



TEN YEARS OF COLLABORATION

A RETROSPECTIVE LOOK
AT USAID'S ROLE IN
HUNGARY'S TRANSITION

USAID Hungary
Budapest, Hungary
August 20, 1999



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I. INTRODUCTION

For the past ten years, USAID has been supporting the efforts of the Government and people of Hungary to make the transition from an authoritarian political system and centrally planned economy to a private sector-led market economy and pluralistic society. By any measure, Hungary has been highly successful in accomplishing this goal and USAID has been instrumental in facilitating its success. Since there are other countries still making the transition with USAID and other donor support, it is worth taking the time to review Hungary's experience and USAID's role to see if there are lessons to be learned. This paper does not seek to isolate the causes of Hungary's success, but rather to focus on the means by which USAID facilitated Hungary's efforts. It is addressed primarily to the development professionals of USAID and to those of other assistance agencies.

As is to be expected in such a complex area as economic and political development, no absolute rules or formulas emerge. Rather, the "Lessons Learned" identify specific programming criteria or implementation methods that seem to have had significant impact on ultimate success. A few lessons may be new, but many reinforce emerging "best practices" in the region and all highlight the difference sound development practice can make. The "Lessons Learned" repeat a number of broadly recognized lessons because, despite being well known, they are so important and too often ignored that they bear repeating at every opportunity. Overall, the "Lessons Learned" in Hungary tend to validate "Lessons Learned" elsewhere in the CEE (e.g. those found in Chapter III of the FY 1997 SEED Act Implementation Report). They also validate many of the changes made in programming and implementation arrangements that emerged as USAID learned "on the job" and its efforts to assist Hungary and other CEE and NIS countries to make the transition evolved and matured. Finally, some of the lessons validate changes brought about by USAID's reengineering.

To provide a background against which to view the "Lessons Learned," Part II of the paper summarizes Hungary's political and economic transformation. Part III summarizes USAID's efforts in Hungary. Neither is meant to be comprehensive but rather to provide highlights and milestones, which will permit the reader to understand the context from which the "Lessons Learned" emerged. Following the background sections, Part IV presents the "Lessons Learned" in detail.

The "Lessons Learned" are derived from many sources:

- ◆ activity completion reports prepared by activity managers
- ◆ completion reports prepared by contractors and grantees
- ◆ five special studies commissioned by USAID/Hungary
- ◆ evaluation reports
- ◆ suggestions provided by the USAID/Hungary staff
- ◆ program documents such as R4's and country strategy statements
- ◆ reports prepared by other donors

II. HUNGARY'S TRANSITION

• *A. Overview* •

During the first half of the 20th century countries containing one-third of the world's population seceded from the market economy and launched an experiment in constructing an alternative economic system. In these countries, a massive effort was made to centralize control of production and allocate all resources through state planning. The failure of this experiment set in motion just as radical a transformation, as these countries seek to rebuild markets and reintegrate themselves into the world economy. Most of the economies of these countries have rejected all or much of central planning and have embarked on a transition toward decentralized market mechanisms underpinned by widespread private ownership of resources. Many of these countries have also rejected the associated authoritarian political system and returned to multiparty democratic governance.

Despite common features, Soviet bloc countries with centrally planned economies were far from monolithic. They had different histories, cultures, and resource endowments. Relationships with the Soviet Union varied widely, as did the degree and methods of control of the economy exercised by the Soviet Union. There is thus tremendous variety in the departure points, strategies, and outcomes of transition across countries. Some countries, typically in the CEE, started with more favorable macroeconomic, structural and institutional conditions. These included lower inflationary pressures, less interdependence with the communist bloc trading system, a more recent history of market economy, and a more favorable location for developing new trade links. Countries also differed in their levels of development, industrialization and income.

The Hungary of 1989, when it formally began its transition from an authoritarian, centrally planned economy to a democratic, market economy, exhibited both common and unique political and economic features which impacted on the transition process. As with all of its fellow CEE and NIS states, Hungary's formal political and economic structures approximated those of the Soviet Union. The State attempted to control the allocation of resources through various mechanisms including the budget and banking systems. The vast majority of the country's economy was owned by the State. The ruling communist party (the Hungarian Social Workers Party) in turn attempted to control the State.

In common with other northern tier CEE countries, before it fell under the hegemony of the Soviet Union, Hungary had been a part of Europe, participating in the industrial revolution and the political ferment of the 19th and early 20th century. As a result, Hungary had experienced multiparty democracy, and had a growing and modernizing industrial and agricultural economy linked by trade to other European countries. Economically, it was a moderately developed country. Socially, it had an educated population, and a growing, entrepreneurial and professional middle class.

During the period of communist rule, Hungary evolved along a different path than its fellow CEE countries. The Stalinist political, economic and social reorganization of the country according to the Soviet model between 1948 and 1953 was exceptionally harsh and led to a severe deterioration of the economy and standard of living. Post-Stalinist efforts to rectify the situation resulted in first a loosening and then retightening of economic and political controls. The harshness with which control of the economy was imposed, combined with historical feelings of national pride, provoked the Revolution of 1956 which made it clear to the Soviet Union and the Hungarian communist party that they could push the people of Hungary only so far. In response, the ruling elite under Janos Kadar, with the tacit support of the Soviet Union, pursued a more consensus-seeking style of political leadership and sought to gain legitimacy in the eyes of the people through economic reforms that would improve their living standards. Under these circumstances, thinking of 1989 as the date on which Hungary embarked on the transition from the Soviet model back to the western European model, is somewhat misleading. In effect, political and economic reforms under the communists had started the transformation process which accelerated in 1989.

In the political sphere, constitutional reforms required that more than one candidate stand for election. This provided a semblance of democracy. A small portion of the economy was privatized formally or informally. Incentives such as production bonuses replaced coercion and economic decision making was decentralized by various mechanisms. Perhaps most important in terms of future impact, pre-1989 economic and political reforms reduced the importance of party membership in gaining an education, appointments to significant positions and advancement within the government and economy. This helped to develop a well-educated class of entrepreneurial managers and weakened the links between "the State" and the ruling party.

• *B. Political Transition* •

While some small steps towards political reform had been taken in previous years (e.g. the 1987 amendment to the Constitution requiring more than one candidate to stand for election) and a certain degree of political dissent was allowed, the process of political reform began in earnest in 1989. With clear signals that Moscow would no longer interfere in the political and economic life of its satellites, the ruling communist elite in Hungary, a more reform minded group who had taken power from Janos Kadar, saw their self-interest being best served by negotiating a peaceful transition to multi-party democracy. The historic National Roundtable negotiations of June to September 1989 between the incumbents and members of the reemerging opposition parties provided the basis for Hungary's return to parliamentary democracy and free and fair multiparty elections in 1990.

In a remarkably short time, a wide range of legislative actions was taken which restored parliamentary democracy in Hungary. Two constitutional revisions enacted in 1989 and 1990 formally returned Hungary to European constitutional ideals and to Hungarian traditions

and conceptions of civil rights and justice. Laws setting up an independent judiciary, regulating the registration of political parties, restructuring local government, establishing electoral procedures and many others were enacted by the interim government between 1989 and 1990.

National and local multiparty parliamentary elections were held in March/April of 1990, the first free elections since 1945, and a center-right coalition replaced the incumbent communist regime. Since then, two more elections have been held at the national and local levels. Each time the incumbent party or coalition lost its majority and a peaceful transfer of power took place, demonstrating the strength and irreversibility of Hungary's democracy. During the tenure of the two previous governments, there was remarkable stability within the parliamentary structure. No crises of confidence occurred and, therefore, there was no need to call new elections.

The initial reforms returning Hungary to democracy were relatively easy. There was remarkable agreement between the ruling party and opposition groups over what was required to make the transition. The interim government carried out its tasks in accordance with the agreements reached at the National Roundtable. From 1990 to 1993 the new, democratically elected Parliament enacted 219 pieces of legislation and amended 213 laws, setting out the framework for Hungary's economic and political transition. By 1994, the institutions of Hungarian democracy (the Parliament, political parties, the judiciary, and local governments) were in place and functioning although most were fragile and in need of capacity building and modernization.

Early in the transition, democratic institutions and principles were fragile. Other than voting in elections, the vast majority of citizens played little role in the initial transformation. While some NGOs flourished during the early stages of the democratic transition, these were largely Budapest-based and focussed on global social and political issues. Though formal controls of the media had been lifted, there were concerns over continuing government control through ownership of media outlets, financing and other mechanisms. The court system, while functioning independently, remained inefficient, denying justice through delay. Although the Constitution guarantees equal rights to all citizens, ingrained attitudes toward minorities, such as the Roma, resulted in de facto discrimination and the violation of rights of minorities.

As the political transition continued, democracy broadened and deepened. A Media Law was enacted in 1995 and two TV stations privatized in 1997. A lively free press and electronic media is evolving, partially as a result of the government's divestiture of media outlets and partly through foreign ownership. Issues relating to the financial sustainability of media, especially at the local level, remain to be solved. Comprehensive NGO legislation was enacted in 1997. The number of active NGOs is now very large (an estimated 40,000 are registered) and they have turned from advocacy of global issues to advocacy of local issues

and the delivery of services. Again, the most important issue to be resolved for NGOs is long-term financial sustainability. Although Hungary has better relations with its Roma (Gypsy) community than other CEE countries, the issue of the treatment of minorities remains problematic and becomes more pressing as Hungary prepares for accession to the EU.

Local Government reform, implemented by constitutional amendments in 1989 and legislation (the Law on Local Self Government) in 1990, abolished the 1,650 existing local councils and replaced them with 3,300 local government units. At the same time, the power of the 19 county councils was significantly diminished. This explosion of local self-government quickly brought government to the people but it also challenged the new administration to develop competence and processes to effectively deliver the services demanded by its citizens. Local government units have a broad range of responsibilities that they must fulfill and services that they must provide. This broad charter has created a mismatch between the responsibilities of local governments and their ability to fulfill them. The problem is compounded by the fact that 80 percent of local government revenues come from the national government via intergovernmental transfers. Local governments do have the ability to levy and collect some taxes and to set tax rates within national government guidelines but do not use this authority effectively yet. While local government units are operating successfully with a degree of dynamism that was lacking in the past, the mismatch of resources, capabilities and responsibilities imposes limits.

Some local governments, with donor assistance, are growing in competence and learning to work more closely with other local government entities, the NGO community, and their own constituents. Although local governments are free to form associations with other local governments, this does not appear to be happening very rapidly. Improvements in intra-government finance have been made, but much remains to be done to clarify the respective roles and relationships between the national and local governments and to provide local government with adequate sources of financing. The local governments themselves must become more efficient and better utilize the taxing and borrowing authorities they already have. These issues remain to be addressed. EU accession has implications for local government that may result in the reestablishment of a regional, county-type structure.

• *C. Economic Transition* •

1. Macroeconomic Stabilization

The communist regime began to move away from the orthodox Marxist economic model as early as 1968, and effected various reforms in fits and starts over the twenty years leading up to the country's return to a market economy. The reforms were not powerful enough to rupture the economic system then in place, but resulted in considerable partial improvements. Directors of state enterprises enjoyed a considerably broader scope of authority and elbowroom in decision making than did their counterparts in other CEE countries. These enterprises were eventually managed and controlled either by Enterprise Councils (managers) or Workers' Councils (employees) that were permitted to decide what to sell, and to whom. Younger, entrepreneurial managers who recognized and understood the concept of profitability gradually replaced older enterprise managers who had qualified for the position by virtue of their political credentials within the communist hierarchy.

A variety of forms of small businesses emerged, first in agriculture, followed by trade and later, in almost every segment of the industry and economy. The statutory rules that governed the foundation of joint venture companies with foreign capital participation facilitated the inflow of foreign capital as early as the beginning of the 1980s. The process of introducing Western standards with respect to the banking system and the tax regime and modernization of the Company Law began in 1988 prior to the major turn-around in politics.

Prices were increasingly liberalized and determined by the market place. Only about 16 percent of prices were fixed by the state by 1990. Hungary joined the World Bank and IMF in 1982. Both the progress and efforts made to harmonize Hungarian laws with the legal environment of the industrially developed Western countries helped to maintain the Hungarian economy's exceptional ability to attract foreign investment from the Western hemisphere in the 1980's.

By 1988 the government realized that a market economy cannot function in a vacuum and that laws had to be enacted to provide a more complete legal framework for the development of the country's emerging market economy. In 1988, a direct income tax system, taxing personal and corporate income, was introduced. In the same year, a modern business association law incorporating many of the corporate vehicles used in the West was passed. In November 1988 a foreign investment law was passed to promote foreign investment in Hungary.

On the negative side, the Kadar regime tried to gain legitimacy and support by providing Hungarians with consumer goods. This policy resulted in substantial foreign borrowing to finance the purchase of consumer goods and raw materials for Hungarian industry that the

Soviet Union could no longer supply. This left Hungary with one of the highest foreign debt burdens in the world, most of it short-term. The breakup of the Soviet Empire, and the disintegration of the communist bloc's trading system, resulted in a severe shock to the Hungarian economy. Many enterprises lost virtually their entire market overnight, as their trading partners within the communist bloc became insolvent or could not raise the hard currency to pay for imports.

While Hungary is generally acknowledged to have started earlier in its reform program, it introduced reforms at a somewhat slower pace than other countries in the region. Despite embarking on transition with a relatively liberalized economy, and despite postponing sharp macroeconomic adjustment until 1995, Hungary was not able to avoid a deep transformational recession. As Hungary began its economic transformation in 1990, its newly elected government was confronted with declining growth, rising inflation, a huge foreign debt, and a large government budget deficit. Real GDP declined by 18 percent from 1990 to 1993. Inflation more than doubled to 35 percent from 1989 to 1991. By 1993 significant deficits had emerged in both the budget (6.5 percent of GDP) and current accounts (9 percent of GDP). Unemployment rose from virtually zero under the communists to 12.5 percent.

On the macroeconomic front, the Government instituted a stabilization program that included tax increases, expenditure cuts, a devaluation of the Forint and tighter monetary policies. It also negotiated a rescheduling of its external debt, choosing to continue servicing the debt fully and on time in order to maintain access to international financial markets. It promoted the transformation of the economy by enacting a radical bankruptcy law that forced many uncompetitive enterprises out of business. The peak was reached in 1992-3 when more than 5000 companies filed for bankruptcy. It also began a wide ranging privatization program that emphasized cash sales to strategic and financial investors, often to foreign interests.

However, the Government delayed implementing critical fiscal adjustment measures and structural reform in the public sector such as reforming the budget process and controlling government spending. As a result, after an initial decline, the government deficit as a percent of GDP began to rise again as revenue declined due to the recession and government spending increased to maintain entitlement payments. Also, the government was forced to recapitalize the banking sector several times because it failed to undertake serious restructuring and privatization. The initial measures of the first freely elected government were sufficient to pull Hungary back from the brink of disaster and produce a 3 percent growth in GDP in 1994. However, the Government's gradualist approach and unwillingness to tackle some of the urgently needed but more economically and socially disruptive reforms led to another crisis and ultimately caused a delay in the resumption of sustained economic growth.

During its first few months in office, the socialist government elected in 1994 did not react to the looming economic crisis. Finally, in 1995 a stabilization package was introduced which dealt effectively with the macroeconomic situation and laid the groundwork for the resumption of sustainable growth. Measures included a devaluation of the Forint and establishment of the crawling peg system for controlling the exchange rate. A temporary 8 percent import surcharge on consumer goods was levied. Measures to restrain income growth were also imposed. Various steps were taken to increase revenue and decrease government spending. The privatization program was revised and reinvigorated including privatization of the banking sector and the energy sector. The Government also addressed public sector and fiscal reform issues seriously. The reforms - commonly known as the Bokros Reforms, after Minister of Finance Bokros - while unpopular at the time, are generally recognized to have quickly reversed the deteriorating economic and fiscal situation and laid the groundwork for sustainable economic growth. GDP growth dipped to 1.1 percent in 1995 and 1996 and finally began rising in 1997, reaching 5 percent in 1998. The economy is expected to grow about 4 percent in 1999. Unemployment has dropped to 7.5 percent.

The current government, elected in 1998, is continuing the policies of its predecessor for the most part. There is a strong consensus that accession to the EU is a priority and that economic and fiscal policies must therefore be compatible with the requirements of accession. Accordingly, there is continuing political support for maintaining fiscal austerity, reducing government deficits and reducing tax rates.

❖ *2. Fiscal Reform*

The budget reform process started slowly, in part because public support for such reform had not fully developed. Also, the reformist communist government and the freely elected successor government favored economic policies that avoided causing living standards to decline by favoring consumption over investment and social appeasement. Serious budget reforms were delayed until the country's economic and fiscal crisis became acute in 1995. The process had to begin with very basic changes, such as aggregating government activities to permit the proper calculation of important fiscal indicators, such as the true government budget deficit. Beginning in 1995, privatization revenues were excluded and so-called off-budget activities included in calculating the deficit. A rudimentary three-year budget planning system was instituted.

Initial reforms were directed at budget execution and control. In 1996, a State Treasury was created and an estimated 3,000 accounts were consolidated into a single treasury account. The State Debt Management Agency was created and then incorporated with the State Treasury at about the same time. Since 1995, it has successfully raised required funds from an emerging capital market. The term of government securities has continued to lengthen.

In 1998, the State Debt Agency issued bonds with a ten-year maturity. The vast majority of off-budget funds have been incorporated into the budget. The government has moved forward with efforts to improve the transparency of the budget and to improve budget planning and formulation. A Citizen's Guide to the Budget, which will communicate the broad policies, objectives and fiscal priorities of the Government, is under preparation. In the near future, the Government will move to a programmatic presentation of the budget and to make the accounting structure compatible with the IMF's Government Financial Statistics.

❖ **3. Tax Policy and Administration**

Tax reform began under the communist-led government in 1988. The reform shifted the tax burden from the productive sector to the distribution sector and to individuals through the introduction of the personal income tax and a VAT. A corporate tax was introduced in 1989. Initially, Hungary's tax policies were driven by the two objectives of attracting investment and supporting a large public sector. This resulted in a narrow tax base due to the extensive granting of preferences, a high tax rate to generate revenue to support the public sector while reducing government deficits, and compliance problems. Over time, the Government has made efforts to broaden the tax base and reduce tax rates. Consequently, tax policies have undergone significant changes almost every year. The fact that Hungary was the first transitioning country in the region to introduce a western-style tax system, and to refine and improve it over the last decade, represents a major accomplishment. Today it is broadly in line with EU practices.

The creation of a modern and efficient tax administration to implement policies will take more time than to improve the policies themselves. High tax rates (including the payroll tax for pensions, unemployment and health benefits) and the declining economy in the early years provided a significant incentive to evade taxes. While there is widespread agreement that much remains to be done to improve tax administration in Hungary, it is also clear that much has been accomplished in recent years to advance tax administration to a much higher level of efficiency and effectiveness. The structure of the Tax and Financial Control Office (APEH) was reorganized along functional lines in the mid-1990s and its staff increased to reflect the growing importance of tax administration. Tax administration activities have been computerized. A Large Taxpayer Unit was established in 1996. Progress has been made in collecting tax arrears though this remains a problem. In January 1999, APEH was assigned responsibility for collecting payroll taxes that fund the government portion of the pension system and unemployment benefits.

❖ *4. Pension and Health Reform*

The inherited pension and health systems represent a significant drain on the government's resources and a cause of continuing budget deficits. Payroll taxes remain high though the entitlement payments and services received by beneficiaries are inadequate. The Government has tackled pension reform, but much remains to be done in the area of health.

Although voluntary private pension funds were permitted in 1993, the key elements of pension reform were only introduced with the passage of a series of laws in 1997. The legislation establishes a new, multi-pillar pension system consisting of voluntary private pension funds, an overhauled state-run, mandatory, defined benefits type component, and a new mandatory private account. Implementation of the new system began in January 1998. The revised pension system raises retirement ages, changes the way pensions are indexed to cost of living and changes the benefits formula to reduce the redistributive aspects of the system. These changes will be phased in gradually. Because it is so new, key institutions such as the private pension fund regulatory agency need strengthening over the next few years. Hungary's pension system is state-of-the-art by international standards and is viewed as a model for other CEE and NIS countries.

Health care has been a priority concern of all Hungarian governments since 1988. Over the past ten years, substantial changes have been made to the system in efforts to make it more responsive to people's needs and to improve efficiency. Notwithstanding the merits of the many changes made in the operation of the health system, there is a general perception that it remains ineffective and costly. The Government of Hungary accepts the fact that well-intentioned incremental changes over the past decade have not had acceptable results. Three new laws were enacted in 1997 to provide a framework for more comprehensive reforms in 1998. Unfortunately, further steps have not yet been implemented though there is some indication that the current government intends to begin the difficult process of health reform.

❖ *5. Privatization*

The economic reforms and complementary changes in laws carried out by the communist regime and the emergence of an entrepreneurial class between 1968 and 1988 permitted Hungary in the 1990s to embark on the orderly sale of interests in state-owned enterprises. The urgent need for cash to reduce Hungary's external debt also argued for the sale of state-owned assets. Hence, unlike Russia and other CEE countries, Hungary did not utilize vouchers or other forms of share participation certificates to privatize.

The transformation of ownership rights in Hungary started in the last years of the 1980s with the so-called process of spontaneous privatization. This management-initiated process,

while it started changing ownership of state-owned assets, had numerous contradictory effects. In many cases, ownership did not devolve to the private sector. Rather, assets were converted to marketable forms (corporatization) and transferred to other state organizations such as banks. State assets were often sold at below their real value since the process was unregulated. The proceeds of sales did not increase state revenue. Nonetheless, by 1990 approximately 150 state enterprises representing about 8 percent of the total number of state enterprises spontaneously privatized themselves. The process continued after 1990 and by 1993 three to four hundred businesses had been established by the spontaneous privatization of an additional 100 state enterprises.

In 1988-89, the government passed new laws (The Economic Associations Act, the Transformation Law, and the Act on Investment by Foreigners) which regulated private enterprise, foreign investment and the transformation of state enterprises. These acts created the initial legal framework for privatization. The Transformation Law of 1989 provided a legal framework for the conversion of all types of state organizations into business organizations.

Government-controlled privatization of state-owned enterprises started to take place only after the first democratic elections in 1990 in response to the perceived abuses of spontaneous privatization. The government's policy was declared in the Property Policy Guidelines. Two new laws were issued which protected state property and established the State Property Agency (AVU) as the agency responsible for privatization and the protection of state property. The AVU was largely unsuccessful during the first two years of operation. Privatization of banks and utilities was suspended in the absence of an acceptable government strategy.

In 1992 the Act on Management and Privatization of State-owned Assets established a holding company (AVRt) to both manage and privatize 160 to 170 state enterprises in the energy, infrastructure, banking, insurance, agriculture and publishing sectors. AVU and AVRt operated in parallel until 1995. AVU essentially supervised the transformation and privatization process initiated by enterprises themselves. In addition, AVU also initiated and supervised the sale of assets using techniques such as private placements, trade sales, public offerings of shares and management and employee buyouts. AVRt had a broader function in that it managed the assets under its control as well as privatized them because the sectors in which it was involved were viewed as ones in which the Government would want to retain a presence.

The privatization program in Hungary is characterized by the wide variety of mechanisms that were used. Private placements and trade sales were accomplished through tenders. Public offerings were used for the conversion of well-known medium and large enterprises that could be expected to be profitable in the long run even without significant changes in operational structure or management. Management and employee buy-outs were supported

by various preferential financial schemes. Rather than issuing vouchers to promote the participation of ordinary citizens in privatization, the usual methods of privatization were supplemented by techniques to provide liquidity for potential domestic participants. Asset leasing was another method used to finance the transfer of assets. Auctions of small enterprises (mostly shops and restaurants) began in April 1991. Over 10,100 retail units were disposed of in this manner between 1991 and 1995. Self-privatization by firms was allowed but under the control of AVU. Special programs aimed at privatizing specific groups of industries (e.g. drugs, tourism, transportation, etc.) were also used.

The process of privatization was accelerated in 1995 by the recently elected socialist government, partly in response to Hungary's looming economic crisis, as the sale of state assets was seen as a source of revenue needed to reduce external debt. The Law on Privatization, passed in May 1995, provided a strategy for privatizing the energy, communications and banking sectors. It also merged the AVU and AVRt into the Hungarian Privatization and State Holding Company (APV Rt.)

From 1995 to 1997, Hungary privatized its energy sector. As a first step in 1994 legislation was enacted to regulate the sector and establish a relatively independent regulatory agency, the Hungarian Energy Office, to both carry out the privatization and regulate the sector.

Similarly, the banking sector was rapidly privatized, with only 10 out of 39 banks partially or wholly owned by the government by 1997. Initial legislation was enacted in 1991 reforming the banking sector. The legislation abolished the National Bank of Hungary's direct dependence on the Government and created a regulatory agency, the Banking Supervisory Agency. In 1996, the bank supervision agency was merged with the capital markets regulatory agency because banks, through wholly owned brokerages, were so heavily involved in the capital markets sector.

By 1998, 80 percent of the economy was in private hands and the process of privatization was largely completed, corresponding to the usual proportion of property in state hands in Western Europe. Sixty-eight percent of revenue from privatization came from foreign sources and seventy-five percent of revenues were paid into the central government's budget and greatly contributed to reducing Hungary's external debt. While hindsight shows that some aspects of the privatization process could have been done better, Hungary out-distanced all other CEE countries and is, arguably, one of the most successful privatization programs in the region.

❖ *6. Private Sector Development*

As noted above, reforms during the communist era allowed the development of small-scale private enterprises in agriculture, trade and other fields. The 1988 Company Act, which provided the legal framework for private enterprise operations, unleashed an unprecedented

fever of enterprise foundation in Hungary. In 1989-90, the number of enterprises grew by thousands every month. Most of the new organizations were small.

By 1990, there were 407,000 officially registered economic organizations in Hungary. Many were spin-offs from large state enterprises. Economic liberalization and the elimination of legal constraints from 1990 onward further stimulated the growth of the private sector. By 1995, there were over a million registered organizations but the number has declined slightly since then. Although many of these registered enterprises are inactive shells created for tax reasons, the active portion is very impressive. The vast majority of private enterprises (over sixty percent) are sole proprietorships - microenterprises with no employees. Microenterprises with 10 employees or less (about thirty percent) make up the next largest group.

Small and medium-sized enterprises (SMEs) have been of particular importance in the economy as they represent over 95 percent of the total number of enterprises in Hungary. The proportion of active workforce employed by SMEs increased from 51.2 percent in 1991 to 66.3 percent in 1997. Microenterprises, which employ 10 or fewer employees, constitute the vast bulk of the enterprises in the SME category. While small and medium size enterprises have been decreasing in number over the last several years, microenterprises have been increasing.

The enactment of a legal framework was critical to the development of the private sector. In general, private sector development has been supported by the liberalization of the economy and the measures taken to promote macroeconomic stabilization. Bank reform and privatization and the development of capital markets have also encouraged private sector growth. However, high rates of taxation and especially the social insurance and pension contributions have had a negative impact on private sector growth.

The role of SMEs in the transition from socialist to market economy has been critical. SMEs were able to increase output during the early transition period when production at most large enterprises was declining. SMEs generated slightly more than 49 percent of GDP from 1994 to 1997. The most important role of the SMEs during the transition was job creation.

While the creation of a legal framework, liberalization of prices and other macroeconomic reforms benefited SMEs, as they did large enterprises, taxation and a lack of credit probably affected the SME portion of the private sector more than large enterprises. Bank reform and capital markets development certainly helped larger enterprises, but did not help smaller ones as privatized banks sought to reduce risk and costs. Therefore, credit for small enterprises declined, leaving special government programs as the main source of credit financing. The current government has recognized the importance of the SME sector to the economy and has indicated that it will take steps to assist SMEs grow and develop.

❖ *7. Capital Markets*

In 1988, the Ministry of Finance began to hold weekly public auctions of government bonds and Treasury bills. In 1992, brokers were allowed to participate in the auctions along with banks. In 1995, the Government Debt Management Agency was established to take over the role of issuing agent from the National Bank of Hungary. A primary dealer system was introduced in January 1996. There are 21 primary dealers who participate in the auctions and are required to make markets in specified issues and to underwrite new issues. Corporate bonds are also traded but they represent a relatively small portion of the market in relation to the volume of government paper.

The Budapest Stock Market was established in June 1990, as a self-governing, non-profit entity owned by its members. These were initially large banks. Brokers, many owned by the banks, replaced them in 1992. A law regulating the market was enacted in 1996. In addition to the spot market in stocks and bonds, the Exchange has a futures market that includes trading in foreign exchange, selected stocks, and derivatives such as stock market and interest indices. There is also an over-the-counter market in unlisted stocks. Capitalization increased sharply from 1995 to 1998 when it was affected by the Russian financial crisis and lost about 30 percent of its value. Unfortunately, investors did not differentiate between Russia and the other formerly communist countries. Because the Hungarian economy is fundamentally sound the market is slowly regaining lost ground.

❖ *8. Agriculture*

Until 1990, agriculture played a significant role in Hungary's economy. This sector produced 15 percent of GDP and employed 19 percent of the labor force. Agricultural exports to other Soviet bloc countries were substantial. Under the Kadar government, farmers were allowed to own small farms and because of the regime's approach to incentives even state farms and collectives were reasonably productive. However, the sector relied heavily on subsidies, and when the transition began production declined and sector-wide unemployment was second only to the mining industry. Export markets in the east as well as internal markets contracted sharply. The transformation of agriculture was especially difficult to accomplish due to the large number of people involved in the sector and the emotional and nationalist concerns associated with land. The situation was exacerbated by the government's unclear position on how it would privatize the land. For example, it sent mixed signals on whether it would privatize all or only some state farms. It also wavered on the issue of the sale of land to foreigners.

The bulk of Hungary's productive land was controlled by 120 state farms and more than 1400 cooperatives. The cooperatives were in turn largely owned by the cooperatives' suppliers and customers which were state-owned enterprises. The ownership of cooperatives

was transferred to cooperative members and employees. Most of the cooperatives remained in production. Their numbers increased to around 2,000 and non-agricultural subsidiary units were spun off. Ninety-two state farms were broken up into small units and sold. While many complications and problems arose, the government succeeded in transferring 3.4 million hectares of land to the private sector. Approximately 800,000 new owners emerged. One result of this transfer was the sharp decline in average farm size. While the number of organizations in the agriculture sector grew, employment dropped. Agricultural organizations (i.e. cooperatives, commercial farms and small, privately-owned farms) with less than 20 employees now account for 75 percent of the entire agricultural sector. Total land area cultivated by households and small private entrepreneurs has been increasing steadily since the mid-1980s. Likewise, the small private producers' share of total production has been growing since before the change of regime, reaching 46.4 percent in 1991 and approximately 53 percent in 1994.

III. USAID'S ROLE

• *A. Implementation Arrangements* •

U.S. assistance to Hungary was authorized in the Support for Eastern European Democracy (SEED) Act of 1989 which was enacted to provide assistance to the countries of Eastern Europe that were taking substantive steps toward institutionalizing political democracy and economic pluralism. From its inception, assistance programs implemented under the SEED Act were to be short in duration relative to the development assistance programs that USAID implements in other parts of the world.

The SEED Act called for the appointment of a Coordinator within the Department of State "to oversee an interagency assistance program to Central Europe." USAID was designated as the lead implementing U.S. government agency and all funding for projects carried out by other U.S. Government agencies was channeled through USAID. A number of non-SEED funded activities, carried out by organizations such as the Peace Corps and USIS, also support the goals of the SEED Act. The SEED program has evolved from being a regional program, without specific country allocations, to one which involves country-specific assistance projects as well. This evolution has taken into account the varying circumstances of the SEED countries as each, in its own way, has moved toward greater democracy, market economies and expanded private sectors.

In response to the SEED Act, USAID was called upon to mount a rapid response to the new situation in Central and Eastern Europe. USAID worked in collaboration with other U.S. Government agencies, multilateral development agencies and bilateral donors. USAID employed the services of American contractors and non-governmental organizations who worked in partnership with host government, private and non-governmental organizations. Given the need for a rapid response and recognizing that the political and economic transition process broadly involved the same basic steps, USAID launched regional and multi-country projects that would quickly make available expertise in key areas, especially in the areas of privatization and democracy. For example, a project to provide assistance in privatization throughout the CEE was developed and one or more contractors with appropriate expertise were competitively selected to provide the required services throughout the region. Grants were given to U.S. non-governmental organizations to assist in the development of indigenous NGOs throughout the CEE. Similarly, funds were transferred to U.S. government agencies such as the Treasury Department to provide assistance in the region. Technical resources available under regional contracts and grants were allocated through a process of annual work plans and task orders. Funds were allocated annually on a sectoral basis with no country-specific funding allocations. This allowed USAID the

flexibility to provide and, when necessary, shift resources quickly to address the fast-changing situation in the region. The program was initially administered from Washington and no USAID personnel were stationed in the field. Within individual countries, U.S. embassies provided political direction and exercised general oversight of all SEED-funded activities.

As experience was gained, it became evident that the CEE countries were, in fact, economically and politically diverse. While the broad basic components of the transition process (e.g. privatization, creation of democratic institutions) and the goal of creating a market-oriented democracy were the same, each CEE country was adopting a unique route to this goal. The pace and order in which reforms were undertaken varied from country to country as well. Hence, assistance programs had to be tailored to fit country-specific circumstances. It also became clear that it would not be possible to manage the limited resources provided under the SEED Act in a cost-effective manner without a field presence. The number of activities and the number of implementing entities grew over time, requiring closer monitoring and supervision and making on-the-ground coordination more important. In response, USAID began to establish field missions and develop country assistance strategies. In addition, country-specific funding allocations were instituted in 1995. The USAID office in Hungary opened in July 1991. The first country strategy for Hungary was prepared in 1993.

After the establishment of the field mission in Hungary and other CEE countries, programming and implementation management responsibilities were shared between USAID Washington and the field missions. Over time, responsibilities were realigned, increasing field mission responsibilities and authorities. However, the continued use of regional grants and contracts administered in Washington continued to require shared responsibility. The reengineering of USAID processes in 1996 introduced a greater emphasis on strategic planning, the use of indicators to monitor results and the use of strategic objective teams. This helped to clarify the programming and implementation responsibilities. It also helped to sharpen USAID's program focus.

• *B. The USAID Program Strategy* •

USAID's overarching goal was "to assist Hungary in its national transformation to a democratic society, a market-oriented and private sector-led economy, integrated into key international systems and Western institutions".

❖ *1. 1989 to 1993*

Through 1993 initial assistance efforts focussed on three broad areas and, within them, 10 long-term objectives:

a) Democratic Governance:

- ◆ effective democratic institutions function at the national and the local level;
- ◆ population understands and participates in democratic process;
- ◆ political process demonstrates tolerance and respect for human rights; and
- ◆ channels exist for free and open communications.

SEED funds devoted to democratic governance were modest, reflecting the cost of the assistance providers, not a lack of program emphasis and priority. Most of these funds focussed on strengthening democratic institutions and processes, targeting the Parliament, local government, the election process, and the judiciary. U.S. assistance helped the country to organize and monitor the first free and fair multiparty election in 1990. Other activities aimed at strengthening the parliamentary functions. Study tours and training were arranged for parliamentarians, judges and legal professionals. Citizenship education in secondary schools and universities was supported through curriculum development, the provision of teaching materials and teacher training. Modest support was provided to NGOs engaged in such areas as the environment, community development and volunteerism. Technical assistance in public administration was provided to local governments. Assistance activities focussed only indirectly on human rights through work in the educational and judicial system and support for fledgling NGOs. Training in print and electronic journalism was provided through various mechanisms and the provision of equipment.

b) Economic Stabilization and Transformation:

- ◆ Hungary attains substantial compliance with Maastricht criteria (which sets broad objectives for EU membership);
- ◆ Hungarian Forint is fully convertible, in current account;
- ◆ dependence on foreign energy reduced; and
- ◆ percent of GDP from private sector increases from approximately 35 percent to 70 percent.

Economic restructuring programs accounted for approximately 75 percent of total funding, primarily for privatization, financial sector reform and the Hungarian-American Enterprise Fund. USAID technical assistance helped to develop the management capacity of the Hungarian Government's newly-formed privatization agency, AVU. U.S. Treasury advisors assisted the Government in financial sector reform. Advice was also provided in the area of small business development.

c) Quality of Life:

- ◆ The percentage of the population at or below the poverty line shows strong, steady fall from current level of approximately 25 percent; and
- ◆ The Government maintains essential social services for the most vulnerable elements of the population.

The SEED-funded assistance program in Hungary did not devote a significant percentage of its budget to activities which advanced social sector restructuring or provided support directly to targeted populations as it was expected European donors would do so. SEED-funded support provided to the Government of Hungary on policy issues related to social sector restructuring was limited to unemployment, housing and health. Training and technical assistance were provided in establishing a model labor center and local employment office staff were trained to teach business skills to new entrepreneurs. Assistance was provided to aid municipalities in formulating and implementing programs to deal with the divestiture of public housing and implementing means-tested housing subsidies. Vulnerable populations were assisted through such activities as an energy grants program and a program to improve the diagnosis and treatment of children with cancer.

❖ *2. 1994 to 1995*

In 1994, USAID's strategy and program were revised to reflect a sharpening of focus, changing priorities and Hungary's progress.

The **democracy and government objectives** were left unchanged but direct assistance to Parliament and electoral process was terminated and greater emphasis was placed on strengthening local government. Assistance to NGOs and the media continued.

The **objectives for Economic Stabilization and Transformation** were revised as follows:

- ◆ progress is made toward substantial compliance with Maastricht criteria, comparable to other EU members;
- ◆ private sector continues to grow and prosper, as evidenced by increase in percentage contribution to GDP from 50-60 percent at present to 70 percent; and

- ◆ progress is made toward establishing a dynamic financial sector as evidenced by: the privatization of at least four state-owned banks; an overall capital adequacy ratio for the banking sector in line with the EU norm of 8 percent; and increased lending to private sector to more than 50 percent of total lending.

Assistance in privatization continued while attention to the banking sector and the promotion of SMEs was significantly increased. The objectives for Quality of Life were also revised to emphasize the need to restructure government delivery systems and to develop the capacity of non-government organizations to deliver social services. The revised objectives read as follows:

- ◆ the percentage of the population at or below the poverty line shows strong and steady fall from current levels of approximately 23 percent;
- ◆ the government restructures existing social delivery systems to more efficiently target those in need; and
- ◆ non-governmental organizations expand their ability to provide social services.

❖ *3. 1996 to 1999*

As part of the USAID reengineering process, the annual Results Review and Resource Request (R4) was instituted. This formalized the use of Strategic Objectives (SOs), Intermediate Results and Indicators to measure the results of U.S. funded assistance. Country program SOs were required to fit within SOs for the region which, in turn, had to fit within broader Agency SOs. In 1996, the objectives of the Hungary program strategy prepared in 1994 were revised to fit the new format to permit the Mission to assess progress and to link them to a revised country strategy prepared at the same time. The objectives described in previous strategies were reconstituted as follows:

SO 1.1 – Transfer of State-owned assets to the private sector

The Mission considered this SO to have been fully achieved. The vast majority of state-owned enterprises had been privatized by 1995, with the exception of the banking and energy sectors, which would be covered under different SOs in the new strategy.

SO 1.2 – Establish a policy, legal, and regulatory framework conducive to broad-based competition and private sector growth

This SO was not carried forward as the policy, legal and regulatory frameworks were broadly in place. Remaining areas of concern were covered under other SOs.

SO 1.3 – Stimulate development of private sector enterprise

This SO was narrowed to focus specifically on SMEs and given a very high priority.

SO 1.4 – Promote fiscal reform

The activities under this SO were carried forward in the new strategy.

SO 1.5 – Develop a competitive, efficient, private financial sector

The activities under this SO were carried forward in the new strategy.

SO 1.6 – More sustainable use of natural resources

Many of the activities under this SO were carried forward in the new strategy.

SO 2.3 – Strengthen local government to make it effective, responsive, and accountable to its citizens

SO 2.4 – Promote the active participation of citizens and non-governmental organizations in political and economic decision making

SO 2.5 – Promote the open flow of information by strengthening the independent media

These democracy and governance SOs were combined into a single comprehensive SO in the 1996 Strategy revision and the activities were carried forward.

SO 3.2 – Improve the sustainability of social benefits and services

This SO was carried forward in the revised Strategy but integrated into a broader one dealing with fiscal policy.

In 1996, the USAID Country Strategy was again revised to reflect Hungary's progress and to sharpen even further the program's focus. Constraint analyses of the SO areas were prepared to ensure that the activities under each SO were properly targeted. In USAID progress reporting documents, Hungary was recognized as a fully democratic nation. Its progress toward a market economy was also recognized with almost 70 percent of its GDP generated by the private sector and the basic policy, legislative and regulatory framework in place.

The overarching goal of the U.S. assistance program remained unchanged: Assist Hungary in its national transformation to a democratic society, a market-oriented and private sector-led economy, integrated into key international systems and Western institutions. This goal was elaborated on by the statement of two sub-goals: 1) assist Hungary in achieving sustainable economic reform; and 2) assist Hungary in completing its democratization process.

The dual thrusts of the new strategy were:

- ◆ to finish the remaining activities aimed at addressing macro level issues; and
- ◆ to assist Hungary in carrying out the last stage of full democratic and economic transition by bringing both the responsibilities and benefits of the transformation closer to the average family and community.

The strategy projected the termination of assistance in 1999. The strategic objectives shown above were reduced to the following five (the numbering and wording of the SOs conform to a more extensive list of SOs developed for the region):

SO 1.2 – Increased soundness of fiscal policies and fiscal management practices Assistance under this objective was intended to help reduce Government deficits that were destabilizing the macroeconomic situation. Assistance was focussed on:

- ◆ improving the Government's budgeting and program management processes;
- ◆ tax policy and tax administration to improve revenue generation
- ◆ reducing the Government's role in the economy by focussing on government spending for pensions and health care.

SO 1.3 – Improved performance of small and medium enterprises

To contribute to the emergence of a competitive, market-oriented economy, USAID chose to focus on the SME sector because it was dynamic and had already shown the potential to be the engine of sustained growth and expanded employment opportunities. To achieve this SO U.S. assistance focussed on:

- ◆ increasing SME access to commercial banking services;
- ◆ improving SME access to market and technology information;
- ◆ improving business systems and practices; and
- ◆ improving policies, laws and regulations affecting SMEs.

SO 1.4 – A more competitive and market responsive private financial sector

This SO was selected because of the critical importance of properly regulated competitive financial markets to rapid, sustained economic growth. To achieve this SO, U.S. assistance focussed on:

- ◆ improving monetary policy;
- ◆ improving regulation and supervision of the financial sector;
- ◆ improving the operational efficiency of financial sector institutions such as the banks; and;
- ◆ reducing the participation of the public sector in financial institutions through further privatization.

SO 1.5 – An economically sustainable, restructured energy sector

An efficient energy sector was viewed as essential to Hungary's competitiveness in world markets, which was in turn essential to sustained economic growth. A restructured energy sector was defined as one which operated in a free and competitive marketplace where price reflects cost and energy is bought and sold on a market basis, is regulated independently of political whim, and regionally integrated with Western Europe. To achieve this U.S. assistance focussed on:

- ◆ improving the efficiency of generation, distribution and transmission of electricity;
- ◆ improving end-use efficiency;
- ◆ rationalizing energy pricing; and
- ◆ improving rate making and regulatory oversight.

SO 2.1 – Better informed citizens increase their participation in political and economic decision-making at the local level

Broadened popular participation in public decision making was defined as the key to successfully consolidating the democratic transition. As advocates, monitors and implementers of public policy issues, non-governmental organizations were viewed as a principal element of increased citizen participation. The availability of useful information was another critical element. Finally, local governments needed to be more effective in involving constituents and responding to their needs. U.S. assistance therefore focussed on:

- ◆ increasing the flow of useful information;
- ◆ promoting a more active and responsive civil society (defined as the citizenry at large and the myriad of non-governmental organizations that provide services and information, and advocate for issues on behalf of the public interest);
- ◆ assisting local government to be more effective and responsive to citizens.

In 1997, USAID added a fourth area of focus - improving collaboration in local governance.

Also in 1997, USAID developed a detailed Close-out Plan that assessed the prospects for achieving the five SOs by September 1999, the target date for closing the Mission. SO 1.5 was found to be essentially achieved with only the completion and termination of activities remaining to be done in 1998. All other SOs were on track and the expectation was that Hungary would graduate from the rolls of USAID recipients on schedule. In 1998, the Mission confirmed that Hungary would be able to complete the political and economic transition without USAID assistance after 1999.

As the termination of the program approached, the Mission was concerned that the sustainability of many non-governmental organizations in Hungary was uncertain. A new program to provide additional support using local implementing organizations was developed and implementation initiated. The program will continue for an additional year beyond the closing of the Mission. Similarly, because pension reform was initiated rather late, insufficient time was available to assure that the regulatory agency for private pension funds was fully capable of fulfilling its role. This assistance activity will be continued for up to two additional years beyond the closing of the Mission. Some activities being carried out by other U.S. government agencies will also continue for brief periods beyond the closing of the Mission.

◆ C. The USAID Funded Assistance Activities ◆

❖ *1. Democratic Transition*

a) Support for Democratic Institutions and Processes

USAID's assistance efforts focussed on strengthening national level democratic institutions and processes, targeting the Parliament, the election process, the judiciary and local governments. With the exception of assistance to local governments, this assistance was limited to the first few years of the USAID program.

- ◆ The State University of New York established the center for Parliamentary Management at the Budapest University of Economic Science to link the human and information resources of the University with the needs of the Parliament. Assistance was provided in the establishment of the legal and institutional framework of the center and strengthening the capacity of the Center to meet the needs of Hungary's legislative body.
- ◆ USIS coordinated the donation of computers and library books and training for Parliamentarians in the U.S. and Hungary.
- ◆ The National Democratic Institute and the International Republican Institute provided technical assistance to assist Hungary in carrying out its first democratic election since 1945. Equipment and materials were furnished to opposition political parties. The League of Women Voters conducted seminars on turning out the voters. No further assistance was provided after the first election.
- ◆ The American Bar Association Central and Eastern Europe Law Initiative (CEELI) supported the judiciary by providing training for judges and legal professionals in the U.S. and Hungary and a long-term advisor. Training and technical advice focussed on subjects related to court administration and management and various alternative methods of settling cases outside of court.

b) Better Informed Citizens

USAID assistance first focussed on strengthening the independent media through the creation of a training institution, the Center for Independent Journalism. While this focus continued, USAID assistance broadened to include helping local governments to develop mechanisms for providing constituents with public information and encouraging local governments, NGOs, and the media to institute mechanisms for collaborative decision making.

- ◆ Promedia, in cooperation with the Center for Independent Journalism provided training to local television and radio stations in such areas as producing local news programming and business management. Promedia also assisted with the formation of an association of local TV stations and provided the new association with capacity building assistance.

A special focus has been working with the media on minority group issues and special efforts have been made to train Roma journalists in mainstream journalism.

- ◆ USIS also implemented training programs on such topics as production techniques, marketing and advertising and personnel management.
- ◆ The International City/County Managers Association (ICMA) helped 13 municipalities to develop an extensive database of local government information both for the purpose of improving cooperation about the municipalities and to improve the flow of information to the public. In addition, the municipalities in two counties received media training to improve their ability to cooperate with the media and to deal with and prepare information for the media.
- ◆ The Demnet project (see below) provided NGOs with training in public relations and public information.

c) Increased Citizen Participation

The primary mechanism chosen by USAID to increase citizen participation was non-governmental organizations (NGOs). Assistance focussed on improving the legal and regulatory environment for NGOs and directly supporting NGOs through training and financial support.

- ◆ The major assistance mechanism was the Democracy Network or Demnet, implemented by United Way International through a specially created local organization, the Foundation for the Development of Democratic Rights. Demnet provided NGOs with capacity building training which included training in advocacy and lobbying, developed a non-profit management teaching curriculum, and published a series of handbooks on subjects such as PR for NGOs.
- ◆ Demnet provided more than \$1.1 million in grants to 387 Hungarian NGOs, concentrating on NGOs outside Budapest and on NGOs working in the fields of democracy, social service, independent media, employment, economic development and environmental protection.
- ◆ One of Demnet's most successful projects was the establishment of "telecottages," small-community telecommunications service and consulting centers, which facilitate information dissemination, access to information (e.g. e-mail and internet), and consulting services for citizens and NGOs.
- ◆ Demnet activities also promoted cooperation between NGOs and local governments and-between NGOs themselves. Six regional satellite networks of Demnet NGO partners were formed to help other NGOs in their regions and participate in the "telecottage" program.
- ◆ The International Center for Not-for-Profit Law (ICNL) played a major role in the preparation of a new NGO law that was enacted in 1997. It provided direct assistance to the drafters of the new law by providing model laws, drafting sections, commenting on specific provisions, and organizing a study tour to the U.S. for drafters. ICNL, working with Demnet, organized "town meetings" around the country to promote broad participation in support for the new law.
- ◆ Two local NGOs, the Foundation for the Development of Democratic Rights (now fully

independent of United Way) and the Autonomia Foundation are continuing to support the development of NGOs through the implementation of TANGO (Targeted Assistance to NGO) a program of grants and technical assistance. Fewer NGOs will receive larger grants in order to give the recipients a better chance of achieving financial sustainability. Local consultants who will act as mentors to the grant-receiving NGOs will provide technical assistance. This will enhance their ability to tailor assistance to the needs of the NGOs.

d) More Effective and Responsive Local Government

Major constitutional reforms passed in the early 1990s gave unprecedented control of local government to local populations and made local governments responsible for delivering a wide range of services. To bring the benefits and responsibilities of democracy closer to the people, USAID devoted a significant effort to strengthening the capacity of local governments to meet the needs of constituents. These efforts took the form of capacity building, promoting collaboration between municipalities, and with NGOs and individual citizens. In most cases, technical assistance, training and study tours were used to create replicable models in a limited number of municipalities. Activities aimed at disseminating information about successful models and institutionalizing the capacity to replicate these models were also supported. A number of activities also assisted the National Government to deal with local government policy issues and various aspects of the legal and regulatory framework supporting the operation of local government.

- ◆ Early in the USAID program, a number of capacity building activities were undertaken. The International Executive Service Corps (IESC) provided volunteer experts to 11 small municipalities and 17 villages as well as three institutes of higher education. These experts provided advice and assistance on a wide range of subjects including economic development, long-range planning, organizational restructuring, financial management and control, and human resources management.
- ◆ The International City/County Managers Association (ICMA) was a significant supplier of assistance. The ICMA provided training and technical assistance to enhance the capacity of municipalities in urban planning and housing development.
- ◆ ICMA also undertook activities: to improve relations between local governments and the national government; enhance local government management capacity; promote inter-local cooperation; and improve public access to local government. ICMA implemented these activities through the provision of technical advice, the design and implementation of pilot activities and training programs. Activities included media training for municipal officials and the development of a computerized database of municipal information shared by 13 local governments. The Center for Municipal Training was established and efforts were made to foster the formation and development of an association of municipalities.
- ◆ As a model for inter-local cooperation, the ICMA assisted 10 communities to develop

- and implement a landfill project to deal with solid waste disposal.
- ◆ The Research Triangle Institute (RTI) worked with municipalities to enhance their capacity to deal with environmental issues such as solid and hazardous waste disposal. Through the process of working with municipalities, pilot projects were designed, local consulting expertise developed and practical concepts developed, tested and disseminated. The activity also assisted participating municipalities to prepare and market funding proposals.
 - ◆ The Urban Institute was another major provider of technical assistance and training. One of the Institute's most successful efforts was a program to introduce modern municipal financial administration and budgeting. Building on a model budget developed for one city, a larger group of municipalities were trained in basic concepts and methodologies of program budgeting. To assure replication of this successful program, an association of municipal finance officers was established and a variety of materials prepared and disseminated.
 - ◆ The Urban Institute created "the Advocate" to develop an outreach capacity to make local government and democratic governance innovations available to communities nationwide. The Advocate also helped Hungarian associations and other institutions to develop outreach capacity. The Advocate has disseminated information on a number of innovative local government activities both directly to interested users and through the press.
 - ◆ The U.S. Department of Labor implemented two complementary activities aimed at dealing with unemployment and community economic development. The initial purpose of these activities was to mitigate the effects of privatization and economic restructuring, but they also became models for promoting cooperation between local governments, NGOs, and the private sector. The first program taught communities how to organize and mobilize community resources to deal with unemployment prior to the implementation of mass layoffs by restructuring companies. The staff of County Labor Centers received training in basic rapid response and worker adjustment procedures and techniques. A Rapid Response Reemployment Assistance Committee, which brought together representatives of County Labor Centers, employers, NGOs and other community participants, was then formed to assist workers before they were actually laid off. The Committee identified training programs, searched for jobs within the community, and took other steps to help workers find new employment. A second model taught communities how to organize themselves and to prepare local economic development plans. Both models have proven to be successful and the capacity to replicate them has been institutionalized with support from the National Government.

❖ **2. Economic Stabilization and Transformation**

a) Fiscal Policies and Fiscal Management Practices

USAID assistance, consisting of long- and short-term advisors, training and study tours, focussed on how the government collects and spends its share of the nation's wealth. The overall aim was to reduce the role of the Government in the economy by providing it with a transparent, efficient, market-oriented budget, fiscal management, and revenue generation and collection systems. USAID assistance also focussed on reforming the country's pension and health systems because the existing inefficient and over-extended systems drain government resources without meeting the needs of the people. Finally, assistance was provided in the area of housing finance in order to reduce the subsidy burden on the Government budget.

- ◆ U.S. Treasury advisors helped the Ministry of Finance to develop better budgeting processes, treasury functions to manage the flow of money to government agencies and debt management functions.
- ◆ U.S. Treasury advisors assisted the Government in formulating improved tax legislation and tax policy. They also assisted the state agency responsible for tax collection, APEH, to reorganize and to strengthen its revenue collection capabilities.
- ◆ Assistance provided by the U.S. Treasury, Financial Services Volunteer Corps (FSVC) and the Center for International Private Enterprise (CIPE) helped the government to formulate a state-of-the-art pension system and prepare implementing legislation. Advisors from the European Management Center helped to develop the capacity of the state agency charged with supervising private pension funds.
- ◆ Assistance in the area of health reform, provided by the U.S. Department of Health and Human Services and U.S. contractors such as 3M-HIS, Health Management Systems and the Agency for Health Care Policy Research, improved the efficiency of the existing system to a limited extent. More importantly, many people in the Hungarian health system as well as key policy makers have had the opportunity to learn about alternative methods for fundamentally overhauling the system.
- ◆ The Urban Institute advised the Government on housing subsidy policy and assisted in the revision of a number of critical laws (e.g. foreclosure law). It also advised the OTP Bank, Hungary's largest bank and the largest mortgage financier, on alternative types of mortgages such as the Deferred Payment Mortgage. Assistance was provided to other potential lenders such as savings cooperatives in order to introduce competition and increase the resources in the mortgage lending market.

b) Privatization

USAID provided substantial assistance in the area of privatization utilizing the services of U.S. consulting firms (Deloitte and Touche/Chemonics and KPMG/Barents).

The assistance consisted of both long-term and short-term advisors as well as training and study tours. Broadly speaking, assistance fell into three categories:

- ◆ Capacity building for the state agencies (AVU, AVRt and APV Rt and the Ministry of Finance) charged with directing the privatization process. This included training of personnel, computerization and the development of methodologies for privatizing different types of companies such as leasing and the promotion of employee ownership. U.S. advisors assisted the Government in drafting enabling legislation for Employee Stock Ownership Plans (ESOP).
- ◆ Direct assistance in privatizing State-owned organizations included assistance in preparing tenders, improving the asset value of companies, promoting privatization to foreign investments, participating in negotiations, etc.
- ◆ Reforming the legal and regulatory framework supporting privatization was done by providing models and advisors to assist the GOH in preparing draft legislation. Notable examples of such USAID assistance included: the Anti-Trust Law; Telecommunications Law; the Bankruptcy Law; and the Agricultural Reform Law

c) Private Sector Development Including SMEs and Agriculture

USAID assistance in other areas described in this paper contributed significantly to the promotion of the growth of the private sector. A stable macroeconomic environment and a private sector-friendly legal and regulatory environment are prerequisites for a flourishing private sector. Likewise, a healthy, competitive financial sector is essential for generating capital resources for private sector growth. Privatization shifted state-owned assets into private hands and some of the programs supporting privatization also supported newly formed private enterprises. USAID assistance under this heading was targeted directly at private enterprises and the local organizations that supported private enterprise. Assistance was largely provided by short-term advisors, study tours, policy research and advocacy, and grants to strengthen local organizations. A number of U.S. organizations, working with local institutions, initiated a variety of training programs for new entrepreneurs, managers and the employees of organizations that supported private sector firms. Short-term advisors, usually volunteers, assisted many private enterprises directly. A variety of activities sought to improve the environment for the private sector through policy research, public advocacy and legal reform. Over time, assistance focussed on small and medium-sized enterprises (SMEs). Programs of assistance designed to focus specifically on the agriculture and housing sectors were also implemented.

- ◆ Indiana University and the State University of New York (SUNY) developed management training programs, including an MBA program, with special emphasis on total quality management, at Hungarian universities.
- ◆ Ohio State University, SUNY, CIPE, Aid to Artisans, and other U.S. organizations, working with local partners, organized basic courses related to starting and managing small businesses.

- ◆ CIPE helped to strengthen business associations through training for officers.
- ◆ RONCO strengthened the capacity of consulting firms to assist SMEs.
- ◆ The International Executive Service Corps, MBA Corps, and Peace Corps provided numerous volunteer experts to work directly with individual enterprises. These volunteers helped the firms to develop business plans and organize their activities more efficiently. They also transferred enterprise-specific skills and knowledge.
- ◆ A group of U.S. Government agencies including the Trade and Development Agency, the Overseas Private Investment Corporation and the Department of Commerce implemented a variety of activities to promote links between U.S. and Hungarian businesses by locating potential American partners and providing information on U.S. markets.
- ◆ The agriculture and agribusiness sector benefited from training for entrepreneurs and managers, direct assistance to agricultural enterprises and capacity building for supporting organizations. Winrock International and ACIDI/VOCA provided volunteer experts. Land of Lakes, a large U.S. cooperative organized training programs. Efforts were made to link U.S. and Hungarian agricultural enterprises.
- ◆ ACIDI/VOCA developed a highly successful program that linked together the many small enterprises involved in specific areas of agricultural production (e.g. dairy products, meat products). These "integrations" included input suppliers, producers, processors and distributors. A large number of these organizations were created with ACIDI/VOCA assistance. The capacity to continue this assistance has been institutionalized in ACIDI/VOCA's Hungarian partner Altagra.
- ◆ CIPE, through grants to think tanks and universities sponsored important policy research and, through dissemination of results, influenced the formulation of policies affecting SMEs. CIPE also organized roundtables that brought together representatives of policy-making organizations, SME stakeholders, and other concerned organizations to discuss important issues affecting the private sector and especially SMEs. CIPE also supported the periodic collection of data on the SME sector, in order to provide the Government with crucial information for policy formulation.
- ◆ World Learning arranged training and study tour programs in the U.S. for enterprise managers, entrepreneurs, and the employees of business associations.
- ◆ The Hungarian - American Enterprise Fund provided both debt and equity capital to SMEs and funded training.
- ◆ A number of programs were instituted to assist newly privatized banks to develop their capacity to lend to SMEs. These included both training and loan guarantees.
- ◆ The Urban Institute undertook a wide range of activities to support SMEs working in the housing sector. Legal and policy reform efforts resulted in a new condominium law and condominium rehabilitation program. Firms engaged in property development, property management, housing renovation and construction, and real estate sales were provided with in-country training courses and were helped to form associations.

d) Financial Markets

USAID assistance in the form of long- and short-term advisors focussed on bank privatization, and developing the institutions that regulate and supervise financial markets. In addition to capacity-building assistance for regulatory agencies, direct assistance was provided for privatizing specific banks.

- ◆ U.S. Treasury advisors worked with several banks and the Minister without Portfolio for Privatization while advisors from KPMG/Barents worked with the Ministry of Finance on various aspects of bank privatization. Generally, the assistance focussed on preparing the banks for sale to private owners. Treasury advisors actually assisted in the sale of some banks.
- ◆ KPMG/Barents provided advisors to develop the capacity of the state agency responsible for supervising banks and capital markets. Specific attention was paid to the agency's on-site and off-site bank examination methods and procedures. Agency staff were also sent to the U.S. for study tours and training. FSVC volunteers provided training in specific areas of concern such as handling Y2K problems.
- ◆ KPMG/Barents assisted the National Savings Bank (OTP) to develop and implement a training program on small business lending for OTP staff preparatory to the initiation of a new small business loan guarantee program.
- ◆ The Financial Services Volunteer Corps (FSVC) provided the services of 100 experts from leading U.S. investment banks, commercial banks, and law and accounting firms to promote the development of financial markets in Hungary. Volunteers visited Hungary for periods of two to four weeks and advised the Ministry of Finance, the National Bank of Hungary, the Budapest Stock Exchange and the Hungarian Bankers Association.
- ◆ First Washington Associates played a major role in establishing Hungary's first professional credit rating agency. As a result of the long-term advisor's efforts, Thompson Bankwatch, an internationally known credit rating agency took a significant equity share in the new organization and will continue to provide capacity building technical assistance.

e) Energy and Environment

USAID's assistance in the field of energy centered on creating the necessary legal and regulatory framework for a privatized energy sector by developing the capacity of the Hungarian Energy Office (HEO), the nation's quasi-independent energy regulatory agency. Other activities focussed on improving energy procurement and energy efficiency through training and workshops. Early assistance focussed on nuclear safety at Hungary's large nuclear power plant. Assistance was provided to help Hungary strengthen its environmental laws and to strengthen citizen involvement in environmental protection at the local level.

- ◆ Bechtel Consulting advisors collaborated with HEO on the development of alternative pricing methodologies and establishment of a "social price threshold" to buffer the impact of price increases on those least able to pay. They also advised the HEO on the development of regulatory methodologies and process and an organizational structure to carry out its responsibilities. Bechtel also provided basic computer hardware and software to the HEO as well as IT support. The consultants also supported HEO's privatization efforts by assisting in preparing assets for sale and preparing bid documents.
- ◆ Hagler & Bailey assessed the energy efficiency of Hungary's industrial sector and made recommendations for improvement.
- ◆ The World Environment Center assisted Hungarian industries to review their production process to identify sources of waste, which also resulted in environmental pollution, and to take low-cost measures to reduce waste. The result was increased productivity and reduced pollution.
- ◆ The U.S. Environmental Protection Agency (EPA) provided a range of assistance. Municipal governments, NGOs, and individual citizens were trained in the preparation of local environmental action plans. The national government and concerned local governments were assisted in the preparation of a plan to improve the water quality of a major watershed. The EPA assisted in the establishment of the Hungarian Environmental Management Training Center.
- ◆ The Harvard Institute for International Development introduced Hungarian experts to the application of market-oriented economics to the field of environmental protection. Working with the Ministry of Finance and interested experts from the academic world, environmental policy and regulatory issues were analyzed using such economic tools as cost-benefit analysis.
- ◆ The Environmental Law Institute conducted training workshops to strengthen environmental laws and regulation as well as enforcement.
- ◆ The University of Minnesota trained people from NGOs, local governments and environmental businesses in various aspects of environmental protection and management. Several Hungarian trainers were sent to the U.S. for training in order to institutionalize the courses that were being offered.
- ◆ The U.S. Nuclear Regulatory Commission and the U.S. Department of Energy provided in-country and U.S. training and technical assistance in nuclear safety for personnel from Hungary's nuclear power plant and the Government of Hungary regulatory agency.
- ◆ Sanders International provided technical assistance and training to Hungarian firms engaged in providing environmental goods and services.

IV. "LESSONS LEARNED" FROM USAID'S ASSISTANCE PROGRAM IN HUNGARY

• *A. Program Design* •

Based on the USAID experience in Hungary, the following "Lessons Learned" should be taken into consideration when designing programs to assist countries in making the transition from centrally planned, authoritarian economic and political systems to private sector-led market economies and pluralistic societies.

1. The reform process is technically, politically and socially complex. The process requires the successful completion of a number of different but related steps. Program planners and their counterparts should break down the reform process into manageable steps. Properly sequencing the steps and the supporting assistance activities is often critical to success. This will facilitate the building of a broad consensus in support of reform. It also permits program planners to assess political support for reforms and the indigenous capacity to manage the reform process.

2. Much has been said about the importance of "political will." Generally, "political will" is taken to mean whether or not critical elements of the central government are supportive of particular reforms. There is no doubt that without "political will" at some point in time, reform will either not take place or not be sustainable. The Hungary experience demonstrates that useful assistance activities in support of reforms can be undertaken regardless of the depth and breadth of "political will" for any particular reform. The type and duration of assistance activities that can be usefully undertaken in the absence of significant support from the central government will be determined by the nature of the reform. Assistance in an area of reform that requires significant modification of the legal and regulatory framework as an early step in the process will be constrained if "political will" is lacking. In areas such as democracy and governance, where there are many participants outside the government, there will be more that can be done. Ultimately, however, there will be reforms that require government action and, therefore, "political will."

Among the activities which can be undertaken in the absence of political will are:

- ◆ conducting activities such as study tours, research and roundtables which can influence the thinking of decision makers;
- ◆ strengthening and supporting the constituents for reform (i.e. organizations such as business associations and other interest representation groups as well as individuals);
- ◆ supporting the development of NGOs and private sector organizations;

- ◆ transferring technical knowledge to those people and groups who will need it when reform becomes possible;
- ◆ training younger, more reform minded people who will rise to higher levels of responsibility in the future; and
- ◆ conducting public education campaigns and opinion polls in order to generate support for reforms and to demonstrate that support to the politicians.

3. In Hungary, USAID gave priority to privatization and fiscal reform as these seemed to be the most urgent tasks. In both cases, Hungary had started the reform process before USAID became involved but sufficient political will to undertake some of the hard reforms at an early stage was lacking. At the same time, many Hungarians were being impoverished by the contraction of the economy and changes brought about by the reform process itself (e.g. rising prices). Under the circumstances, it might have been wiser to allow room in the program for the early initiation of assistance to SMEs which can be the engine of sustainable economic growth and generate employment. Earlier attention should also be given to social reform/quality of life activities as these can mitigate the negative impact of the transition process, thereby helping to retain general support for reform.

4. The perception that successful programs and models can be transferred from one CEE or NIS country to another because they share a common Communist experience is valid only to a point. Such programs and models must, of course, be adapted because of varying historical, cultural and linguistic differences. They are also not transferable without adjustment because the economic and political systems within the region are not exactly the same and do not evolve in the same manner. Programs and models must be tailored to suit specific local needs including the level of political support. They must be additive and integrated into what is happening in the country setting. Program designers should understand how local conditions differ from those of countries where the experience was gained and be willing to make adjustments. Local participants must be encouraged to use the program or model as a starting point for trial and possibly adaptation.

5. The objective of sustainability is much more likely to be achieved if it is a conscious element in the initial program design and the ongoing program implementation process (e.g. built into scopes of work for assistance providers). Defining what will constitute a sustainable end result can help to guide program design in the right direction. Institution building is not only a key to successful reforms, but also critical to sustainability. A concrete plan to achieve financial sustainability must be developed on "day one" and then assessed and updated at regular intervals. Other activities that were found to promote sustainability in the Hungary program include:

- ◆ carrying out programs countrywide or at least in as many places as possible and certainly outside the capital city rather than limiting activities primarily to one or two locations;
- ◆ enhancing the spread effect of training by incorporating into the training concepts and

skills which will allow the trainee to transfer what has been learned to colleagues and follow-up activities which will allow:

- ◆ translating key project materials into the local language and distributing the material to carefully selected target audiences;
- ◆ developing mechanism for the replication of pilot activities as part of the activity;
- ◆ promoting a strong sense of ownership on the part of participants; and
- ◆ building indigenous capacity through intermediate support organizations such as professional business associations and local organizations such as NGOs and local government.

5. Countries in transition have little or no experience in formulating policy in an open and democratic manner. Donor programs tend to focus assistance on the development of specific policies. Supporting an open public policy dialogue process as part of the overall effort can help institutionalize effective policy making and implementation. Programs should incorporate a multi-pronged set of strategies that engender policy dialogue by:

- ◆ supporting policy research organizations such as think tanks and academic institutions that can provide information and analyses to inform the policy dialogue;
- ◆ training the media to play a role in fostering policy dialogue;
- ◆ creating fora for the discussion of emerging policies; and
- ◆ training NGOs and associations to participate in policy debates on behalf of their members.

6. At the implementing organization level, it is essential that critical counterparts be committed to reform and to the programs of assistance being implemented to assist in reform. Counterparts must include people who are sufficiently high ranking within the organization to bring about change, make decisions, influence policies, etc. It is critical that program designers obtain the concurrence of counterparts in the project scope, objectives, deliverables, duration and tasks before the project is initiated. If committed counterparts can not be found, program designs should be adapted by exploring counterpart ideas and objections, working with other organizations where possible and/or undertaking activities that can encourage the development of counterpart support and commitment.

7. Given the complex interplay of competing stakeholders, there will always be proponents and opponents of a specific reform. Support from a line ministry does not necessarily mean support throughout the government. Support in a local community will never be uniform. Proactive advisors cannot restrict their efforts to immediate counterparts. They must identify other important stakeholders and reach out to keep them informed and involve them in the process, in order for them to build consensus and support for reforms. The representatives of political opposition groups must not be overlooked in countries with new democracies.

8. Objectively verifiable indicators designed to measure the impact of activities should be built into activity designs and the activity budget should include allocations for their collection and analysis. Results that are difficult to measure such as changes in mind-set require special indicators developed using organizational psychology and social survey methodologies. The use of indicators has a developmental benefit for local partners who are generally unfamiliar with them. It helps them to focus their activity on results and permits them to demonstrate to other donors and their own government that they can achieve results.

9. Pilot projects, if properly designed, can be very useful in transition situations because they provide:

- ◆ a means for testing and adapting new concepts in the country specific setting;
- ◆ a visible demonstration that can engender support and a demand for replication; and
- ◆ a training ground for developing the local expertise that will be necessary for replication.

No matter how successful a pilot is in situ, it is a failure if it is not replicated in other locations. If a pilot project is to be considered successful, first and most obviously, the basic concepts that are being tested must be demonstrably successful. Second, there must be a mechanism for generating demand for replication (e.g. dissemination of results). Third, there must be a self-sustaining, institutional capacity to replicate the pilot activity (e.g. trained trainers employed by an NGO, an association, a government agency or private consultants). The pilot activity must be designed to achieve the ultimate goal of replication from the very beginning on the assumption that it will succeed. In assessing the success or failure of a pilot project it is important to assess the setting in which it is being implemented. An understanding of the environmental factors, which contributed to the pilot's success, is essential for replication.

10. There are strong complementarities across the broad components of economic, democratic and social reforms. For example, programs that promote democratic principles may help to allay fears connected with the transition to free market economies by assuring people that the protection of individual rights extends to the market place. Designers of different program components need to pursue integrated and mutually reinforcing assistance activities that promote synergies between the various activities being undertaken to achieve a specific reform objective. Integrated activities have greater impact because they promote collaboration, and achieve goals of more than one program.

11. Networking and collaboration on activities with other donors can contribute to successful results and sustainability. For example, World Bank and IMF leadership is essential in promoting macroeconomic stability and fiscal reform through the development of organizational, legal, regulatory and policy-making infrastructure, but both have limited

grant resources for technical assistance as compared to USAID. The European Union has resources but is probably the most difficult organization to work with because of its highly centralized decision making process. However, generalized donor coordination does not seem to work very well. Therefore, activity designers and managers should focus their efforts on those donors actively working in or interested in the same or related areas. Then they must be proactive in promoting the involvement of these donors, especially when it is critical to the success of the activity and/or when they can leverage additional resources.

12. "Top down" programs set the policy and legal framework and lay the basis for systemic change. "Bottom up" programs seek reform at the local level and build the constituency for initiating and sustaining reform. Both approaches are useful in undertaking reforms in virtually all areas. The balance will differ with the area of the reform. For example, activities supporting reform in areas such as fiscal policy and energy restructuring focus largely on the central government. However, public education, often overlooked, is essential to promoting understanding and acceptance, if not active support for reforms. A more favorable public sentiment can strengthen the central government's resolve to undertake reforms.

13. Assistance programs must be demand driven. However, assistance providers can be proactive in promoting the adoption of reforms and the acceptance of programs of assistance to support needed reforms.

14. Legal and regulatory reform plays a major role in the overall reform process. Therefore, a sufficient understanding of the country's legal codes and judicial processes is a prerequisite to developing and implementing effective programs that reform the legal and regulatory framework.

❖ B. Program Implementation

The following "Lessons Learned" apply generally to the implementation of assistance activities by donor agencies and assistance providers (contractors, grantees, independent consultants, etc.):

1. Given the complexity of the transition process, the waxing and waning of political support for reforms, the evolving priorities of the host government and other donors, flexibility is a necessary watchword in program implementation. The ability to move funding from one sector to another and from one activity to another is critical if assistance is to be focussed where the prevailing conditions bode well for progress. This implies the existence of flexible assistance instruments that permit adjustments in work plans and personnel. It also implies having people on the ground who can continuously monitor the situation and judge when and what changes are needed.

2. Within the overall scope of the strategic objective, flexibility of work plan implementation is essential in activities addressing sectors in transition as emerging opportunities may lie outside the parameters of existing plans or challenge previously planned activities. This flexibility should be built into activity designs as well as be reflected in a willingness on the part of assistance funders and providers to adapt the work plan during the course of implementation. Donors should recognize at all times, that taking advantage of opportunities may mean deviating from accepted work plans and reallocating resources. Flexibility (the ability to quickly deviate from the original focus, budget, design, etc. without causing impediments to the activity) should be a main component of effective project management.

3. Transition situations are characterized by rapid change. An in-country office can help an assistance provider to respond to rapid change, better manage its activity, facilitate communication with donors, sustain policy dialogue with local implementing partners and encourage informed programmatic decisions. An in-country office allows partners to collaborate more closely and develop trust between the partners and the assistance provider. It facilitates flexibility in activity design and implementation. It encourages the use of local professionals who can enhance understanding of the local situation and facilitates communications with stakeholders. A local office is essential if one of the objectives of the assistance provider is to engage in policy reform and advocacy that requires sustained dialogue.

4. If a local office is established and, as is usually the case, largely or completely staffed by local employees (a highly desirable goal), it is imperative that proper management systems and controls be established. Local staff must be thoroughly trained as they are unlikely to be familiar with donor financial management mechanisms and western standards of ethical conduct, as well as relevant techniques for delivering assistance (e.g. interactive training methodologies). Local staff and local consultants also need to become familiar with activity objectives, indicators, procedures, etc. Relationships between in-country offices and headquarters need to be sufficiently close to ensure that regulations and work plans are followed.

5. Attempts should be made from the initiation of the program to establish a sense of "community" between and among assistance providers, partner institutions and other stakeholders. By developing vehicles such as interministerial or advisory committees, working groups, planning and training seminars which can foster communications, stakeholders can be brought together to solve problems, develop political support, counter resistance to reform and build consensus in support of reform. Care must be taken to assure a politically diverse group of stakeholders in order to develop support for reform across the political spectrum.

6. In countries with functional democracies, it is important to involve representatives of all political parties. Direct participation (e.g. sending members on study tours, inviting representatives to participate in meetings and workshops, etc.) is highly desirable. At a minimum, representatives of the political opposition must be kept abreast of assistance activities. This can help to counter resistance and facilitate the transition if governments change bringing opposition representatives in to position of authority.

7. A number of USAID activities involved the use of local consultants who received capacity building training either directly or on-the-job, in collaboration with expatriate advisors. Local consultants served as trainers and advisors/consultants to target organizations. The involvement of local consultants under the aegis of expatriate advisors gave end-users a chance to learn how consultants can provide cost-effective services and to gain confidence in the local consulting community. The development of indigenous consulting capacity in the private sector contributed to the sustainability of the activities.

8. The language of reform is technically complex and may be unfamiliar to recipient country participants. Often there are no words for essential concepts in the local language. Sometimes, the Communist heritage has given a new and unwelcome meaning to a common word. Such linguistic problems are especially prevalent in areas of reform dealing with democracy and governance. Words such as liberty, democracy, volunteer and NGOs can evoke completely different concepts in the minds of foreign advisor and indigenous participant. It is, therefore, important to assure a common understanding of key terminology early on.

9. Identifying local counterpart organizations to carry out program activities can be very difficult. Some prospective non-governmental organizations may be attracted by the possibility of funding although the activity is peripheral to the organization's mission and competence. Some prospective counterpart organizations may be dominated by one person and lack depth in personnel. The best counterparts, whether in or outside the government, are those who have on-going activities and interests similar to those of the assistance provider.

10. Donors and assistance providers must be wary of the tendency to overload the limited number of effective local organizations by asking them to take on more activities than they can effectively manage or take on activities which are not within their core competence. Relying on "the same old crowd" can appear to be partisan especially as the leaders of the business and NGO community may have significant political affiliations.

11. Advisors with real world skills in the U.S. (e.g. a small town manager) can be an asset but they must be acclimated to working in a foreign environment. Activity managers experienced in working abroad must be prepared to provide a higher level of initial support and direction to such advisors.

12. Long term and short-term advisors with concrete, transferable skills can successfully provide technical assistance if the strengths and weaknesses of each type of advisor are taken into account. Long term advisors can build relationships of trust and develop a detailed knowledge of the local situation. They can sustain a policy dialogue and respond to opportunities to move reform forward as they occur. Short-term advisors can transfer specific skills and solve well-defined problems. They can bring useful knowledge, experience, and advice at crucial moments and accomplish time-limited tasks in a cost-effective manner. The long-term advisors, having built relationships and developed local knowledge, can identify appropriate opportunities for short-term advisors, generate interest in and support for the advisor's work, make logistical arrangements and brief, guide and facilitate the work of the short-term advisor. The long-term advisor can also follow up on the work of the short-term advisor. A short-term adviser who can undertake a series of visits can be especially effective. Activities benefit from having the flexibility to bring in short-term personnel to deal with unforeseen issues/needs and to respond to targets of opportunity.

13. Local partners should be encouraged to address complementary issues that fall in other areas of reform if they have the capacity and such activities are within the mission and vision of their organization.

❖ C. "Lessons Learned" about specific areas of reform

1. Democracy and Governance

a) Democracy is a set of ideas and derived principles. The ideas of democracy have demonstrated an unusual power over people and have profoundly influenced the shape of the world today. In the conduct of democracy and governance assistance programs, it is the dissemination and practice of democratic principles that results in the development of democratic institutions and processes. Teaching people and organizations the process can often be more important than the end product that results from the assistance activity.

b) The basic principles of democracy (e.g. transparency in government) can be difficult to teach in the abstract. Utilizing a concrete subject (e.g. the local government budget process) that demonstrates and relies on a democratic principle offers a potentially more successful approach.

c) Increased citizen participation and collaboration is impossible to promote directly. Enlisting citizens in the pursuit of a common goal, the achievement of which requires participation and collaboration, must motivate it. Democracy and governance programs at the local level work best when they involve key leaders and influential organizations, and address areas of community interest (e.g. housing). In Hungary, job creation and local economic development provided a focal point around which the value of participation and collaboration could be demonstrated.

d) Public education should be a key component in democracy and governance programming. Local organizations must be taught how to use public education activities to achieve organizational goals and promote sustainability through local support.

e) While it is important to state program objectives clearly and develop performance indicators, it is also important to recognize that this is not easy for democracy and governance programs. Objectives may have to be more generalized and performance measures less tangible. Some aspects of a democracy program may only be assessed over the long term.

f) Targeting assistance on organizations outside the central government is critical to supporting pluralism and decentralization.

g) Since process can be more important than product in promoting democratic principles and developing the capacity of democratic institutions, the methods used to provide assistance must allow for the application of democratic principles.

3. Privatization

a) Six enabling environmental conditions are needed to support privatization and should be encouraged and assisted in parallel programs:

- ◆ political will;
- ◆ establish and enforce legal and regulatory framework;
- ◆ tax reform;
- ◆ accounting reform and strengthening audit functions;
- ◆ develop capital markets; and
- ◆ reform the banking sector.

b) Companies that can be profitably integrated into a market economy should be privatized first. Do the easy privatizations (i.e. companies whose assets are in good condition which will attract interested purchasers) first to gain experience.

c) The banking and energy sectors are more difficult to privatize because they have unique features (e.g. national interest concerns, natural monopolies) or problems (e.g. bad loan portfolios). Also having a reformed legal and regulatory framework and an independent regulatory agency in place early in the process are critical to success. The organizations that are charged with privatizing these sectors would require specially tailored assistance programs to assure that the required expertise is available.

d) The primary purpose of privatization is to transfer state-owned assets to private ownership. The underlying assumption is that private ownership will result in management that is more efficient and provide the company with access to capital and new technologies because the new owners are interested in obtaining a return on their investment. This is not always the case if the new owners are either not interested or unable to take a hand in managing the company or unable to hold management accountable because of the method of privatization. Privatization should be structured to ensure that companies are in the hands of owners and managers who have the will and resources to make them successful in a free market economy.

4. Private Sector Development

a) While the Government and other donors supported the SME sector early in the transition, USAID's valuable experience and resources would have been very useful at an earlier stage. USAID gave priority to the privatization of state-owned companies. Support for the development of SMEs began later in the process. Because the SME sector is critical to the overall development of the private sector and the growth of the economy, and especially valuable for job creation, activities that will promote an enabling environment for SMEs should be started early in the transition.

b) Key components of support for SMEs are:

- ◆ direct technical assistance to new enterprises;
- ◆ training in basic business skills;
- ◆ increased access to credit;
- ◆ building business associations; and
- ◆ access to technology and business information.

c) Supporting multiple business associations and entrepreneur/business training organizations will promote competition, which in turn will help to assure quality and responsiveness to members/customers. Also, it is impossible to predict which associations and organizations will mature and become self-sustaining. Supporting multiple organizations eliminates the need to make choices.

d) To promote the sustainability of organizations that support SMEs, fees should be introduced at an early stage and gradually increased over time.

5. Pension Reform

a) While there is much that can be done to lay the groundwork for pension reform, especially the state-run portion, private pension funds cannot function safely and sustainably without the following three supporting conditions:

- ◆ privatization has to be fairly advanced;
- ◆ capital market reforms have to be fairly advanced; and
- ◆ there must be macroeconomic stability, i.e. relatively low and decreasing inflation and interest rates.

b) Allowing the development of voluntary pension funds prior to implementing full-scale pension reforms is crucial. These voluntary funds serve as an important educational and lobbying force for the new pension reform. Regulatory mechanisms can be developed and the private pension funds can develop their competence in advance of the establishment of mandatory pension contributions to private funds. Because it is in their interest to have a portion of the mandatory pension contribution as well, the private funds can become an effective lobby for pension reform.

c) Private pension fund regulation is crucial and worthy of significant technical assistance. The development of a regulatory agency must be started as early as possible to assure that private pension funds are properly supervised.

6. Energy

a) A credible, competent regulatory body and a reformed legal and regulatory framework are pivotal to the process of energy asset privatization. Energy privatization is an important element of an overall country privatization strategy. It promotes the development of the country's infrastructure development and can stimulate overall economic growth. Privatization of the energy sector can also reduce pollution reduction. For Hungary and its CEE neighbors energy privatization is necessary for entry into the EU.

b) In the case of a highly technically specialized area such as the energy sector, a regional approach combines essential international comparative experience and expertise with local host country knowledge and local project management and oversight. Importantly, this also enhances each country's membership in regional networks.

❖ D. Other "Lessons Learned"

The following "Lessons Learned" applied to specific components of assistance normally provided by donors.

1. Programs Utilizing Volunteers

a) Many programs of assistance utilized the services of volunteers. Based on this experience, requisites for a successful volunteer program include:

- ◆ a resident, long-term, in-country coordinator with good managerial skills supported by an in-country management team which can link local companies/organizations with

- appropriate volunteers, i.e. make good matches;
- ◆ well-defined scopes of work which are feasible for a volunteer to undertake in the time owed;
- ◆ effective recruitment of volunteers who are culturally sensitive and can adjust to the foreign environment;
- ◆ an adequate language training program or counterparts who speak English;
- ◆ appropriate rewards or recognition for volunteers.

b) Careful identification of local companies or organizations with whom the volunteer will work is especially important. They must be willing to host a volunteer, fully concur in the objectives, scope and duration of the volunteer's assignment, and fully understand and be willing to provide required support. Program managers (e.g. the in-country coordinator) must visit the site at which the volunteer will be located to inspect both the working environment and living arrangements.

2. Training Programs

a) Sending policy decision-makers and "influentials" abroad for study tours can be an effective method of promoting reform. Seeing how things are done in other countries provides participants with new ideas and working demonstrations of what is possible. Trips abroad to participate in conferences, workshops and consultations are essential for transforming attitudes and outlooks on democracy and market reform issues. Training should include facilitated sessions on linking experiences which will add value to such training programs.

b) The selection of appropriate persons for a study tour can facilitate project success. Including representatives from a variety of concerned organizations and stakeholder groups (e.g. political opposition representatives) will foster communications and a shared understanding of alternative approaches, solutions and information. Groups of stakeholders who must work together can also develop into a team as a result of participating in training activities.

c) Training programs and study tours often need to be arranged on short notice to respond to specific demands for information or opportunities to influence key players. Having a flexible training mechanism, such as a contractor with the expertise to organize short-term training and study tours and the flexibility to select the right people, can be critical to promoting reform.

d) Practical training on specific topics geared to the needs of the trainee's organization (i.e. contracting with local governments, financial management, etc.) tends to be much better received and more useful than more general training. The training should seek to transfer a specific set of skills.

e) Foreign trainers sometimes lack the specific knowledge of the local situation necessary to make training useful in everyday practice. Combining local and foreign trainers can overcome this problem and foster sustainability.

f) Where possible, training programs should grant degrees or certificates that will gain official recognition by the country's accreditation authorities or an international body.

g) Regional training, including conferences, workshops and visits to project sites proved to be very valuable both as a learning experience as well as for networking. Seeing a reform or activity working well in a neighboring country can inspire confidence and speed up implementation.

3. Programs Which Make Grants to Local Organizations

a) It is important to structure grants to local organizations so that they focus on the real needs in communities as defined by the community itself. Grants focussed on topics that are too nebulous or theoretical will likely attract weaker proposals.

b) The monitoring of local grantee partners, and general communication between the grant-making organization and grantee, need to be frequent and regular, not only to ensure project implementation is carried through, but to allow sub-grantees/partners the opportunity to ask questions and receive advice.

c) Training and granting activities should go hand-in-hand. Organizations that receive only training may not have the resources necessary to meaningfully implement what is learned in training and those receiving grants without training may be unable to properly utilize the resource. In addition to more generalized capacity building related training, provisions should be made for training which meets specific needs generated by the grant-funded activity.

d) Build the indigenous capacity to manage grant-making programs as quickly as possible by hiring local professionals at the beginning of the project. Do not keep expatriate advisors when host country personnel can clearly handle the job. Incorporate mechanisms into the activity design that will permit the local organization to access technical assistance when needed.

e) The preparation of a full-scale grant proposal is a complex and time-consuming exercise. Often potential grant recipients do not fully understand the request for proposals. A two-stage approach in which potential recipients can submit shorter preliminary proposals or concept papers and basic prequalification data about their organization might prove to be more efficient and effective.

APPENDIX I

• *USAID Specific "Lessons Learned"* •

The following "Lessons Learned" apply specifically to USAID:

1. Keeping comprehensive, well organized files, by putting special emphasis on structured documentation, is important as it provides a basis for evaluating programs, identifying "best practices" and developing "Lessons Learned". During the course of program implementation, good files are crucial to providing information which can explain what was done in the past and what assumptions were made at the time. This can often save time and prevent the duplication of errors.
2. Problems occur when USAID Washington decentralizes implementation authority to field missions but utilizes highly centralized assistance/contracting mechanisms such as IAA's, regional contracts to a single service provider or large, regional grants to a single NGO. As noted in the "Lessons Learned" above, flexibility is critical in transition programs. To be able to adjust funding as progress and opportunities require, to allow contractors and grantees to have flexibility in their work plans requires locally-based activity management.
3. Close cooperation between contractors and the locally-based USAID personnel ensure better USAID oversight of the activity and more directed assistance than is possible when project oversight is based elsewhere.
4. The impact of related programs implemented by different U.S. Government agencies could be enhanced with more formalized coordination and communications between programs, in addition to informal monthly meetings of all SEED-funded partners.
5. In the field of energy, it is possible to assist governments with the privatization process by helping them to set up competitive bidding procedures despite the fact American companies are among the bidders without arousing claims of bias. The U.S. technical assistance provider must be highly professional and sensitive to the issue.
6. The Strategic Objective Team approach can work against inter-SO synergies. Mechanisms such as regular joint team meetings need to be implemented to assure that activities in different SOs are mutually supportive and opportunities for synergies are not missed.

APPENDIX 2

**• USAID Funding for Hungary
by Strategic Objective •**
(x \$1,000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Fiscal	327	2,221	3,787	3,560	6,071	5,823	5,042	2,069	1,663
SME		6,272	5,530	8,428	7,291	7,203	5,416	2,985	1,362
Financial	4,962	22,733	27,107	11,882	20,959	2,984	2,632	761	1,355
Energy		9921	1,439	699	1,028	2,322	1,264		
Local Governance	1,634	7,064	7,479	3,818	3,778	6,616	5,059	2,021	1,726
Special Initiatives	950	11,744	1,473	2,500	3,823	2,397	1,372	1,208	900
Yearly Totals	7,873	51,025	46,815	30,888	42,950	27,344	20,785	9,043	7,005



For more information, contact the USAID Regional Services Center at 36-1-475-4314,
or visit the USAID/Hungary website at <http://www.usaid.org.hu>