong to this level as well; if we assume that changes in regulations, taxes or subsidies have an instant effect on the market behaviour of firms and individuals. The longer-term effect of central intervention is that persistent measures change the structure of the market and the economy, and the relationships among firms. These belong to the governance part of the economy (L3). The strategy focusing on the attraction of outside resources requires a predictable government, and that on the other hand requires the stability of the political system. Items related to the political system belong to Level 2, but it has to be said that changes on this level may take decades, according to Williamson.

We shall start the presentation of our suggestions with those belonging to the highest level (L2). Because of the hierarchical system, the factors higher above are the prerequisites of anything below them. We have found that one of the pillars of best practice is the reliability of the economic policy. The corporate tax decrease policy in Ireland was started more than two decades ago, and it was consistently carried out; the many decades of minority governments have led to a special culture of political consensus seeking in Denmark that makes it possible to carefully plan and fine-tune long-term social policies; the state is committed to long-term development goals in Austria and Finland. Political stability is coupled with the transparency of the public sector and a very low level of corruption in all cases. The latter two further enforce the reliability of economic policy, as they decrease the chance of interest groups capturing the state, and destabilising the policy making.

Disciplined public finances are also an important part of the best practices. After the 2008 financial crisis, it is clear that balanced budgets are important, but they seem to be an absolute must for a reliable investment environment. A stable budget position guarantees that the government does not have to take unexpected

measures that affect company costs (e.g. tax raises or new taxes, withdrawing tax remedies, subsidies).

The reliability of monetary policy, more particularly the reliability of exchange rate policy, is equally as important as that of fiscal policy. It is well known that exchange rate stability is a central element of the economic policy measures of open economies. The euro partially ensures that stability, although the exchange rate against other major currencies can still be very volatile. Because at least two-thirds of the trade of the European countries are conducted within Europe, the euro is able to provide a relative stability on the continent, and lets the member countries get rid of the best part of their exchange rate risk.

Level	Component
L2	Advanced political culture Low level of corruption Stable and foreseeable socio-economic environment Stable public finances Exchange rate stability – Eurozone membership
L2-L3 transition	Social partnership in labour market affairs Collective agreement of employers and employees on national, sectorial and company level
L3	Transparent government, e-government solutions Regulatory impact assessment – measuring the effects of government interventions
L3-L4 transition	Persistently low corporate tax rate, with additional tax exemptions State of the art infrastructure Stable investment environment, coordinated tax and subsidy system Support for company-university-researcher cooperation
L4	Clearly defined development goals: research and development, information and communication technologies Substantial state subsidies on corporate innovation Substantial central help for start-ups and export expansion, involving subsidies, information and counselling services, and business support agencies Low level of corporate tax rates Flexible labour market

*Development areas for the strategy focused on the attraction of outside resources (own edition)*

The institutional framework that ensures the stability of the labour market was placed between Levels 2 and 3. Labour market issues are basically part of the allocation problem, so they should belong to Level 4. Nevertheless, it is also known that the pure market model is not an efficient one on the labour market, and usually there are dozens of institutional factors regulating it. This is why the institutional framework of the labour market is higher up in Williamson's hierarchy. In Austria and Denmark the collective bargaining system is completely integrated into the institutions of the central government, and therefore it is linked to Level 2, but it also has an effect on the governance of companies (L3), which is why it was put as a transition between the two levels.

The dependency on the higher level structures is especially true of labour market institutions. More precisely, the Danish-Austrian type of social partnership and collective bargaining system can only be successful if the willingness to seek compromises and solidarity are an integral part of a country's culture (factors belonging to L1 and L2). Hungary had experimented with the system in the 1990es, but gave up on it after several failures, so the suggestions on L2-L3 are only for the sake of comparison. What is worth remembering is that long-term labour market stability is key to the outside-resources-oriented strategy, and this can only be achieved if a well-functioning institutional framework is in place. Some areas require some sort of central regulation and planning: the smoothing of cyclical fluctuations (e.g. compensating for lost income in case of becoming unemployed); balancing structural weaknesses (e.g. the feedback of labour market needs to the education system). In other cases, institutional guarantees may be needed to prevent the state from distorting the market (e.g. separating real wage changes from market powers).

The second-order economising called governance by Williamson (L3) represents the efficiency of the government regulations in case of an economic policy analysis. This is important for the attraction of outside resources, because the administrative burdens of the bureaucracy increase the transaction costs of everyone, including the owners of foreign resources. The extent of transaction costs caused by the state therefore is a prime indicator of both capital investors and immigrants. Denmark and Finland are front runners in e-government solutions. These solutions provide huge advantages: e.g. they make bureaucracy more transparent, increase the speed at which services can be provided by the



state, make it easier to declare and pay taxes, and help in creating huge databases that make public policy decisions more reliable.

Ireland is a great example for regulatory impact analysis. Starting from 2000 they gradually adopted the principle that the market distortion effects of government regulations are assessed. Basically a systematic attempt was made to quantify the transaction costs and changes in market behaviour caused by the intervention of the state. Thanks to the regulatory impact analysis, the instruments that have the strongest market distortion effect may be filtered out, and the costs of both the state and the business sector can be decreased. The introduction of this approach has the added bonus of showing a more rational image of the bureaucracy, and making it look more attractive for investors.

All of our other suggestions consist of economic policy measures that have a direct effect on the allocation of resources, and an instant impact on the economy, and so they belong to Level 4 (or to the transition between L3 and L4). The hierarchical structure still applies, of course; the lower-level suggestions can only work efficiently if they are compatible with the higher-level characteristics of the country.

Ireland, Denmark and Austria have each set up a tax system where the relatively high overall tax burden is achieved with a low corporate tax rate (although the orders of magnitude are different: Ireland for many years has had one of the lowest corporate tax rates in the world, its effective value is below 10%; the Danish is somewhat higher than the Irish, while the Austrian corporate tax rate can only be considered low if we compare it to the average of the developed welfare states). As the tax rate is a pivotal point in the investment decisions of the transnational companies, a consistently low corporate tax can be a great attraction.

In all countries, the state support for clusters is a main priority. Clusters usually involve the cooperation of companies, research institutes, universities, development agencies and risk capital firms, but they are also supported by the state. The practice of Denmark, Austria, Ireland or Finland shows that state support alone is not enough; the clusters may only be successful if they carry special knowledge that is competitive in the world market. Those industries are worth supporting that have traditionally performed well and whose main companies are well known in the world market (good examples for the Danish are food, pharmaceuticals and wind energy, for the Finnish wood or information technology, for the Irish process innovation, and for the Austrians car manufacturing clusters).

The flexible labour market is another attraction for transnational companies. If the termination of employment does not require many administrative tasks, and can be carried out with relatively low costs, companies are able to adjust to the fluctuations in the world market demand. Denmark also has a social safety net, and applies several active labour market instruments that ensure that the unemployed can find a new job relatively quickly.

The suggestions described in this subchapter will not only strengthen the model based on the attraction of outside resources, but the FOI analysis showed that they primarily affect the factors that are the pillars of such an economic policy orientation. The economic policy should concentrate on these instruments, if the main priority is the attraction of outside resources.

#### **CORPORATE CHALLENGES OF THE OUTWARD FOCUSED STRATEGY**

The chosen development path will have its consequences on the micro level, affecting the managerial and entrepreneurial challenges of the economy. One of the obvious consequence is that most policies favour larger, foreign-owned companies, setting up a dual structure of the economy. Government subsidies are only offered if a minimum threshold is achieved, so smaller firms (typically owned by local actors) miss them.

<b>Country</b>	<b>CZ</b>	<b>HU</b>	<b>PL</b>	<b>SK</b>
Minimum number of jobs created (focus industry)	40	25	250	40
Minimum amount of investment (million EUR, focus industry)	5	1	10-40	3-10 1.5-5 (SME)

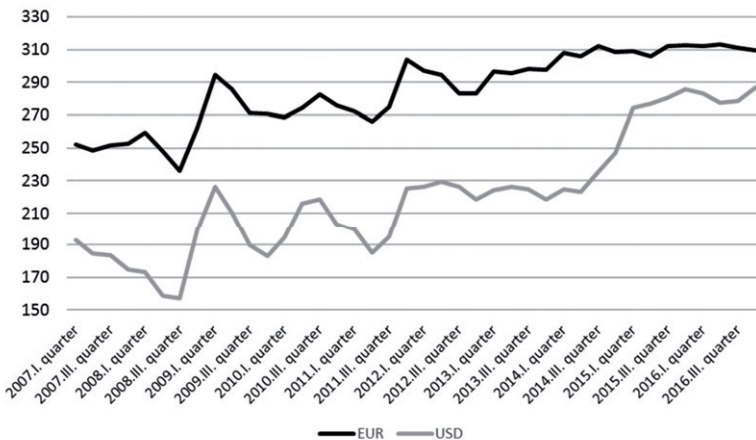
*Minimum requirements for government incentives in the V4 countries*  
 (<http://www.czechinvest.org>; <http://www.hita.hu>; <http://www.paiz.gov.pl>;  
<http://www.sario.sk>)

The above table shows the minimum requirements for an investment to be eligible for government subsidies. In some cases these requirements are not completely comparable, because they vary according to the type of the incentive (subsidy for job creation, government grant or tax relief), to the multiplier of the region (developed or underdeveloped compared to the country average), and to the size of the investor (large company or SME), but Hungary has typically the

lowest requirements. The low requirements can lead to a dispersion of resources, but it also helps smaller firms to get access to vital resources.

The Hungarian government has also introduced the institution of strategic alliances. A company can become the strategic ally of Hungary if it has invested a considerable amount (worth several hundred millions of Euro) in the country, employs a lot of people (several hundred), and signs a contract with the government about the alliance. Almost 60 strategic alliances were signed in Hungary between 2012 and 2014. Although the contract is not very factual in nature, the companies usually agree to further increase employment, increase their R&D activity in the country, involve more local suppliers in the value chain and stay active supporters of the local societies, while the Hungarian government offers tax incentives, eligibility to government grants, and public procurement privileges in exchange.

The exchange rate regimes also influence the investment conditions in Hungary. The country has opted for a weak home currency, that favours firms that rely on local inputs, and are export-oriented. Importers, on the other hand, are negatively affected by this policy choice. Hungary uses the dirty floating regime meaning that exchange rates are quite unpredictable. Although some developments (e.g. the trade balance surplus, the inflow of European development funds, the relatively high return on Hungarian government bonds) suggest that the forint (HUF) should appreciate against the leading currencies, the Hungarian National Bank seems to be keen on delaying this effect.

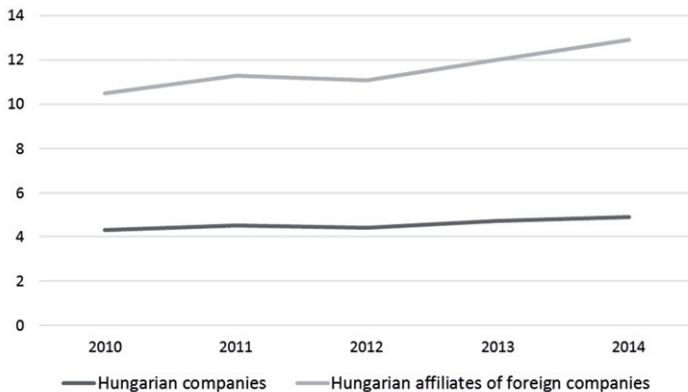


*The HUF/EUR and HUF/USD exchange rate (MNB)*

The depreciation of the local currency on the other hand can also give some advantages to investors, although these advantages usually are only temporary. The depreciation of the forint (HUF) has made the labour costs of local producers a lot lower in euro terms, which is a major boost of competitiveness. Hourly labour costs (more precisely: hourly labour costs in industry, construction and services – except public administration, defence and compulsory social security) were the fifth lowest in Hungary within the European Union in 2015 (only 30 percent of the EU average). The Euro labour cost in 2015 is less than it was in 2008.

Country	2000	2004	2008	2012	2013	2014	2015
European Union	16.7	19.8	21.5	23.9	24.2	24.5	25.0
Bulgaria	1.3	1.6	2.6	3.4	3.6	3.8	4.1
Croatia	:	6.9	9.2	9.5	9.5	9.4	9.6
Czech Republic	3.7	5.8	9.2	10.0	9.8	9.4	9.9
Estonia	2.9	4.3	7.8	8.6	9.2	9.8	10.3
Hungary	3.6	5.9	7.8	7.4	7.4	7.3	7.5
Latvia	2.2	2.9	6.0	5.9	6.2	6.6	7.1
Lithuania	2.6	3.2	5.9	5.9	6.2	6.5	6.8
Poland	4.2	4.7	7.6	7.9	8.1	8.3	8.6
Romania	1.5	1.9	4.2	4.1	4.4	4.6	5.0
Slovakia	2.8	4.1	7.3	8.9	9.2	9.7	10.0
Slovenia	10.9	11.2	13.9	15.6	15.3	15.6	15.8

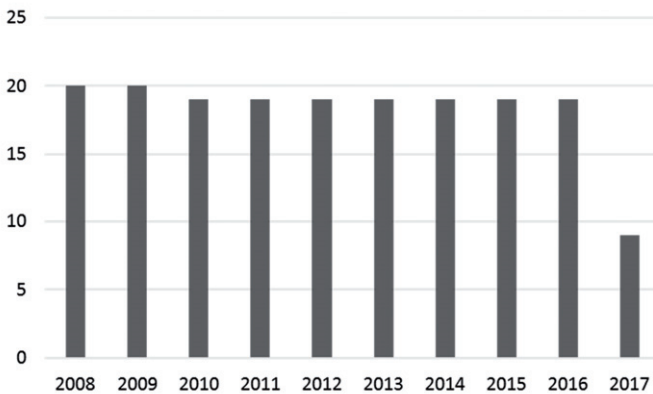
*Hourly labour costs in some EU countries  
(expressed in Euros, source Eurostat)*



*Productivity of Hungarian firms, million HUF/employee (Source: KSH, 2016)*

Interestingly enough, labour costs are related to the investment rates. Bereczk (2015) found that the correlation is positive, meaning that firms that have higher wages invest more. This, again, enforces the dual structure of the economy, and reduces the productivity of smaller local firms. The lack of investments is shown in the value added data as well (see the previous figure).

The corporate tax rate has traditionally been relatively low in Hungary, compared to the EU average. In 2010 the new regulation meant that smaller enterprises only had to pay a 10% corporate tax, while a 19% rate was applied for companies having a HUF 500 million revenue or higher. In 2017 Hungary lowered the corporate tax to 9%, which is one of the lowest in Europe (it is the lowest in the OECD), and is in the tax haven category. Unpredictability is the main challenge again, as corporate tax regulations have been changing quite hectically in the country.



*Corporate tax rate in Hungary (Source: NAV)*

The outward focused strategy seems to create a growth trap for small- and medium-sized companies. According to Muraközy (2015) 57.3% of the material cost of multinational companies operating in Hungary comes from imports, and only 13% is provided by Hungarian owned enterprises operating in Hungary. Muraközy stresses that the share of Hungarian suppliers is especially low in sectors (e.g. electronics, car manufacturing) where the economies of scale are very important. The low share is mostly explained by the low competitiveness of the Hungarian firms. Policy makers have made efforts to improve on this situation. One example is the agreement made with Knorr-Bremse in early 2017 that aims

to include over 100 Hungarian firms (Ministry of National Economy, 2017). The agreement is a result of the Irinyi Plan started by the Hungarian government.

## **CONCLUSIONS**

The outward focused development path leads to a dual structure of the economy. One of the main problems with this strategy is that in order to make the country more attractive, policy makers are continuously pushed to offer support to larger firms, and hence the dual nature of the economy prevails. It seems that temporary growth can come from the dual model, but the long-term sustainability of growth within this model is very much questionable. Recent developments suggest (see the agreement made between Knorr-Bremse and the Hungarian government) that even the large, multinational companies are interested in a more competitive Hungarian SME sector.

A possible way out from the outward focused strategy is the connecting of the Hungarian SME sector to the large multinational corporation through the supplier chain. This would not only increase the effectiveness of the SMEs, but will also contribute to the reduction of the informal and black economy. In order to make it happen, multinational companies need to provide assistance, the Hungarian SMEs on the other hand should be willing to grow and to become more transparent. The increased intensity of supplier cooperation is in line with cluster and innovation system development. Cooperation is a key, the culture of which has to be learnt.

Since the outward focused strategy prioritizes the international relations, another possibility for enhancing competitiveness in the SME sector is internationalisation. EU funds are available for the purpose; however the firms often seem to lack the special knowledge required for the successful completion of the internationalisation process (Bartha & Gubik, 2016).

**CHAPTER 9. – THE CONFIGURATIONS OF SME’S COMPETENCIES ARE NOT  
COMPETING: AN EMPIRICAL STUDY OF HUNGARIAN SMES**

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