

**USAID  
STRATEGIC PLAN  
FOR  
COOPERATION  
IN  
FOR  
HUNGARY**



**Prepared By  
USAID/Hungary  
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**USAID/HUNGARY STRATEGIC PLAN  
1996-1999**

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## EXECUTIVE SUMMARY

The Hungary of 1996 is clearly at the threshold of achieving its formidable goals of a complete political and economic transformation and taking its place among the world's foremost political and economic institutions. First and most importantly, Hungary has joined the ranks of fully democratic nations. The country has a completely democratic and representative political system based on free and fair elections and rule of law. Hungary's Parliament is considered an effective rule-making institution. The executive and legislative bodies conduct their affairs in an open and transparent manner. Hundreds of pieces of major legislation underpinning Hungary's transition have been enacted. Fundamental liberties and individual freedoms are guaranteed by laws and generally practiced. Hungary's press is free.

With the most recent round of privatization now completed, Hungary's transformation to a private sector-led economy has been no less dramatic. Bringing in over \$13 billion in Foreign Direct Investment -- a record both in relative and absolute terms -- Hungary is a regional leader in privatization. Today private enterprise comprises almost 70 percent of the country's GDP. The basic policy, legislative and regulatory frameworks necessary for the smooth functioning of a private sector led market economy are also in place and steady progress continues on improving the routine elements of this framework.

In 1996, Hungary managed to reach its goal of a budget deficit of under four percent, thereby achieving the blessing of the International Monetary Fund (IMF) and accession into the Organization for Economic Cooperation and Development (OECD).

Despite revisionism concerning the old system and some wrong-headed myths about how things might have been, few talk about a possibility of Hungarians' reversing political or economic direction. At risk is the possibility of stalling or slippage in the time-table of economic reform. Such slippage would be extremely damaging to Hungary's future growth. The next two to three years very likely present Hungary's only opportunity to make such radical changes which will permit the basis for the sustained 5 to 6 percent annual real growth rate needed for Hungary to "catch up" to what it hopes to be fellow members of the European Union. Once this unique window closes, Hungary will join more traditional nations in the pace and magnitude of the changes possible.

We in USAID see our role in Hungary as part of a broad U.S. Government -- and even larger international effort -- to assist Hungary in achieving the objectives of transition Hungarians established in 1989 and our Mission Goal mirrors this: *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.* Since the first funding began in 1989 and the

establishment of a Mission in 1991, we have accomplished much. Hungarians are particularly effusive in USAID's role in helping in its exemplary privatization effort.

We are also recognized as having made significant contributions in helping Hungarians develop key legislation -- the National And Ethnic Rights Bill, the Media Law, Employee Stock Ownership Plan (ESOP) Law, the series of privatization laws, the Bankruptcy Law, the Anti-Trust Law, the Farm Bill, the Environmental Framework Law and the Telecommunications Law -- to name a few. We have played our part in helping Hungary develop the structures and procedures of a free, parliamentary democracy. The immediacy of our aid -- and its flexibility -- are repeatedly identified by Hungarians as having been singularly helpful at this crucial time in Hungary's history.

We see our final proposed Strategic Plan for FY 1996-99 as having two general thrusts. First, we shall finish the remaining activities aimed at addressing macro-level issues. Second, we shall assist Hungary's ability to carry out the last stage of full democratic and economic transition: bringing both the responsibilities and benefits of the country's transformation to a level closer to the average Hungarian family and community -- in business, in government and in non-governmental associations.

As USAID/Hungary's program has matured, we have narrowed our focus to five remaining strategic objectives:

- Increased soundness of fiscal policies and fiscal management practices;
- A more competitive and market-responsive private financial sector;
- Improved performance of private small and medium enterprises;
- An economically sustainable, restructured energy sector;
- Better informed citizens increase their participation in decision-making at the local level.

As we near accomplishment of the above objectives, more fully defined in the following pages, we are proposing decreasing levels of SEED assistance to Hungary: \$17 million in FY 1996; \$15 million in FY 1997; and \$7 million in FY 1998. We foresee FY 1999 as our final year of implementation.

Because of our temporary status as a Mission and the approach of close-out, we must more effectively deal with issues of keeping current staff and training new staff as a result of our high turn-over. We have proposed several elements to guide a development of an internal strategy to maintain needed staff able to continue to achieve expected results in what has come to be considered an outstanding manner.

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## I. Proposed USAID/Hungary Strategic Plan: 1996-1999

USAID/Hungary is submitting this refinement as the Mission's final Strategic Plan. In our proposed strategy, we continue to see USAID's role in Hungary as part of a broad U.S. Government effort, and an even greater international effort, aimed at assisting Hungarians in achieving the objectives of their ambitious national transformation. Hungary's transition has aimed to: 1) open and decentralize political decisions and increase participation by Hungarians; 2) establish a dynamic, competitive, market-oriented economy; and 3) re-integrate Hungary into key Western political and economic institutions. USAID/Hungary's overriding goal remains:

**GOAL: 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.**

We see our FY 1996-1999 program focusing on two thrusts: 1) completing the final stages of key macro level programs of previous strategies; and 2) helping Hungarians with the final stage of bringing both benefits and responsibilities of the country's transformation to a level closer to the average Hungarian in: business; government; and non-governmental organizations.

Certain guiding elements of USAID/Hungary's Strategy will continue.

- *We shall concentrate on those areas where we believe the United States has a comparative advantage in providing assistance.*
- *We shall continue to seek ways of keeping our assistance flexible, timely and responsive.*
- *We shall also continue to see USAID's programs as catalysts for helping Government, other donors, and Hungarians identify and experience successful alternatives to previous approaches.*
- *We shall also continue to use our program as preparing groundwork or pilot phases for larger efforts in key areas of transition by other major donors or by the Government of Hungary and serving as a bridge to those larger efforts;*
- *And because of the size and complexity of Hungary's economy, the sophistication of its institutions, and the nature of transition, we shall continue to allow ourselves to exploit new targets of opportunity, if their timing fits with our overall strategy period and levels.*

Historically USAID's program has identified three separate overriding sub-goals: economic, democratization, and social reform. As macro-reform has taken place, we see the economic-political-social distinctions diminishing. Gradually, important synergies are emerging: between business and non-governmental associations; between NGOs and local governments; and between government and business, such as important legislation affecting small and medium enterprises. In this final strategic plan, USAID continues to aim to assist Hungary in the economic and democratization areas. And while we see the economics-political dichotomy blurring, we have maintained the two sub-goals for presentation purposes. Our strategy, however, will henceforth aim to encourage existing synergies and promote new ones.

**Sub-Goal: Assist Hungary in achieving sustainable economic reform.**

Hungarians realize that they cannot achieve their objectives of sustained investment, economic growth and integration into Western institutions without first stabilizing their economy to encourage international private investment and restructuring. The Mission's highest priority will remain promoting fiscal reform and stabilization. We shall also join other donors and the private sector in promoting stronger financial institutions and a sustainable energy supply, also key to sustained growth. Finally, we shall continue to promote small and medium enterprise development, which we believe will promote a needed "culture of competition" and lead economic recovery and employment generation in Hungary over the medium term. Our focus is outlined in specific Strategic Objectives below.

**Sub-Goal: Assist Hungary in completing its democratization process.**

Hungarians have succeeded in establishing a successful, recognized democracy. They must now complete the process by attempting to bring both the rewards and responsibilities of the new order to the local level. We propose to concentrate our efforts in assisting Hungarians to participate more fully in decision-making which affects their well-being and that of their families. A particularly important contribution USAID hopes to introduce is the concept of self-help and local initiatives in problem solving and the special roles that non-governmental organizations can play in areas previously assumed to be the responsibility of a government that can no longer afford to provide them. USAID's fifth Strategic Objective below outlines our approach.

## **II. Strategy by Strategic Objective**

In our proposed Strategic Plan USAID/Hungary has narrowed its focus to five remaining Strategic Objectives. We expect that the number of Strategic Objectives will fall to four as our Energy Restructuring effort concludes before 1998.

In addition to our Strategic Plan, the Mission has prepared an extensive array of performance indicators which we shall use to monitor program performance at the Mission level. A smaller number of these indicators will constitute our Results Review package which we present annually to USAID/W. We have included illustrative indicators selected from our overall list for each Strategic Objective and Results Group to provide the reader with a better understanding of the breadth and scope of our proposed objectives.

**STRATEGIC OBJECTIVE NO 1:****Increased Soundness of Fiscal Policies and Fiscal Management Practices**

## Illustrative Indicator

	1993	1994	1996	1999
Consol Centr Gov't Balance (% GDP)	-7.8	-7.1	-3.9	-2.3

Sound fiscal policies and fiscal management will remain the necessary underpinnings of Hungary's efforts to achieve a dynamic private sector economy and a *sine quo non* for successful completion of Hungary's transition. USAID will consider this strategic objective to be fully achieved when: *Hungary's fiscal policies and fiscal management practices are generally recognized as sound, prudent and supportive of a stable, balanced socio-economic environment favorable to increased private sector investment and sustainable high economic growth.*

**Problem Analysis**

Large general government deficits during 1991-1994 have been identified as a principal reason for progressive destabilization of macroeconomic financial structures in the Hungarian economy. By 1993, domestic imbalances had spilled over to the external sector, resulting in unprecedented pressure on the balance of payments and the exchange rate. Inflation rose from 21.1% in 1993 to 28.3% in 1995. During the period 1992-1994, the general government deficit averaged more than 7% of GDP. In 1993, total spending by Hungarians was 9% higher than incomes. The current account deficit of the Balance of Payments rose to the equivalent of 9.5 percent of GDP as exports declined and imports soared. Gross household savings declined from about 15% of GDP in 1991 to less than 8% of GDP in 1993. The stock of external debt rose 32% during the 1993-1994 period, from 59% of GDP in 1992 to 69% of GDP in 1994. During the same two year period, debt service rose from 39% of exports of goods and non-factor services to 61%. Surprisingly, arrears have not accumulated (as is often the case for countries with this magnitude of debt servicing burden).

The intrinsic causes of these imbalances have been political, bureaucratic, economic and technical. On the political side, there has been the need by authorities to minimize disruptions inherent in the change from a communist command system to democracy and markets. This has included an attempt to maintain an implicit social contract in the areas of health and social security, albeit with very limited means available. It has taken time for government decision-makers to understand that there are alternative modalities for realizing these social objectives. Even more important, officials have needed to recognize that the cost ineffective ways in which many objectives have been carried out, competed to the disadvantage of Hungary's economy by limiting the ability to make needed

public capital investment. And, of course, Hungary's bureaucracy, did not disappear or even change substantially with the transition, even though demands on the system have changed significantly.

On the economic side, Hungary is a moderately well off middle income country. However, it is far from being in the same league as industrialized Western countries. The loss of subsidized trading arrangements with the former Soviet Union and reduction in output brought about by reorganization as well as confusion in the transition from predominately state ownership to private ownership of enterprises had a large impact on household incomes and consumption patterns, most of which was concentrated between 1990 and 1994. Problems such as wide-spread unemployment did not exist before 1990.

From the technical perspective, it has also not been simple to make the transition from communism, which owned most of the factors of production and did not need to levy taxes for government operations, to democratic government requiring public justification of government programs and taxes and borrowing to finance these programs. In areas such as tax policy, for example, there was neither time nor technical expertise for doing the systematic planning needed for a coherent, broad-based tax system. Thus, Hungary's tax system evolved as an *ad hoc* system of unrelated taxes copied in form -- though not necessarily substance -- from other Western countries. Implementing institutions have not had the necessary expertise, whether the activity has been basic budgeting and monitoring, or raising revenues.

Stabilizing macroeconomic financial structures will require substantial reductions in aggregate demand. There will be losers as well as winners. The challenge facing the GOH and the Central Bank is how to bring about needed reductions in spending by the government and the population without compromising or stopping progress on economic restructuring or delaying economic recovery and expansion.

### **The General Strategy**

USAID supports the GOH's global strategy for addressing the fiscal deficit. This strategy is based on the three principal elements of responsible budget management: 1) more efficient budget and program management; 2) improved revenue generation; and 3) rationalization of the role of government. In 1995, Hungary managed to get its consolidated budget deficit down to 6.6% of GDP, and in early 1996 gained IMF approval of its program through a new Stand-by arrangement.

USAID/Budapest's general strategy in assisting the GOH in achieving its goal is to work with the GOH and other donor partners to develop effective, cost-efficient ways to strengthen the institutional underpinnings of sound fiscal policy-making and financial management. One strategic element will be to promote a more responsive financial sector and effective monetary policies. Accordingly, USAID's fiscal policy strategic objective is closely managed with our strategic objective to achieve a more competitive and market responsive private financial sector.

Changes in fiscal policies and fiscal management practices on the national level are expected to have significant impacts at the local level. Thus, managers of the Mission's fiscal and financial Strategic Objective Teams (SOTs) will collaborate closely with the managers of our local government/citizen participation SOT.

Properly executed, needed adjustments in government budgeting, development of program content, raising revenues, and managing government financing and deficits will not compromise economic restructuring, but include measures that stimulate consolidation of the restructuring process, and provide the basis for sustained future economic growth and development uninterrupted by serious recession. In fact, a fast growth scenario with sustainable growth rates reaching 5% a year by 1998, will require a quickly stabilized economy providing the conditions (*inter alia*, declining inflation, reasonable interest rates, a stable exchange rate) for sustained private investment growth of 10-15% a year over the near- to medium-term. A high growth scenario, which would include solid export performance with annual growth rates around 8%, is essential to facilitate declining single digit unemployment rates and increased standards of living to levels of Western European partners.

In addition to structural adjustment lending and balance of payments support, the IMF and the World Bank have provided important technical assistance to Hungary in the areas of tax administration, revenue forecasting, treasury/debt management, expenditure management, pensions administration and health sector reform. Complementary USAID assistance has been provided in many of these areas, particularly through USAID financed U.S. Treasury assistance programs. USAID will continue to coordinate assistance efforts with the IMF and the World Bank to support the GOH's determination to improve fiscal policy and fiscal management practices with defined activities in the areas of efficient budget and program management, improved revenue generation and a rationalization of the role of government.

### **The Customers**

Every citizen is affected directly by how a Government manages its fiscal policies. Thus, USAID's ultimate customers are the Hungarian people, who will enjoy higher quality government services delivered in cost effective ways that are expected to require a diminished tax burden over time. Our principal intermediate customers are the Ministry of Welfare and the Ministry of Finance. Other key intermediate customers include the National Health Insurance Fund and the National Pension Insurance Fund and the Ministry of Environment.

Our implementing partners at present include IMF, World Bank, EU-Phare, USIS, U.S. Treasury, USHHR (clinical guidelines/protocols), FSVC, SOLON (health financing consultants), Center for Private International Enterprise (CIPE), and the Joint International Commission on Accreditation (NGO: sets standards of accreditation for hospitals, clinics, medical doctors...).

## **Strategy by Results Framework**

USAID/H Strategic Objective Team has identified two groupings of First Order Intermediate Results which provide the necessary and sufficient conditions to address the constraints identified:

- Results Group 1: *More Efficient Budget and Program Management;*
- Results Group 2: *Improved Revenue Generation;*
- Results Group 3: *Reduced role of government.*

## Results Group 1: More Efficient Budget and Program Management

### Illustrative Indicator

	1992	1994	1996	1999
<b>Diff Planned/Actual Budget Def (Deficit Diff as % of planned)</b>	<b>182.5</b>	<b>5.4</b>	<b>10.0</b>	<b>6.0</b>

Note: This indicator summarizes differences in planned and actual revenues and expenditures, the efficiency of the budget process, the relevance of program content, etc. The Fiscal SOT is working on complementary indicators to be used as in-house management tools.

Hungary's budget and program management have been characterized by a number of problems in recent years. Budgets are often prepared with little or no reference to program content and objectives to be achieved. It is not unusual for budgets to be based only on an ongoing baseline, plus an estimate of inflation. Few operating units are downsized or eliminated. USAID and its partners are working with the GOH to modernize and rationalize the budget process, budget management, and the adoption of modern management techniques.

Taken together, health services, pensions and education typically account for some two-thirds of the combined expenditures of the central government and the national insurance funds. Accordingly, these are critical areas where GOH, USAID and other donors will increasingly focus during the next several years.

The ongoing World Bank financed \$132 million Health Services and Management Project is intended to improve public health and disease prevention. A major focus (\$47 million) will be on improved policy making and management capabilities. The Bank's program includes public health and health management training, with plans to establish a new School of Public Health and a School of Health Services Management. An \$8 million EU-Phare project to support health system restructuring includes complementary policy, organizational and management framework components for health care delivery in Hungary. USAID interventions in the health sector complement and support other donor initiatives and are expected to have important spread effects on public sector management and budgeting, including development of technology assessment capabilities, implementation of cost-effective clinical guidelines and improved reimbursement systems.

## Results Group 2: Improved Revenue Generation

### Illustrative Indicators

	1993	1994	1996	1999
<b>Tax Audits (thous)</b>	<b>296</b>	<b>309</b>	<b>325</b>	<b>400</b>
<b>Tax Returns (mns)</b>	<b>7.5</b>	<b>8.6</b>	<b>9.0</b>	<b>9.4</b>
<b>Fees (% Central Gov't rev.)</b>	<b>0.5</b>	<b>0.7</b>	<b>0.8</b>	<b>4.0</b>

The Hungarian tax system is *ad hoc* and changes frequently in response to revenue needs. It places heavy reliance on indirect taxes such as a 25% VAT which is burdensome for many poor households. VAT taxes collected are sometimes not forwarded to the tax office. Hungary's narrow tax base with high rates encourages evasion. In 1994, general government spending was nearly 60% of GDP, while overall tax burden was about 40%. Particularly onerous is the payroll tax that costs employers 48.5% of payroll, plus an additional 11.5% levied on employees (total: 60% of payroll). There is little willingness to pay such high taxes.

The Ministry of Finance has recently named tax reform and strengthened tax institutions as a high priority reform area. USAID's strategy to assist Hungary to improve revenue generation includes collaborating with the GOH and other donors to strengthen tax institutions' abilities to improve tax administration, broaden the tax base to make the system more equitable and facilitate lower rates, and continue to work with specialized government agencies (nationally and at the local level) to develop systems of user charges for services in operations where such charges may be appropriate.

With respect to tax administration, such things as introduction of a Single Identification Number, reducing processing workloads, simplifying forms, and decentralization of collection are areas in which rapid progress can be achieved. Improved audit procedures and computerization are needed.

The GOH has already initiated reviews of individual taxes with an eye to rationalizing the system to make it less cumbersome, more equitable, to minimize disincentives to savings and investment and discourage avoidance and evasion. Most changes to date, however, have mainly been driven by the need for increased revenues. USAID is reviewing how it may be able to offer technical assistance to speed the evaluation process and spur needed near-term reforms.

Hungarians are becoming increasingly accustomed to user charges of various kinds. But there are many kinds of services (health care, for example) for which user charges are very low or non-existent. All government services should be systematically reviewed to determine whether user charges would be appropriate, how to target them, and appropriate amounts to be charged. All activities that can be self-financing, either wholly or partially, should be self-financing.

In addition to USAID financed U.S. Treasury activities in tax administration and complementary Fund and Bank efforts in these areas, HIID's Environmental Economics Policy Program establishes valuable precedents on integrating priority GOH objectives with the tax system.

### Results Group 3: Rationalization of the Role of Government

Illustrative Indicator

	1991	1994	1996	1999
Cons Centr Gov't Expend (% GDP)	54.2	56.1	49.0	45.0

Extensive changes in the tax system and the structure of taxes in Hungary is essential. Controlling spending is equally important. Hungary's strategy since the Spring of 1995, to reduce Central Government expenditures has been a combination of "cold turkey" withdrawal of some safety net schemes, improved targeting of social transfer payments, improved budget and program management at some agencies, and shifting of important responsibilities to local governments (sometimes without commensurate authorities to raise revenues to finance them).

Much needs to be done. Appropriate targets range from reducing the unwieldy size of government through civil service reform and reducing government employment to reducing the massive social spending that accounts for some 40% of general government expenditure and absorbs 25% of GDP. Effective civil service reform and staffing rationalization can result in eventually reducing government employment from 25% of the country's total employment to around 18%. Social spending can probably be reduced by some 20% without damaging the integrity of Hungary's implicit social contract by targeting resources to those in need in the case of family allowances, rationalization of health sector services, medicines and costs and pension reform. The dependency ratio (dependent on others and social transfers) in Hungary of the working age population, that is, the population aged 15-59, has doubled since 1990, from 20% to 40%. This trend is not compatible with a viable economic future.

Hungary's social security system, which includes pensions and health, is extremely inefficient, not well conceived and very costly. Although an age dependency ratio (population aged 60/working age population aged 20-59) at around 0.36 in Hungary is not yet alarming, system dependency (pensioners/contributors) has risen from 0.50 in 1990 to 0.66 to place Hungary's system dependency among the highest in the world. The system-wide effective retirement age in Hungary is some 53 years of age! Disability-justified retirement is common in Hungary (in 1993, 27% of all pensioners received benefits originally awarded based on disability). The World Bank estimates that 1994 expenditures on health, pensions and sickness benefits were the equivalent of about 57% of covered wage bills, and significantly exceeded combined contributions to the Health and Pension Funds. The need for reform is evident. The will for reform is at hand.

USAID's Strategy to achieve a reduced role of government in Hungary, like other areas related to fiscal reform, will require first rate analyses of how schemes used successfully in other parts of the world can be adapted to Hungary. The Strategy will aim to promote informed public debate to familiarize people with the issues

and likely benefits of proposed changes to secure public support and enthusiasm. Technical assistance and training will be made available to assure smooth implementation, and development of an appropriate regulatory framework for pension and health sector reform, as well as the roles these new systems might play in the country's evolving financial sector. Above all, the Strategy must be collaborative, and responsive to the needs and concerns of all our intermediate and final customers-the GOH and the people of Hungary.

Pension reform not only can be a vehicle for increased security in old age, it can be a significant spur to economic growth. A private pension system in which a basic 10% of wages and salaries is regularly invested (assuming that only one-third of annual value added in Hungary has its source in wages and salaries) could raise annual GDP growth in Hungary by as much as 0.8 percentage points.

USAID and other donors, particularly the World Bank, can make significant contributions to assure viable pension reform in Hungary. USAID has begun working with the GOH and the World Bank staff toward this end. Rationalization of social sector spending, including increased private sector involvement in activities heretofore the exclusive domain of government, are necessary to facilitate a reduced role of government. USAID is drafting a Concept Paper on the specific role USAID should have in these areas (especially pension reform) so as to complement and amplify the important impacts expected from the activities of other donor partners and the affirmed commitment of GOH authorities to serious reform.

**STRATEGIC OBJECTIVE NO 2:****A More Competitive and Market  
Responsive Private Financial Sector**

Illustrative Indicator

	1991	1994	1996	1999
Financial sector assets (% of GDP)	100	93	100	120

Modern, responsive financial systems embracing the banking system, the insurance industry, security and capital markets are necessary for efficiently and effectively channeling savings to the investment opportunities that propel and sustain economic growth. The financial sector in Hungary remains underdeveloped and unresponsive to the needs of a market economy. The blossoming of a competitive, market economy in Hungary that is dynamic and robust enough to provide Hungary its desired *entrée* to the West and position Hungarian enterprises to compete effectively with other players on world markets cannot occur without substantial further progress on the development of modern financial systems and markets in Hungary. USAID will consider this strategic objective to be fully achieved when *Hungary has a competitive, market responsive private financial sector that routinely and efficiently mobilizes savings that finances the level of private sector investment that can assure Hungarian competitiveness and rapid, sustained economic growth.*

**Problem Analysis**

Hungary's overall financial system is weak and its banking sector is still dominated by poorly performing State banks. Financial system supervisory institutions are in a start-up phase and not yet developed. The extent to which supervisory agencies can be genuinely independent has not yet been established in Hungary. Inefficient banking system intermediation has resulted in inappropriate asset structures, high spreads and poor average operating performance. Average capitalization of banks is not adequate by international standards.

The insurance industry, although generally considered to be in fairly good shape financially, does not offer the range of insurance coverage generally found in Western, industrialized countries. Private health coverage, for example, is very limited. Supervision of the insurance industry is practically nil. Securities markets are underdeveloped and do not yet enjoy widespread public confidence.

Of the 43 banks in Hungary in 1995, 22 were partially or wholly foreign owned. These 22 banks controlled just 21% of banking assets, yet accounted for 44% of the corporate lending market. The large state-owned banks have difficulty competing in the financial market place despite expensive government attempts to restructure them in recent years.

## **The General Strategy**

A well functioning, competitive financial sector that can mobilize savings and provide effective access to capital for private investment activities is necessary for sustained broad-based economic growth and development. Fortunately, most of the policy, legal and regulatory frameworks needed to consolidate progress on an improved financial system are in place. The challenge is to sustain the actions necessary to overcome remaining constraints in ways that will foster faster growth and improvements in social welfare.

On the macroeconomic front, the government and the Central Bank must continue to aggressively implement fiscal and monetary policies that will reduce inflation and pressure on the balance of payments to stimulate private enterprise and financial sector development. At the same time, the structure and practices of the financial sector must continue to evolve in ways that improve the mobilization of domestic savings needed for the substantial increases in private investment required to place the country on a higher growth path.

USAID has determined that institution building through assistance targeted at the new regulatory agencies fills a critical need and that this assistance is cost effective and provides relatively high returns. Continued progress on developing both the supporting institutions that the financial sector relies on and supervision is needed before Hungarians can feel that the sector is sound, well regulated and a safe place to invest savings as well as a reliable source of funds for productive business expansion.

USAID's current assistance strategy for the sector entails a more limited focus than in the past. Although we may continue to work with individual businesses in such areas as training bank credit managers and loan officers, except for a single Urban Institute activity dealing with training bankers in mortgage lending, these activities will be carried out under our Small and Medium Enterprise Strategic Objective. The financial sector SOT will manage activities designed to referee the system in terms of its principal institutions: The Central Bank, Ministry of Finance, the three supervisory agencies, a proposed new credit rating agency, Hungarian Bank Association, the Budapest Stock Exchange, Securities Clearance and Settlements Facility and similar institutions. The activities of the financial sector SOT will be closely coordinated with those of the Mission's fiscal SOT. The core management unit of the two teams are presently shared, and will continue to be shared.

It should be noted that USAID's overriding concern and focus is on the banking sector, where most of our activities are taking place.

## **The Customers**

USAID's ultimate customers, that is, the beneficiaries of activities under this Strategic Objective, are savers and investors and the institutions they do business with. Until recently, individual businesses, for example, some of the large state-owned banks targeted for privatization were intermediate customers also in the sense that some of our assistance was directed at specific problems in specific banks.

USAID's intermediate financial sector customers will be the Ministry of Finance, the Central Bank, the three regulatory agencies (or departments of a super agency should advocates for a super agency succeed in actually creating such), a proposed new credit rating agency and the Securities Clearance and Settlement Facility.

Implementing partners for this strategic objective include U.S. Treasury, World Bank, Financial Service Volunteer Corps (FSVC), KPMG-Barents, First Washington Associates, EU Phare, the British Know-How Fund, the Hungarian Banking Association, and the Urban Institute.

## **Strategy by Results Framework**

USAID/Hungary Strategic Objective Team has identified two groupings of First Order Intermediate Results which provide the necessary and sufficient conditions to address the constraints identified:

- Results Group 1: *Improved Regulation and Supervision;*
- Results Group 2: *Improved Operational Efficiency.*

## Results Group 1: Improved Regulation and Supervision

Illustrative Indicator

	1991	1994	1996	1999
<b>On-site bank examinations/audits (No.)</b>	0	8	15	18

Private banking, insurance and securities activities in Hungary are relatively recent and regulation and supervision have not yet been fully established, although the regulatory agencies have been set up. These institutions have weak organizational structures and have difficulty keeping up with rapidly expanding companies in these areas. Information processing systems are overloaded and not integrated. The supervisory agencies have difficulties in attracting experienced people because they cannot pay more than what civil service rules and regulations allow. In addition, the independence of these institutions has not been fully established nor have they developed crisis management systems. The legal environment is confusing and contradictory. The rulings of the State Banking Supervision, the State Insurance Supervision and the Stock Exchange Supervision have not been tested in the courts. In addition to external problems, the internal reporting systems of banks and other financial institutions leave much to be desired. For instance, regulations curbing the illegal flow of so-called "dirty money" came into existence only in 1995.

USAID will continue to accept requests to comment on and strengthen draft legislation in this area, as we are doing with the proposed new Banking Law and Bank Supervision rule-making capability. In August 1996, the Economic Cabinet approved the new banking law draft which will merge the Bank and Stock Exchange Supervisions by 1/1/97. This development makes the job of the State Banking Supervision more complex, because it will need to incorporate into the institution building task responsibilities related to the Stock Exchange, which are responsibilities similar to those of the Securities and Exchange Commission (SEC) in the US.

## Results Group 2: Improved Operational Efficiency

Illustrative Indicator

	1991	1994	1996	1999
<b>Return on invested capital (Financial Instit. profits as % GDP)</b>	<b>2.2</b>	<b>3.6</b>	<b>3.8</b>	<b>4.5</b>

The financial sector must become more sophisticated by lowering costs, at the same time providing the private sector with needed and expanded cost effective services.

The larger the number of companies able and willing to be listed on the Budapest Stock Exchange (BSE), the more mature the securities industry will become. In the last two years, initial public offerings (IPOs) provided lower cost capital than credit markets, but many companies were either unable or unwilling to submit to the rigorous requirements of the BSE. In the insurance industry, the mostly foreign owned companies (12 of the 14 insurance companies) are either partly or totally foreign owned. With pension funds the insurance industry will become a growing source of funds for enterprise capitalization. Companies must expand services dramatically to lower business risks and increase capital availability.

A new USAID activity in Hungary is collaboration with the Hungarian Bank Associations to set up a credit rating agency. Although some international rating agencies include some Hungarian companies in their ratings and some Hungarian enterprises do fee based work, a respected agency that does systematic, reliable credit ratings of corporate bonds, commercial paper and credit instruments of local government units does not exist.

The Hungarian banking sector continues to be dominated by state-owned banks and in addition to successful bank privatization in 1995, when parts of OTP and Budapest Bank were sold, the GOH is eager to privatize remaining state-owned banks, or to divest majority ownership and management responsibilities. Banks expected to be privatized in 1996 or early 1997 include Magyar Hitel Bank, K&H, and AEB. U.S. Treasury advisors are advising the Ministry of Finance on remaining bank privatization actions.

**STRATEGIC OBJECTIVE NO 3:****Improved Performance of Small and Medium Enterprises (SME)**

Illustrative Indicator

	1992	1996	1997	1998	1999
<b>Exports/Sales (%)</b>	<b>10.1</b>	<b>11</b>	<b>14</b>	<b>18</b>	<b>22</b>

The SME sector is of critical importance to the Hungarian economy. Some 50% of all jobs in Hungary are with these enterprises the SME contribution to GDP is near 50% and it contributes almost 30% of the value of industrial exports. A major problem is that as the national economy restructures, impressive SME impact is not due to the emerging diversity of company ownership, size and structure, but to a fairly narrow segment of the sector. 97% of all SMEs are microenterprises with fewer than 11 employees. Many are mere shell companies. Only 2.4% of all SMEs are in the "small" category, while even fewer, 0.6%, are classified as "medium," even though they are responsible for most of the contributions to economic development. Positive SME growth trends of recent years have stopped as the total number of productive firms is now declining. The proportion of shell companies to legitimate firms has grown to more than 40%. Many would-be entrepreneurs are people with modest incomes who view their entrepreneurial activities as a means to avoid dropping out of the middle class.

Bi-polar agriculture mirrors and amplifies the problem of other sectors in SME development: the co-existence of large industrial agricultural enterprises (1,400) microenterprises or small-holdings (1.4 million) on the one hand, with the delayed emergence of full time medium sized private commercial farms, or agribusinesses that should constitute the healthy, sturdy massive middle stratum on the other.

Accordingly, there is a pressing need over the next three years to support small enterprises with growth potential so that they can contribute more to the national economy. This premise guides USAID's SME Strategic Objective. USAID will consider the SME Strategic Objective achieved when: *Hungary will have a thriving, growing private sector characterized by confident small and medium enterprises (SMEs) doing business in an environment that rewards risk taking and initiative, provides models for strong operational performance, and presents opportunities for sustained expansion. SMEs will be recognized as the engine of economic growth through their potential to integrate the economy by utilizing Hungary's well-educated, cost effective labor force and their ability to rapidly adjust to changing technologies and opportunities in the international market place.*

**Problem Analysis**

Three major constraints facing SMEs emerge repeatedly in studies and assessments of the sector: 1) limited access to credit; 2) knowledge and information gap among business owners; and 3) an often inhospitable public policy and macro-economic environment.

An overall scarcity of capital is a major problem for the Hungarian private sector in general and is particularly acute for SMEs. The large fiscal deficit of the public sector is still being financed by banks which invest funds in low risk, high yielding government bonds. The remaining public credit and most private bank lending goes to the relatively less risky larger corporations. SMEs, which are considered risky and have significantly higher transaction costs, are frozen out. On occasion, the donor attitudes tend to reinforce this *de facto* policy.

External and internal knowledge and information gaps are common among most business owners in Hungary. A typical proprietor is a skilled craftsman, but lacks adequate management skills for financial management or planning. External gaps refer to insufficient knowledge of markets, suppliers, technology, business systems, and financing mechanisms. Internal gaps refer to the limited utilization of modern business systems and practices.

Inadequate support to SMEs from the public policy environment includes national tax policies, company "pay-in" requirements for employees, and increased property taxes when business sites are improved. Local governments in underdeveloped areas with high unemployment could, for example, offer long-term financing and leases or other non-tax incentives to attract more viable private firms to their areas. Resolving these constraints is necessary to improve the performance of SMEs, and will be a major component of the USAID/H program for the final years of our aid to Hungary.

### **The General Strategy**

USAID will draw upon the experience and lessons learned over the past five years in implementing the SEED Act and strive for synergy with the sizable assistance being channeled to the sector by other donors. Specific USAID interventions will come in areas where we have a strong comparative advantage in technology transfer and know-how. Our interventions and those of our implementing partners will target those firms and managers which, having identified problems which can be resolved, seek out our assistance. Subsequently, we will work with these new partners to select additional customers whom they believe will benefit from the program. This approach is appropriate for two reasons. First, firms with high growth potential are likely to be among the first to identify needs and seek solutions. As they improve their operations, these firms are expected to lead Hungary's economic growth. Second, demonstration or ripple effects from assisted businesses will impact on those not assisted. Demonstration effects occur when interventions or assistance leads to results that are so successful that assisted firms can be identified as models or examples of what can be accomplished. Ripple effects refer to more gradual impacts, as other firms observe favorable results and begin to emulate practices and techniques that contribute to success.

## **The Customers**

We see our end-customer as SMEs whose businesses form more than 99% of the enterprises in Hungary's private sector. The USAID program will specifically target those SMEs which demonstrate interest, a certain level of potential and the ability to serve as credible, replicable participants and models. Logically, consumers should also benefit as SMEs improve their performance and produce goods and services more efficiently at lower cost.

### **Strategy by Results Framework:**

USAID/Hungary Strategic Objective Team has identified four groupings of First Order Intermediate Results which provide the necessary and sufficient conditions to address the constraints identified:

Results Group 1: *Increased Access to Commercial Banking Services;*

Results Group 2: *Improved Access to Market and Technology Information;*

Results Group 3: *Improved Business Systems and Practices Developed and in Place;*

Results Group 4: *More Rational Tax Structure in place.*

## Results Group 1: Increased Access to Commercial Banking Services

Illustrative Indicator

	1991	1996	1999
<b>Banking system credit to small enterprises (% of GDP)</b>	2.5	2.2	2.5

In the early 1990's credit was more available and conditions for accessing it were not as stringent as today. Many SMEs applied for and received loans which subsequently became non-performing<sup>1</sup>. After that experience, banks turned very cautious and the number of annual loans declined on the order of 60%.<sup>2</sup> Typical collateral requirements amount to 150% of the loan plus one year of interest. Terms average five to seven years for small and medium sized companies, and three to six years for micro enterprises.

It is hoped that the reforms now underway in the financial and fiscal sectors will improve the receptivity of the banking sector to SME lending. The ability of the remaining public banks to finance public sector deficits will be limited due to a shrinking portfolio of profitable SOEs, pressures to reduce public deficits by the IMF, World Bank and the EC and internal pressures to compete with privatized banks and cut subsidized credit to the GOH. Privatization should also help as the growing number of private banks compete for business. Supervision by the State Banking Supervision (SBS) will lead to stronger financial institutions and more confidence in the banking sector. It is expected that lending to the private sector can increase substantially overall and lending to SMEs, will be increasingly viewed as "politically correct" and good business.

USAID's efforts to improve access to commercial banking services will be improved by teaching SMEs to prepare better loan applications, training loan officers and other key bank personnel how to be more responsive to the sector, and providing information about available financial services to SMEs. Other donors have ample funds available for private sector lending to SMEs. We will use our TA and training resources and the proposed Credit Guaranty Fund to work with banks and the donors to develop "packages" of financing and technical assistance for selected SMEs and prove the viability of such lending.

The agriculture and agribusiness sub-sector of SMEs will be specifically targeted as this sub-sector has traditionally had more limited access to credit than other SMEs. Even when lines of credit are specifically available for agricultural producers, they are frequently not accessed. Very high collateral requirements is a major constraint. Our implementing partners will look for innovative ways to increase access, for example, by making credit available to agricultural associations rather

<sup>1</sup> In December 1991 under the old loan classification system, 19.9% of all loans to enterprises were classified as problem loans. By 12/93, this proportion had increased to 46.2% under the old classification system and 71.7% under the new classification system.

<sup>2</sup> Lending patterns of the OPT Bank, formerly state-owned, now partly privatized are typical. In 1992 it made 97,800 loans to the SME sector, in 1993 70,300, by 1994 these had declined to 41,370.

than individuals, or by providing warehouse receipts for stored production which can then be used as collateral. It is expected that collateral mechanisms like these will lower the lending risks and accordingly, credit terms will improve. Successful models may be applied to other SME sub-sectors.

**Results Group 2: Improved Access to Market Technology and Information:**

Illustrative Indicator

	1995	1996	1999
<b>Users of sponsored database facilities (No.)</b>	0	0	20,300

• includes sponsored Internet access

Essential to any business success is increasing the entrepreneur's knowledge of markets, technology, financing mechanisms, etc. Knowledge in these areas will contribute to increased production and sales as managers identify new customers and employ advanced technology.

The use of the Internet is a fundamental element to the multi-donor effort aimed at developing a sustained system of information flows to SMEs. The strategy is to introduce Internet to the chain of 35 Local Enterprise Agencies (EU PHARE) established to provide training and support to local enterprises. The strategy will also extend such training to the Hungarian Foundation for Enterprise Promotion (MVA). Emphasis will be on allowing small entrepreneurs to access and disseminate information (i.e. information on their products to increase sales).

Another vehicle to increase access to information will be to establish a network by enabling associations, organizations and service providers to collect and disseminate existing information in usable forms. For example, when entrepreneurs need to determine additional market opportunities, they need information on prices in those markets, transportation costs and market contacts. Networks will make this information accessible over strategically located computerized databases. Finally, appropriate information will be made available to banks and other lenders so that it can provide input for credit decision making. Compiling information for regions will be beneficial for local SMEs as it facilitates the development of a vertical integrated system with benefits for agricultural and food producers, packagers, and service providers.

**Results Group No. 3 : Improved Business Systems and Practices Developed and In Place**

Illustrative Indicator

	1991	1996	1999
<b>Targeted firms w/ business plans (No.)</b>	<b>TBD</b>	<b>TBD</b>	<b>TBD</b>

Modern business systems and practices are clearly critical to efficiency and dynamism and the perception of potential creditors and clients. The Mission strategy is to strengthen financial management, accounting, marketing, strategic planning and production. Accounting and marketing were largely ignored under communist regimes, but they are key to improved operations of SMEs poised to compete in domestic and international markets. The accounting systems of small businesses commonly consist of a part-time accountant who "keeps the books." He/she is not a financial advisor. Installing computerized accounting systems and instructing managers in their use is an example of assistance that can lead to improved SME operations.

USAID will support local organizations which help entrepreneurs acquire skills and systems for their businesses. These include consulting firms, associations and agencies. One technique to enable managers to develop and install new systems is to send them to other countries for on-site training. We will also complete our efforts to institutionalize modern business and management instruction and curricula into the university and technical education system.

Local organizations such as small business associations play the vital transition role of substituting for government involvement in the sector. With the transformation to market orientation, the need for industries to regulate and administer themselves, formerly a government role, is critical. Associations can do this through establishing ethical standards, disseminating best practices, and advocating for the industry. The U.S. has a comparative advantage in providing assistance to help develop self-sustaining professional industry-based associations.

Our analyses indicate that real estate associations are ideal for demonstrating this concept. These associations existed prior to USAID's intervention and, though immature, possessed latent capacities for serving their membership. These associations were also independent from the government and were strongly private sector oriented. USAID has established a methodology for developing self-sufficient real estate associations and for enabling them to serve their members. This methodology is applicable to other industry groups and is a model for supporting SMEs through their associations.

Rural organizations, including associations, can lead to successful development of SME agricultural/agribusiness production when they are used as a cost effective mechanism for members to purchase inputs at a lower price, develop marketing channels, access credit and lower cost group insurance plans. In addition, local

associations encourage grassroots democracy and empowerment. Successful development of agricultural production will encourage other SMEs which support the food economy involved in processing, packaging, and transportation.

**Results Group No. 4: More Rational Tax Structure for SMEs**

Illustrative Indicator

	1992	1996	1999
<b>Taxable priv dom bus profits (% of GDP)</b>	-7.1	3.0	4.5

Improving policies, laws, and regulations to favor the development of SMEs is necessary. Activities under this result will be coordinated with those under other Mission strategic objectives. For example, under the Fiscal Policy SO, USAID and Treasury advisors will continue to advise the GOH on policy and regulatory changes favorable to job creation include reducing non-wage labor costs, rearranging unemployment benefits to encourage take-up of new jobs, and offering local tax incentives to encourage businesses which wish to locate in hard-pressed high unemployment areas. Financial reform is expected to contribute to broader based lending.

USAID will also support local Hungarian institutions, including associations, foundations or NGOs which wish to play leading advocacy roles for the sector. For example public policy institutes could become advocates for the establishment of a national consensus about a coherent long-term agricultural policy framework. Strengthening and providing training for these organizations will contribute to the sustainability of activities after transition.

**STRATEGIC OBJECTIVE NO. 4:**

**An Economically Sustainable,  
Restructured Energy Sector**

Illustrative Indicator

	1993	1996	1997	1998
Return on investment in utility sector (%)	-10%	1%	8%	8-12%

A reliable, economically and technically efficient energy sector is key if Hungary is to realize its goals of sustained economic growth and be competitive with the world's market economies. USAID will consider the Energy Strategic Objective achieved when: *Hungary enjoys a predominantly private-owned energy sector which is regulated by a highly competent and autonomous agency, using market signals to establish tariffs and in which there is an increasing ability for users to control their energy consumption.*

**Problem Analysis**

Hungary's pre-transition energy sector of the 1980s was economically inefficient and technologically backward. There were no economic incentives to produce or use energy in a way that reflected its real costs. Specific end use technologies were promoted by the old government allocation systems which today are non-economic and often environmentally harmful. Under market conditions these inefficiencies are an impediment to economic growth and the competitiveness of Hungarian industry. Un-restructured, Hungary's energy sector would impede Hungary's integration into the European Union. Yet, Hungary does not have the resources to fully modernize generation, transmission and distribution.

**The General Strategy**

Hungary's goal is to restructure its energy sector to provide a modern and efficient (lowest possible cost) supply of energy on a sustainable basis; institute a regulatory and pricing system that promotes investment, competition and efficiency; and provide consumers with the technical and financial tools to respond to market signals. Correspondingly, Hungary's strategy to reform the energy sector is based on three thrusts: Improved efficiencies of production, transmission and distribution; Effective regulatory body in place; and Improved end-use efficiencies.

These efforts are interdependent in many ways. Only foreign investment in Hungary's energy sector can provide the significant amount of fresh capital and technology transfers needed. Effective pricing will play a key role in assuring investors reasonable returns on their investments. However, the burden of needed significant price increases will meet with resistance from consumers, who may find that they cannot afford energy costs and decide they cannot accept foreign ownership of a "strategic sector." Key to balancing interests between investors and consumers is an independent regulatory body which is, and is perceived as,

competent, transparent, and fair to all, allowing for reasonable returns to investors while representing the public interest. This regulatory body has been established now as the Hungarian Energy Office (HEO) and as the HEO proceeds to implement the above restructuring strategy, USAID will provide support to assure development of its needed high level of competency and professionalism.

Mirroring our strategy in other sectors, success at the macro level will not be forthcoming if some attention is not paid to the consumer. Rationalized pricing is the key, but in the short run, prices will rise significantly. Consumers must be given some knowledge about how they can protect themselves against high energy costs or they will oppose such drastic reforms. Thus, creating a sustainable capacity to promote energy savings is the micro counterpart to USAID's work at the national level.

### **The Customers**

The consumer, presumably everyone in Hungary, is USAID's and the GOH's ultimate customer. When reform is fully completed, Hungarians will benefit from an assured supply of energy and with modernization, competition, and connection with the European Grid complete, the lowest possible prices.

Our prime intermediate customer is the semi-autonomous Hungarian Energy Office (HEO), which will become a recognized, highly competent, transparent, and fair organization as a result of their relationship with USAID.

As part of our pilot work at the local level our customers include certain municipalities and public facilities burdened with inefficient generating units and high energy bills, and also private sector energy service companies (ESCO's) that USAID will help to implement self-financing energy efficiency initiatives.

### **Strategy by Results Framework**

USAID/H Strategic Objective Team has identified three groupings of First Order Intermediate Results which provide the necessary and sufficient conditions to address the constraints identified:

Results Group 1: *Improved Efficiency of Production and Delivery;*

Results Group 2: *Effective Regulator Body in Place; and*

Results Group 3: *Improved End-use Energy Efficiency.*

## Results Group 1: Improved Efficiency of Production and Delivery

Illustrative Indicator

	1996	1997	1998
<b>Thermal efficiency of electricity generation (%)</b>	<b>27%</b>	<b>30.6%</b>	<b>35.0%</b>

For the energy sector to be economically sustainable, it must be restructured to improve the efficiency of production and delivery. In the electricity sector, inefficiencies at the system level have caused energy companies to incur significant losses. At the district heating level, municipalities and consumers have had to bear the financial burden of inefficient boilers and distribution systems.

Technical inefficiencies will be addressed on three fronts: 1) through fostering strategic private investment both in the purchase of existing plants and new capacity construction; 2) modernizing management practices at the grid and unit level to make facilities more efficient and more responsive to customer needs; and 3) in electricity, guaranteeing system reliability in terms of supply and sector standardization by improving interconnections and integration of the power system to the EU Grid.

Strategic private investment is key to modernizing Hungary's antiquated, inefficient energy infrastructure. The sector is in need of billions of dollars of technical investment in order to realize efficiencies that will bring energy production costs in line with market prices and result in a cleaner environment. The presence of a clear regulatory system is key to fostering this investment.

Another important part of improving the efficiency of energy supply is the introduction of modernized management tools that reduce operational costs, promote efficient use of energy resources and improve service to the energy consumer. Privatization of individual generation and distribution units will introduce new management practices at electricity and gas companies. But, in order to improve the energy and economic efficiency of the sector, management tools such as Integrated Resource Planning and Demand Side Management must be introduced at the national grid level; at the municipally-run district heat utilities; and at units remaining in state hands.

Improving production and distribution is not enough. Energy companies will not survive if they are unable to understand, cooperate with, and educate their customers. With recent price increases, accounts receivable problems are becoming more the norm. With regulatory incentives in place energy companies will instruct their customers in efficient energy practices, in addition to providing quality service to ensure payment of energy bills.

By integrating its system with the Western European power grid (UCPTE) and natural gas grid, Hungary is introducing world market price incentives and technical standards to its production and distribution system to make it efficient by

EU standards. Efficiency improvements will be obtained through price competition at the power generation, transmission, and distribution levels, and through diversification of energy supply networks. To achieve this, the GOH has applied for formal membership in the UCPTÉ. In 1995, UCPTÉ determined that Hungary's system was operating synchronously and within UCPTÉ standards. Hungary is awaiting formal membership pending trial operations and compliance with technical and environmental standards. Also, a natural gas pipeline is under construction between Hungary and Austria to provide an alternative source of gas and give Hungarian reserves access to EU markets. Finally, USG is sponsoring Hungary's membership in the International Energy Agency, a precursor to EU membership.

**Results Group 2: Effective Regulatory Body in Place**

Illustrative Indicators

	1994	1996	1997
<b>HEO implements price regulation (Yes/No)</b>	<b>N</b>	<b>N</b>	<b>Y</b>
<b>Licenses for new cap. through competitive bidding process (Yes/No)</b>	<b>N</b>	<b>N</b>	<b>Y</b>

The presence of an effective and independent regulatory body is a fundamental and necessary means of promoting increased investment and competition in generation and distribution, establishing a fair rate structure, and putting energy efficiency regulations in place: all part of the effort to balance the demands and interests of producers and consumers. Pricing decisions are the foremost and most sensitive balancing task of the regulator, HEO.

Cost-based and fair pricing is the linchpin of an economically sustainable energy sector. Under socialism, cheap energy prices encouraged energy intensive investments which now make many Hungarian firms non-competitive. The legislative mandate to make electricity prices cover costs by 1997 stipulates that the HEO use a pricing formula which includes production and distribution costs and provides for a fair rate of return on investment. Legislation does not specify, however, how the HEO should determine a fair price and how consumer tariffs can help the lowest income brackets absorb a 50 percent increase in their energy bills. The HEO's ability to navigate these difficult waters requires particular USAID focus in the next year as new tariff rates are established.

In a sector prone to natural monopolies, the regulator's role is key to promoting fair and broad-based competition among producers and distributors. A key way to keep prices down and investment levels rising is the institution of a fully competitive environment that fosters open access, competitive licensing for new capacity and a vertically dis-integrated model of ownership. Here, too, the Hungarian Energy Office will play a critical role, mandated with the task of licensing and monitoring utilities and making recommendations to the Minister of Industry and Trade on energy policy and establishing the new regulatory environment.

As the HEO continues to demonstrate its technical competence and effectively articulates its vision for a competitive sector, it is beginning to assume the role of a national independent Public Utility Commission. However, at this time it still lacks a measure of independence in pricing control, and decision making on new capacity and licensing. Under current circumstances, prices and plant licensing are still determined as much by political considerations as by economics and open competition, and HEO needs to develop autonomy.

### Results Group 3: Improved End-Use Efficiency

Illustrative Indicator

	1994	1997	1998
<b>DSM programs in place at distribution utilities (No.)</b>	<b>N</b>	<b>3</b>	<b>6</b>

Rational end-use energy prices are essential to promote (i.e., finance) energy efficiency initiatives and to stimulate necessary investment in the energy sector, but alone are not enough. The inevitable consumer energy price increases threaten the course of market transition when not accompanied by opportunities for the consumer to save energy. The GOH faces a strong lobby from pensioners and the general public, as they are accustomed to un-metered and subsidized heat and electricity supplies. The political pressure to provide cheap energy to the household sector will inevitably increase as prices rise. The reaction on that front will be the real measure of the Government's commitment to consolidating a market-based, economically sustainable energy sector.

There are significant market barriers that must be overcome before energy efficiency can be realized by the consumer and the sector can be economically sustainable in both supply and demand. Such barriers can be grouped in the following areas: lack of information available to the consumer about energy efficiency; lack of finance available for energy projects due to few project financing models, the high costs of credit, and too-short terms for energy loans; lack of a mature, competitive energy efficiency industry that provides energy efficiency goods and services; and energy efficiency policies and regulations not in place.

Energy efficiency information is being disseminated through the growth of USAID-supported NGO's such as the Hungarian Energy Consumer's Association (MESZ) and professional associations such as the Hungarian Chapter of the Association of Energy Engineers (AEE). Through these groups and a series of successful USAID energy efficiency demonstration projects, Hungarian Energy Service Companies (ESCOs) have developed the technical expertise to recommend and implement production and management changes to achieve efficiencies and cost-savings.

While technical expertise has been developed, parallel energy efficiency financing demonstrations are under way which utilize available energy efficiency credit lines or financing from municipal budgets, local utilities, and energy-burning customers. Private sector ESCO's will be trained in identifying and financing efficiency

projects while demonstrating to large energy users the potential role of performance contracting and third party financing; and the viability of implementing future projects with municipal or utility partners - without further donor assistance.

On the regulatory front, USAID assistance is strengthening the HEO's role in defining and judging demand side management (DSM) programs to promote energy efficiency at distribution utilities. Additionally, the National Energy Conservation Action Plan sets out several specific innovative policy mechanisms that the government can utilize to both promote energy efficiency and lessen the impact of price increases on the consumer. These include: progressive consumer pricing that promotes decreased and non-peak energy use; adoption of EU energy efficiency standards; tax incentives for energy efficiency investments; and support of institutional linkages between finance institutions/revolving funds and technical experts.

**Strategic Objective.NO. 5: Better Informed Citizens Increase Their Participation in Decision-Making at the Local Level**

Illustrative Indicators

	1996	1997	1998
<b>Voter turnout for local initiatives (%)</b>	5	15	50
<b>Incidence of local referenda initiated by citizens (No.)</b>	5	15	75

USAID recognizes that the consolidation of democracy hinges on the principle of irreversibility, or the ability of new democracies to incrementally overcome threats to regime reversal. These threats come less from anti-democratic forces than from a government's inability to solve such governance problems as unemployment, economic insecurity, social injustice, or to complete difficult market-oriented reforms. Successful consolidations are a process of institutionalizing democratic processes, and values and institutions, thus making democracy so broadly "legitimate" that ordinary citizens are willing to defend it against internal attack.

The key determinate of successful democratic transitions and consolidations has been the ability of democratically elected governments to provide good or effective governance, which in turn provides a stable foundation for economic growth. Broadening participation in both the political process and governance decision making, to include non-governmental organizations (NGOs) and public-private partnerships, serves to improve the quality of a country's governance, as well as increase the likelihood that necessary governance reforms are undertaken and sustained. In addition, effective and sustained governance is more likely to occur when conditioned by increased political participation and accountability, which not only constrains but guides local government's exercise of authority in decision-making while increasing civil society's role. Citizen participation, more effective local governments, and a stronger civil society together will drive the democratic consolidation in Hungary and make it a lasting and positive element of Hungarian life. USAID will consider the 2.1 Strategic Objective achieved when: replicable models are established for Hungary's public administration modernization in which local governments generate and manage their own resources-- accountably and with citizen input--and in which non-governmental organizations play a role, in concert with, or apart from government and businesses, and when replication vehicles for these models are in place.

To ensure that replication vehicles for models are institutionalized, USAID has contracted an Advocate for Civic and Municipal Innovation under a three year PSC contract. The Advocate will be charged with developing a strong outreach capacity to make local governance innovations available countrywide, empower

indigenous Hungarian associations and other institutions to develop the capacity to support outreach on a sustainable basis, and facilitate communication and coordination between and among relevant USAID activities and other donors.

### **Problem Analysis**

Donor assistance in Hungary has primarily concentrated on strengthening democracy through the development and support of national institutions and focusing direct citizen assistance in Budapest and some heavily populated outlying urban areas. USAID assistance, however, is targeted at the local level where approximately 70 percent of the population resides in communities with populations under 50,000. More than 3000 municipal governments exist and some 35,000 non-governmental organizations (NGOs) are operating. USAID's efforts to support the democratic consolidation in Hungary will ensure that citizens are better informed and increase their participation in decision-making at the local level. USAID activities will work in a concerted manner to strengthen non-governmental organizations (NGOs), make local governments more efficient and accessible, work to bring NGOs and local governments together, and increase public information of local issues.

Increased citizens' participation is the end objective to be achieved by USAID's local governance assistance. Assistance to local government, however, is just one means to integrate citizens into the decision making process at the local level. It is equally as important to strengthen NGOs and increase public information on local issues in order to enable USAID assistance associated with this SO to produce the results that it is targeted to achieve.

### **Strategy by Results Framework**

USAID/H Strategic Objective Team has identified three groupings of First Order Intermediate Results which provide the necessary and sufficient conditions to address the constraints identified:

- Results Group 1: *Increased flow of useful information;*
- Results Group 2: *More active and responsive civil society;*
- Results Group 3: *Local government more effective and responsive to citizens.*

### Results Group 1: Increased Flow of Useful Information

Illustrative Indicator

	1996	1997	1998
<b>Public relations/media plans developed and initiated by local governments (No.)</b>	30	100	500

The free and unencumbered flow of information is both a fundamental element of a stable democracy and a means to maintain that democracy through informed, pluralistic decision-making. Traditionally, in Hungary the flow of information has been tightly controlled by the central government. This was true both vertically where local governments were not privy to decisions handed down to them from centralized powers; and horizontally where citizens were not given the information nor the opportunity to take part in decision-making within their own communities.

Under the current transition to democracy, formal controls on information have largely been lifted yet the avenues and mechanisms are not fully in place at the local level to foster the participation of an informed citizenry. In addition, independent media and NGOs have a greater role to play in both disseminating information and promoting public debate of relevant issues.

USAID's strategy to increase the flow of useful information will be accomplished by strengthening independent media at the local level, and ensuring that local governments provide citizens with access to information.

### Results Group 2: More Active and Responsive Civil Society

Illustrative Indicator

	1993	1996	1999
<b>NGOs engaged in advocacy related activities (No.)</b>	518	550	650

Civil society is defined as the citizenry at-large and the myriad of NGOs (institutions and organizations) that provide services, information, and advocate for issues on behalf of the public interest. In the early stages of democratic consolidation, civil society inevitably undergoes a degree of deflation as the tremendous energies that were expended during transition give way to the realities of household economic survival. Many Hungarian NGOs that were initially concentrating on global social and environmental issues are now focusing on local economic transition issues such as creating employment opportunities and economic development. Correspondingly, USAID's focus has shifted to the local level. As USG assistance has helped to establish and strengthen state institutions vital to Hungary's democratic transition, there is now no greater long-term challenge in the post-transition period than the establishment of a strong civil

society capable of participating with government in the public realm of local-level, community-based decision making.

USAID's strategy to promote a more active and responsive civil society will be achieved by fostering cooperation between local governments and NGOs to deliver key services, helping local governments and NGOs create mechanisms for collaborative decision-making, training NGOs to advocate for issues more effectively, increasing NGO cooperation and ensuring that NGO capacity increases, in part through assisting the creation of NGO policies, laws, and regulations. NGO activity achievements will be monitored to determine how they have impacted upon the pre-selected SO and IR indicators to ensure that USAID's assistance has been properly targeted.

**Results Group 3: Local Government More Effective and Responsive to Citizens**

*Illustrative Indicator*

	1996	1997	1998
<b>Inter-local cooperative councils/fora established (No.)</b>	20	75	500

While NGOs and advocacy groups provide a means for citizen action in their communities, it is equally important for local governments to establish efficient and transparent processes for managing their numerous responsibilities. Local governments must also be receptive and responsive to citizen concerns, and encourage more communication through the creation of mechanisms which foster participation and feedback. Local governments can achieve these results through improved service delivery, more effective management including increased cooperation with other localities, increased numbers of mechanisms for receiving citizen input, and through contributing to a national level framework which itself is conducive to effective local government. It is important to recognize that local governments in Hungary have the responsibility for delivering such services as water, heat, power, waste disposal, education, welfare, and health care. In addition, a network of country labor centers operates an employment service. Service delivery is often the most obvious means by which local governments interact with citizens and business; it provides citizens with excellent criteria for judging a local government's commitment to its constituents. A failure to effectively remove waste, to provide water, heat, or electricity, to manage municipal properties, or to assist unemployed job seekers in finding productive employment opportunities can translate into citizen dissatisfaction and distrust.

USAID's strategy to help make local governments more effective and responsive to citizens is being accomplished through a wide variety of means. Specifically, USAID efforts focus on fostering local government and NGO cooperation to deliver key services and working to improve the general management capacity of local

governments. This includes developing and assisting in the implementation of improvements in financial administration at the local government level, such as helping municipalities develop and institutionalize processes that generate annual capital budgets that integrate citizens inputs for establishing priorities for financing municipal capital improvements. These efforts also extend to increasing inter-local cooperation, which improves the ability of county labor centers to respond to employment crises; assisting in the creation of mechanisms for dispute resolution, promoting changes in the national level framework, which will enhance the policy environment, and diversifying municipal revenue sources that will be conducive to increasing the overall effectiveness of local governments.

### **III. Program Management:**

#### **Level and Use of Resources**

##### **Program Levels**

The Mission is proposing five strategic objectives, which are highly inter-related but discrete: Fiscal Reform, Financial Sector Reform, Small and Medium Enterprise Strengthening, and Democratization. The strategy proposes a level of SEED financing of \$17 million in FY 1996; \$15 million in FY 1997; and approximately \$7 million in FY 1998. We shall seek to enhance these funds, where possible, by re-obligating unexpended funds from prior year projects.

As projects and strategic objective elements attain their results targets, they will require less levels of effort and will be closed-out. We propose FY 1999 as USAID/Hungary's final year of implementation, with close-out by September 30, 1999. The Mission's assessment of resource requirements derives from three basic observations. First, there remains significant need for targeted, albeit less, technical assistance to Hungary for sustainability to be assured; second, it is now unequivocally clear that Hungary is both committed, and able, to use U.S. assistance appropriately; Third, we believe that we have found mechanisms -- consolidation, team management, results approaches -- to manage the proposed program efficiently.

#### **Staffing and Management**

##### *The Staffing Environment*

The fact that the bilateral USAID/Hungary will provide employment for just over three years very much defines staffing issues. Foremost, as we approach close-out, talented staff are considering options outside USAID/Hungary. While employees do go to the Regional Financial Management Center (RFMC) or the Embassy, the exodus problem is compounded by the fact that salaries are not keeping up with this dynamic economy. Thus, USAID finds itself in a position that we can no longer provide job security nor matching salaries. Mission management must work with USAID/W to address this situation now. We propose developing an in-house corporate strategy for keeping talented employees in order to assure success of our proposed programmatic Strategic Plan. This strategy would include:

- assuring that USAID/Hungary is perceived by other USG organizations, other donors, our development partners and Hungarian firms as a first rate management organization and our employees top of the line;
- providing employees the best level of training. Because of high turnover, USAID/Hungary anticipates significantly higher training costs than we would under other circumstances. In addition, to keep good employees, the employee must believe that staying with USAID will prepare them well for enhanced career opportunities after USAID's departure. We propose focusing on our advanced concepts of re-engineering and team-building; management skills, key technical skills and language.
- develop a flexible bonus system which serves as incentives for employees needed to do the job to remain as long as necessary.
- avoid compounding morale and workload problems by establishing cumbersome replacement procedures. For every slot left open, someone is doing double the work in such a small Mission.
- develop creative and flexible staffing arrangements. If employees wish to stay with USAID and work part-time so they may work for another firm or go to school, we should find ways of accommodating this and find ways to allow our staffing patterns to reflect FTEs as opposed to slots.
- develop now effective out-placement capabilities for FY 1998 and 1999 for employees.

## Proposed Staffing

In keeping with USAID's efforts to manage significant programs with concentrated staff, the USAID strategy envisages going from five USDH in FY 1995 to three USDH by the end of FY 1996 and remain at three USDH through FY 1999, our expected close-out year. These three USDH, the AIDREP, a Project Officer and a Executive Officer will guide the structure of the Mission as work scales down.

	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999
USDH	5	3	3	3	3
USPSC (OE)	4	4	4	3	3
USPSC (PRG)	7	7	6	6	6
FNPSC (PRG)	1	3	3	3	3
FNPSC (OE)	14	14	14	14	14
<b>TOTAL</b>	<b>31</b>	<b>31</b>	<b>30</b>	<b>30</b>	<b>30</b>

## Management Approach

Managing so much with the problems of limited staff and high turnover require creative management and a team approach. The management of our portfolio under re-engineering requires clarification in terms of the new DMS 200 series. In the absence of such clarification, the Mission has done the following:

- reduced the number of management units and limited the number of strategic objective teams.
- Fiscal and Financial Strategic Objective teams have been "twinned" to divide in half the number of meetings required for each staff member, while keeping the spirit and advantages of the Strategic Team approach.
- Energy, slated to close in FY 1997 has the status of "junior strategic objective" and a more limited approach to partner participation and team decision-making.
- Attempt to identify qualified local FSNs to replace more expensive and less permanent USPSCs, as in the case with Local Government;

## **Monitoring, Evaluation and Reporting**

Immediately following approval of the Strategic Plan, the Mission will refine a monitoring system, already begun under the Bureau's new monitoring and reporting system. The Mission Steering Committee will set up broad guidelines. Each Strategic Objective Team will set up procedures for monitoring and evaluating the performance of all activities within its domain and reporting to the Mission Steering Committee. The Program Office is responsible for guiding this process and assuring the fulfillment of all USAID/W requirements. The Project Office will remain responsible for advising Strategic Objective Teams on project management and monitoring.

# **HUNGARY STRATEGIC PLAN**

**1996-1999**

## **Annex**

- A. Overview**
- B. Strategy Background**
- C. Results Packages: 1996-1999**
- D. USAID/Hungary Budget Summary by Intermediate Results**
- E. Justification for FY 1998 OYB at \$8 Million Level**

## **A. OVERVIEW**

### **1. Background**

Today's Hungary is slightly smaller than the state of Indiana and accounts for only about 1% of Europe's territory. Although landlocked since the 1920 Treaty of Trianon, Hungary's location in the center of Europe provides it with certain strategic advantages as a potential crossroads between Eastern and Western Europe. Its 10.3 million population is small relative to most other countries of Europe and is declining. With its fertile Great and Small Plains, Hungary has long been known as a productive agricultural country. Under Communist planning, much effort was directed at industrializing the country. Today, agriculture comprises only 8% of active employment, compared to 32% for industry and 54% for services. With a Western tradition going back to the Roman Empire, Hungarians place considerable importance on Hungary being viewed as a Western country. Hungarians take great pride in having provided Western civilization with a disproportionate number of artists, musicians, scientists and Nobel prize laureates. This Western outlook plays an important role in public attitudes regarding decisions related to integration into international and Western institutions such as OECD, the European Union and NATO, to political and economic restructuring needed for that integration, and to Hungary's international focus such as its recent role in international efforts at peace-keeping in Bosnia.

During the later part of the Communist period, Hungary became a relatively affluent country by Eastern-bloc standards, enjoyed a favorable position within COMECON and was an early experimenter with a market economy. However, this standard was not sustainable and by 1989, Hungarians realized that forty years of political and economic dictation had left the present generation with a monumental economic crisis. The pervasive economic role of the state, the discouragement of private initiative and a legacy of coercive economic relations with other Central European and Eastern countries had put the economy in a chronically weak and dependent condition and totally at odds with Hungary's potential.

After establishing a Parliamentary style democracy and electing its first post-communist era President and Parliament in 1990, Hungary set forth on a radical transformation aimed at re-establishing a market economy. Hungary's transition, however, began at a time when the country's economy was characterized by a plethora of severe tensions in equilibrium and structure. Gross foreign debt had reached \$20.4 billion by the end of 1989. Hungarians pointed out at the time that there was no theoretical guidance for such radical transitions from command to market economies and that historical experience had no practical examples to

provide guidance. The transition would be wrought with uncertainty, ebbs and flows of political will and genuine hardship for large numbers of Hungarians. Because of Hungary's relative economic liberalization, the country was one of the first beneficiaries of the SEED Act. Planning for U.S. assistance to Hungary began in early 1989, and several modest grants were provided to facilitate Hungary's political and economic evolution shortly after passage of the SEED Act.

## **U.S. Foreign Policy Interests**

U.S. over-arching policy interests in Hungary parallel the U.S. general interests in the region, namely to: assure peace and stability in Central and Eastern Europe; to foster Hungary's entry into Western economic and political institutions; and to encourage Hungary to play a positive role in important international issues and events. Hungary enjoys a strategic location, as most recently evidenced by its cooperation in serving as the staging area for over 20,000 U.S. peace keeping (IFOR) troops for Bosnia.

## **2. Trends, Constraints and Opportunities**

### *Significant Trends: Democratization*

By almost any standard, Hungary in 1996 is a democratic country. The country has a fully democratic and representative political system based on free and fair elections. In March 1990, Hungary's first national parliamentary elections were held and were generally considered to be free and fair. The first post-communist democratic government was formed in May 1990. In 1994, new elections resulted in the Socialist Party winning an absolute majority of seats (54%), replacing the previous center-right coalition. This peaceful transition of power demonstrates the sustainability of Hungary's democratic change.

Hungary's Parliament is now considered an effective rule-making institution. The executive and legislative bodies, both nationally and locally, conduct their affairs in an open and transparent manner.

Fundamental liberties and individual freedoms, including freedom of speech, religion and association have been codified by laws, and with some exceptions, respected in practice. In 1994, Hungary passed its law on ethnic and minority rights. However, Hungary's government continues to have problems in its response to ethnically motivated incidents. And some minorities, particularly Gypsies, reportedly continue not to be treated the same as most other Hungarians.

With the enactment of the December 1995 Media Law, Hungary now enjoys

legislated freedom of the press. Although national radio and television stations are publicly owned, some local radio stations are privately owned, as is cable television. Many newspapers are operated by local self-governing administrations, but there are large numbers of private publications. Editorial integrity is generally respected, although true investigative journalism is still rare. In addition, telecommunications, including Internet, are in private hands and thriving.

Under the Constitution, the courts are responsible for the administration of justice. The Supreme Court exercises policy control over the operation and adjudication of all courts. A separate Constitutional Court is charged with reviewing the constitutionality of laws and statutes. The right to a fair trial is provided for by law and respected in practice. All citizens have the right to own private property. Hungary's adjustment to democratic government has been rapid. The Freedom House scoring, based on a scale of 1 to 7, with "1" representing the highest level of freedom, is a good indicator of how far Hungary has come. In the area of political rights, Freedom House established Hungary as a "5" in 1988-89. By 1990-91, Hungary had risen to a "2" and by 1993-94 reached the highest "1" rating. In the area of civil liberties, Hungary rose from a "4" in 1988-89 to "2" in 1990-91.

However, many Hungarians are frustrated by a new and unfamiliar form of government which they do not truly understand. They see their standards of living eroding and do not see the new political system as providing them with control over the downside. The Hungarian "cold-turkey" approach at decentralization almost overnight devolved major socio-economic responsibilities to local communities unable to manage or finance them. Hungarians do not yet work within a mind-set of individual initiative or self-help. They see no viable alternative vision to the very broad safety net the previous political system provided.

With the major structures of a functioning democracy in place at the macro level, Hungarians continue to need help in bringing democracy to the grass roots. The average Hungarian demands to know how the new system provides for social economic support taken for granted for 40 years -- and how to live and thrive in the new system. To make Hungary a truly Western-style democracy, Hungary will have to continue to strive to strengthen its civil society through improvements in the media and non-government organization structure.

Most local governments have yet to become effective and accessible, and need to foster the integration of a rapidly growing NGO sector into community affairs both as a forum for day to day citizen participation and as an effective partner working with local governments in the interest of local populations. Although most local government officials in Hungary are competent and able to manage, many do not have access to the technical expertise associated with modern management.

Management systems are generally incomplete, and cooperation with the large NGO community is often unenthusiastic.

*Significant Trends: Economic*

The basic policy, legal and regulatory frameworks needed for smooth functioning of a private sector led market economy are in place, and steady progress continues to be made on improving routine functioning under this framework. Today, almost 70% of Hungary's GDP is in private hands thanks to recent sales of energy and telecommunication works, bringing in an additional \$3 billion in foreign direct investment. Hungary holds the region's record with a stock of over \$13 billion in foreign direct investment. Indeed, Hungary has attracted nearly 50% of the capital invested in the region. The United States is the leading investor in Hungary with over \$3.5 billion in various sectors.

Hungary's transformation has been accompanied by wrenching economic dislocations and weaknesses. From 1988 through 1993, Hungary experienced a five-year-long shrinking of its economy of over 18%, comparable to the Great Depression in the United States from 1929 to 1933. In 1994, the Hungarian economy began to come out of this severe five-year recession. Household incomes grew in real terms for the first time since 1989. Industrial production began to increase at significant rates for two consecutive years, leading recovery of real GDP. Unemployment at 11%, while still high, is declining. The fact that such recovery of economic activity has been driven by an expansion of investment by the private sector, which now accounts for around 70% of GDP, would justify predictions of a new investment cycle and raise the prospects of sustained growth of GDP over the medium term. The economy grew 2.9% in 1994 and 1.5% in 1995. Consensus projections of average growth in 1996 cluster around 2%. We expect sustained growth of 5% a year by 1999.

Hungary came out of its "transformational" recession with major weaknesses. The recent recovery was accompanied by a very large current account deficit, itself reflecting a large imbalance in the fiscal accounts. These "twin deficits" are unsustainable, but progress is being made. The fiscal deficit declined from 7.5% of GDP in 1994 to 6.6% in 1995 and the current account deficit of the Balance of Payments declined from 9.5% of GDP in 1994 to 5.6% in 1995. With a public debt to GDP ratio of 0.71 at the end of 1995 (down from 0.85 at the end of 1994), Hungary's growth prospects may be compromised unless the process of expansion continues to be accompanied by steady reduction in the level of gross external debt to approximately 60% of GDP. Significant progress is being made on realizing this important objective.

Thanks to extraordinary privatization success in 1995, Hungary surpassed its goal of 4% of GDP for its fiscal budget deficit, thereby assuring the blessing of the IMF by means of an IMF Stand-by Agreement and accession into the OECD. However, *sans* privatization revenues, the deficit was sticky, amounting to a very high 6.6% of GDP. Hungary's ability to keep its budget deficits low over the medium term has not yet been demonstrated.

The impacts of a shrinking economy as restructuring has occurred have been extensive and quite disruptive. These impacts include: a massive decline in formal employment and the emergence of high unemployment; growing income disparities and increased poverty; the opening of large, un-sustainable twin fiscal and balance of payments deficits; high inflation; extremely high taxes; and a large external debt burden.

Formal employment in Hungary at the end of 1994 is estimated at approximately 82% the number employed in 1988 before serious restructuring began. The emergence of high unemployment, although moderated by a dynamic, pervasive informal sector estimated at 30% to 40% the size of the recorded formal economy in terms of likely value added, has been particularly disruptive, especially since high unemployment rates in some areas of the economy, are multiples of national rates. During 1995, unemployment is estimated to have fluctuated in the range of 11- 12% of the labor force, but at significantly lower real wage levels than in 1988. During the 1989-1993 recession, real wages declined by around 6%. But the return to positive GDP growth has not raised real wages, which during the 1994-1995 period may have fallen an additional 5% or so for a cumulative decline since 1988 on the order of 11%. Whereas in real terms, company wage bills declined 5% a year in 1994-1995, returns to capital grew 14% a year. Further declines in real wages are expected in 1996.

The incidence of relative poverty has increased substantially in recent years. The incidence of poverty based on a threshold of 50% of mean household income increased from 4.3% of households in 1989 to 34.6% in 1993. Based on these data, the poverty gap declined from 17.1% to 15.6%, indicating that poverty is fairly shallow, that is, although the number of poor households has increased substantially, typical incomes of households classified in poverty in 1993 were only 15.6% less than the income of households at the threshold defining relative poverty.

This modest gap explains, in part, why poverty for many households is transient. The rest of the explanation is the frequent churning of households between brackets in the income hierarchy. From 1993 to 1994, some 40% of households changed relative income positions by two or more decile. The poorest 10% of households, however, do not change relative positions as dramatically or quickly

as most households. Indeed, it is these households that have suffered the largest declines in real incomes in recent years. Most of the households in this decile can be characterized as being in permanent, severe poverty. Limited access to market incomes is the principal determinant of relative poverty, although improved targeting of public transfers could substantially eliminate poverty with little or no increase in total transfer payments.

Increased unemployment and large increases in the number of poor households may be one of several reasons why social transfers, which accounted for 31% of general government spending in 1988, rose to 39% of general government spending in 1994. General Government revenues declined from 62% of GDP in 1988 to 53% of GDP in 1994. The fiscal deficit was zero in 1988. In 1993 and 1994, the general government fiscal deficit (excluding privatization revenues) averaged over 7% of GDP, resulting in substantial destabilization of macroeconomic financial structures.

During the period 1990-1994, inflation measured by the consumer price index (CPI) averaged 25% a year. Inflation in 1995 rose to 28.3% and exchange rate depreciation in terms of U.S. dollars was 17%. Net foreign liabilities (flow basis) rose from nil in 1992 to 10% of GDP in 1994 as the current account balance of the country's Balance of Payments changed from a significant surplus of \$359 million in 1992 to a deficit of \$3.9 billion by 1994. In 1994, total spending in Hungary was 9% higher than total income. The difference was financed by borrowing, foreign direct investment and donor flows. The stock of external debt rose 32% during the 1993-1994 period, from \$21.6 billion (59% of GDP) in 1992 to \$28.5 billion (69% of GDP). Debt service jumped from 38.6% of exports of goods and non-factor services in 1992 to 60.8% in 1994. To put the debt numbers in perspective, countries often have servicing difficulties when the stock of debt reaches around 40% of GDP and servicing exceeds 30% of exports of goods and non-factor services. Fortunately, Hungary has managed its debt servicing obligations well. Arrears have not accumulated.

Although the SME sector is growing rapidly, significant problems and constraints remain, namely widespread business losses and poor management stemming from inadequate business skills, limited access to information and appropriate technologies, and difficult access to credit facilities because of inadequate accounting systems and the perception by banks that most enterprises are high risk. These problems are not generally associated with large enterprises or the rapidly growing joint venture companies, but small to medium enterprises of less than 300 employees that account for 99% of enterprises in the country. The small and medium enterprise sector has been identified as the sector with the greatest potential for assuring future economic growth and absorbing the bulk of future employment needs in the country.

The financial sector in Hungary remains underdeveloped and unresponsive to the needs of Hungary's growing private sector. The financial system that embraces insurance, banking and other capital markets is immature and not yet fully capable of responding to the diverse needs of a growing, complex market economy, even though most of the policy, legal and regulatory framework needed for future success is in place. In 1996 the Ministry of Finance turned all rights over the country's national banks to the State Privatization Holding Company, un-blocking the possibility of bank privatization.

### **3. Opportunities**

By virtue of its strategic location, highly educated population, relatively inexpensive labor by Western European standards and good climate, Hungary offers a wide variety of opportunities for sustained economic growth and development. The country has comparative advantages in many industrial areas such bauxite production, vehicle manufacturing, pharmaceuticals, glass production, agricultural equipment and chemicals, to mention just a few. Service industries also present many opportunities. In addition, Hungary's agriculture could play a role in economic growth as well, if neighboring tariff and trade practices permit. Principal growth sectors which stand out (identified in a recent study) are telecommunications, services, including financial services and advertising, construction, food processing, automobile and automobile parts production.

### **4. Constraints**

The constraints to Hungary's ability to achieve a rapid transition fall in four basic categories:

1. There is simply so much to do at once. Virtually every element of every sector must be restructured. A good insight into the problem is provided by Parliament's agenda immediately after the decision to reform. In the space of just over a year, it modified or annulled thousands of laws and regulations. This took preparation, review, study, and voting. Implementation then fell to those affected. Privatization of the housing sector, only one aspect of both the business and social sectors, provides another insight. In Budapest alone over 400,000 of approximately one million houses were turned over through sale arrangements to their dwellers after 1991. Most of these were in state-owned apartments which through privatization suddenly became condominiums, which in turn needed legislative guidance and regulatory oversight for condominium management. In addition, after 40 years of communism, much of the housing stock was in very poor condition, new owners had little knowledge of how to upgrade the stock.

Legislation for managing, repairing or zoning was weak, non-existent or contradictory and credit for renovation was unavailable, mostly because such credit was heretofore unknown. This scenario repeats itself in virtually every sector of the economy touched: business, energy, local government, financial markets, health, education and pension reform, to mention a few.

2. Much of the population is unprepared, mentally and technically, to undertake their new roles. Forty years of cradle to grave directed society has left many people unprepared or unwilling to accept risks, take individual initiative or exercise self-reliance. Hungary's and USAID's attempts to promote the use of non-government organizations and local associations to replace government often meet with complete lack of understanding on the part of average Hungarians with no tradition of volunteerism and sometimes with hostility on the part of bureaucrats. In many cases, such as home ownership where the issue is forced, the average Hungarian simply does not have the knowledge on how to proceed or where to go for help. And often, help normally provided by an independent association is either not available or ineffective. Similarly, the concept of competition, as known in the West, is not strong, even among small entrepreneurs.

3. People are not universally prepared to shoulder the burden of such dramatic reforms. Since 1990, real household incomes have fallen an estimated 15% (based on patterns and levels of consumption). Prices for basic necessities and services -- food, transportation, housing, energy, health, and education -- are fast outstripping the average Hungarian's ability to pay. There is a general consensus that economic reform in Hungary is proceeding smoothly; however, the life of a country and the life of an individual differ greatly and many Hungarians are not sure they will be able to see themselves through. In 1994, Hungarians voted to return the former, albeit restructured, communist party in a demonstration of widespread voter frustration and discontent. The now governing Socialist Party, however, much to the dismay and anger of many of the voters who helped return them to office, has embraced the exigencies of the transition and adhered admirably to needed reforms which, however necessary, continue to be painful to substantial numbers of the electorate.

## **5. Other Donors**

The Strategy Section details USAID's work with Hungary's other donor partners in areas of our strategic objectives. In general, Hungary's partners and their activities are outlined below.

The World Bank group, the EBRD and the European Union through its PHARE program as well as several bilateral donors are increasingly well represented in

Hungary. Their objectives, strategies and programs complement USAID's.

#### **EU-PHARE**

Since 1990, EU Phare has committed approximately \$637 million in assistance to Hungary through technical assistance programs and loans. EU Phare planned assistance to Hungary from 1995-1999 will be approximately \$553 million. Their activities focus in the following areas: European Integration, including the approximation of laws and public administration; education and training with emphasis on the establishment of a human resources development fund; economic development focusing on agriculture, privatization and restructuring small and medium sized enterprises; regional development, trade and investment promotion; tourism development; public finance; social sector reform; infrastructure development with emphasis on road and water rail transport, communications, transit, water management, energy and the environment; and participation in EU programs. Since 1990, enterprise development (including privatization), agriculture, and environmental projects have accounted for over half of EU-Phare's commitments.

#### **WORLD BANK**

Since 1986, the World Bank has committed approximately \$1.7 billion to 20 loans under its supervision. An additional 10 loans with a value of approximately \$950 million are currently under preparation. The Bank has focused on supporting Hungary's efforts at creating a market-oriented competitive economy more conducive to private sector development through hybrid loans, investments loans, structural adjustment loans, and quick dispersing funds to support institutional and policy reform. The Bank's main goals in Hungary are three-fold: 1) promoting reforms that ensure an economic policy environment which does not discriminate against private sector activity; 2) supporting the development of institutions and services that facilitate private sector growth; and 3) supporting the private sector through targeted assistance to small and medium sized enterprises.

#### **BRITISH KNOW-HOW FUND**

Since 1990, the British Know-How Fund has committed approximately \$45 million in grant funded assistance to Hungary. Although there is no fixed annual budget for Hungary, approximately \$6.5 million is programmed annually. Assistance is mainly provided through grant support to individual projects. Priority areas for the Fund include: economic restructuring/privatization; financial services development; management education and training; small business development; employment services; public administration; and environmental reform.

## **EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)**

Since 1991, the European Bank for Reconstruction and Development (EBRD) has approved approximately \$1 billion in loans for 35 investment projects in Hungary. This is the highest percentage of financing from the EBRD next to the Russian Federation. The EBRD provides both public and private sector financing. However, the private sector has received the largest amount of EBRD financing in Hungary. Additional funding has also been provided for limited technical assistance. Priorities for the bank loans and technical assistance are: promotion of the private sector through privatization of state owned enterprises, restructuring of state owned companies; financing private Hungarian companies and state owned companies; development of the financial sector; financing of critical infrastructure, mainly telecommunications, transport, energy and natural resources; financing municipal sector projects; tourism; and agribusiness.

## **GERMANY**

Since 1990, the German Government has provided approximately \$71 million in assistance to Hungary through its bilateral assistance program. Although there is not a fixed annual budget, Hungary receives approximately \$14 million a year. The main focus for the German assistance program is support to small and medium-sized enterprises, which accounts for 40% of the program. Other priorities for the program are: assistance to farming, agribusiness, privatization, labor and social policy, banking, environmental protection, and legal reform conducive to EU integration.

## **JAPAN**

Since 1990, the Japan assistance program has provided approximately \$15 million in assistance to Hungary. Assistance is provided through five institutions: Japan International Cooperation Agency (JICA), the Association for Overseas Technical Scholarships (AOTS), the Japan Productivity Center (JPC), the Japan Overseas Cooperation Volunteers and, the Japanese Import-Export Bank. Priorities for the Japanese assistance program include: environmental protection, agriculture, industrial and productivity development, health care, and cultural activities.

## **B. STRATEGY BACKGROUND**

### **1. Assistance Framework**

In 1989, the Support to Eastern European Development Act (SEED) outlined the basic framework for what the United States hoped to help Hungarians achieve in transition. Pro-market reforms began early in Hungary, as did the legislative changes that would ultimately underpin the emergence of the largest private sector in Eastern Europe. As a result, Hungary was one of the earliest beneficiaries of SEED assistance.

From the onset, USAID's objective was to help Hungary address the obstacles to its transition to a democratic, stable and prosperous nation taking its place in the international arena. Transition assistance would address three broad areas: economic transformation, democratization, and the quality of life. Specifically, the USG and USAID envisaged that Hungary's transition stage would be completed when:

- The policy, legal and regulatory frameworks necessary for effective democratic governance and private sector development and growth are in place;
- Fiscal policies and fiscal management practices are sound and prudent and supportive of a stable, balanced socio-economic environment favorable to private sector investment and sustained, broad based economic growth and development;
- The sustainability of basic social benefits and services is assured;
- A competitive, market oriented economy has emerged in which the majority of economic resources is privately owned and managed;
- There is a thriving, growing private sector characterized by confident small and medium enterprises (SMEs) doing business in an environment that rewards risk taking and initiative, provides models for strong operational performance and presents opportunities for sustainable expansion;
- A competitive, market responsive private financial sector routinely and efficiently mobilizes savings to finance private sector investment and economic growth;

- The energy sector is substantially privately owned and managed and regulated to balance cost effective service to the public with incentives for increased private investment
- Governance at all levels is transparent and accountable and citizens actively and freely participate in democratic political processes
- The goal of, and models for, the participation of citizens and non-governmental organizations in all aspects of political and economic decision-making are generally perceived as accomplished;
- An independent media and open flow of information is taken for granted;
- Hungarians enjoy a natural environment which is not detrimental to their health or welfare and the sustainable use of natural resources is assured;
- Expected dislocations and temporary adverse impacts of the transition process have been adequately addressed.

Because of the magnitude and breadth of transition, USAID's strategy is to develop a highly flexible array of appropriate assistance mechanisms to respond to Hungarians' decisions on the areas to address first and Hungary's other donor partners' programs. USAID assistance has carefully focused in areas where the U.S. has a clear predominant capability, Hungary has the political will, and U.S. assistance complements work by other donors.

Early focus was on the institutionalization of democratic change, elections and key legislation and on privatization and fiscal reform, as well as selected interventions to mitigate the worst effects of transition on the poorest segments of the population. Subsequent assistance has complemented work done by Hungarians in energy reform, and financial reform.

Ultimately, U.S. assistance would provide Hungarians with alternate concepts of centralized decision-making and the ubiquitous "safety-net."

USAID's strategy was to provide assistance quickly, and reduce USAID's assistance as other donor assistance became available and Hungary moved from the immediate transition stage to issues surrounding membership in the European Union.

## **2. Performance Status by Strategic Objective**

### **Strategic Area I: Economic Stabilization and Transformation**

While the macro-economic environment was stabilizing and investor confidence was growing in 1994, economic aggregates were far from satisfying Maastricht criteria. Inflation stood at 19%, nominal interest rates exceeded 24%, the current account deficit of the Balance of Payments closed the year at more than 9% of GDP and outstanding external debt balances reached 70% of GDP. Inflation predictions for 1996 are in the range of 23-24%, and unemployment rates are not expected to differ much from average rates in Western Europe.

#### **Strategic Objective: Increased Transfer of State-Owned Assets to the Private Sector**

With the most recent round of privatization now completed, Hungary has become the region's leader in privatization. Only 30% of the 1,857 state-owned companies in 1990 remained in state hands at the end of 1995. Accumulated direct foreign investment since 1989 is in excess of \$13 billion (foremost in the region both in absolute and relative terms) and value added generated by the private sector may now exceed 65% of total GDP, compared to approximately 35% six years ago.

This outstanding performance resulted from an exemplary coming-together of exceptional political commitment on the part of both post-democratic Hungarian administrations and a highly flexible, collaborative and well-targeted U.S. assistance package directly targeted for privatization totaling more than \$20 million.

Shortly before the elections in 1990, Hungary's State Privatization Agency (SPA) was established to oversee the country's until then ad hoc privatization efforts. The GOH requested U.S. assistance within the framework of the SEED act. Assistance to the SPA immediately targeted two priorities: 1) make SPA a recognized, competent, and successful force in the privatization process; and 2) provide necessary direct technical assistance in privatization transactions which would lead to rapid privatization of a large number of enterprises.

With early USAID assistance, the SPA became a respected and trusted organization. Early USAID assistance also enabled the SPA to proceed to the second step and with a second stage of USAID assistance, write tender offers, find buyers, evaluate bids, and structure and negotiate deals. During the period September 1993 to July 1995, the SPA, with direct USAID input, sold 42 enterprises and closed 20 postponement, bankruptcy and liquidation transactions.

The total value of these operations amounted to some \$620 million: \$241 million in sales proceeds and \$379 million in new capital subscribed.

In late 1992, the privatization effort for the less profitable smaller firms and agriculture enterprises began to lag amid growing concern that undercapitalized Hungarian investors were unable to compete with foreign capital in the contest for the remaining stock of viable State-Owned Enterprises (SOEs). USAID contracted with Coopers & Lybrand and Chemonics to develop a wider range of financing and management methodologies. In addition, USAID assisted Hungary in drafting Employee Stock Ownership Plans (ESOPs) enabling ESOP legislation which soon became the third ESOP law on the books in the world, after the United States and the United Kingdom.

By the end of 1995, approximately 200 companies employing over 75,000 people had been privatized through ESOP plans. The Coopers & Lybrand and Chemonics team also developed a series of other non-traditional privatization mechanisms including lease-purchase, installment payment facility, management buyout, voucher (credit notes) and asset management contracts.

In 1994, USAID also provided assistance to assist the then State Asset Holding Company (AVRt), and later known as the State Privatization and Property Company (APVRt), in working on politically or technically complicated privatization projects, such as companies producing national treasures (ceramics, for example) and companies producing in strategic areas. APVRt and KPMG completed the privatization of VIDEOVOX in January 1996. Hungary's APVRt is now fully qualified to complete virtually any of the privatization actions that remain to be undertaken.

USAID's support for the privatization process has typically been discreet due to the sensitive political nature of restructuring and reform. This is particularly the case for many technical assistance and training activities, including study tours to the U.S., with objectives related to restructuring the legislative, regulatory and policy enabling environment. Since 1991, USAID has provided approximately \$2 million to assist Hungary in changing laws and regulations that hinder reform. Notable examples of such USAID assistance include the Anti-Trust Law, the Telecommunications Law, the Bankruptcy Law, the ESOPs law, and the proposed Agricultural Reform Law and assistance to local advocacy groups through such organizations as the Center for International Private Enterprise (CIPE), the International Development Law Institute (IDLI), and the American Bar Association (ABA).

Hungary's success in privatization and U.S. Government support to these efforts

are inseparable. Many Hungarian policy makers will point this out when describing our assistance, as did the CEO of the APV Rt in a February 27, 1996 letter to the American Ambassador in Hungary.

Status: USAID considers this Strategic Objective fully achieved and has closed it as an ongoing Strategic Objective. The last of important privatization activities, banking and energy, are critical to other strategic objectives and will be carried under them.

**Strategic Objective:      Increased Soundness of Fiscal Policies and  
Fiscal Management Practices**

Hungary's fiscal situation remains tenuous, rapidly rising social sector spending and falling revenues resulted in central government fiscal deficits over 7% of GDP in 1993-94, driving up government borrowing and making financing for the private sector more expensive. CPI inflation figures for 1995 stood at 28.3% and the exchange rate had depreciated by 17%. Tighter fiscal discipline in 1996, reinforced by an IMF Standby, is expected to rein in the deficit to less than 4% of GDP although inflation may be sticky, falling only to a still high 23-24% range. With government spending for social services at 40% of total outlays and 22% of the work force still on the government payroll, much work remains to be done.

USAID's agenda the past two years has included promotion of fiscal reform, reduction of social benefits through adoption of means testing policies, raising the efficiency and reducing the carrying cost of GOH provided social services and reducing environmental costs through special environmental pollution taxes. USAID assistance in the fiscal sector, principally through US Treasury Advisors, has focused on internal management systems at the Ministry of Finance, and pension reform. Special areas of attention include tax policy and administration, revenue forecasting, treasury and debt management, and expenditure controls. At the urging of US advisors, a new Treasury Department in the Finance Ministry has been established and charged with oversight of GOH budget implementation and monitoring. Another new Ministry entity, the Debt Management Agency, has been organized. A U.S. advisor, a retired head of the U.S. Comptroller of the Currency, played a key role in convincing the Ministry of the need for a more structured and disciplined approach to the issuance and management of government debt instruments.

U.S. Treasury advisors continue to work closely, both here in Hungary and in the international fora, with the IMF, World Bank and others, on a wide range of issues of mutual interest. A new IMF Standby recently approved by the IMF Board of Governors, the first in four years, will provide a more structured framework for

donor collaboration and increase pressure on the GOH to stay the course on fiscal reform.

USAID involvement in complementary Strategic Objectives should help the GOH trim outlays, e.g., improvements in hospital management, means testing for subsidies in housing and energy, more efficient local governance, and service oriented NGOs. Most importantly, as the privatization process of the SOEs and public banks nears completion, the GOH will find its ability to maintain present high levels of social expenditure greatly reduced. USAID collaboration with the GOH to assure budget equilibrium is more relevant and productive than ever before.

For FY 1996, the GOH has obtained approval from Parliament of a National Consolidated Budget with a deficit of 4% of GDP. In April, the IMF agreed to a large Stand-by arrangement. Also in April, Hungary was approved for membership in the Organization for Cooperation in Economic Development (OECD). Reductions proposed in the FY1996 budget derive from a strategy to get delinquent revenues to the Social Security Fund from non-performing industries. This strategy may not be sustainable without the GOH's continued commitment to address issues of increased efficiency and further (even painful) cost-cutting.

Status: This uncompleted Strategic Objective remains critical to completion of Hungary's economic and political reform efforts.

**Strategic Objective: Accelerated Growth of Private Enterprises**

Hungary's enormous success in privatization has a built-in strategy of private enterprise development. New foreign owners of privatized Hungarian firms also supply these firms with infusions of investment funds for modernization and upgrading as well as important technological know-how and skills. The approach helps assure knowledge of, and linkages with, outside markets. Small and Medium Enterprises (SMEs) do not benefit from this advantage. Yet, in Hungary's intermediate growth strategy, it is clear that a focus on SMEs merits important attention.

The SME sector presents numerous opportunities and challenges as a focus for USAID assistance. First, it is already a rapidly growing and vibrant sector making major contributions to overall economic recovery and the reduction of Hungary's high unemployment; second, it offers a ready learning ground for Hungarian entrepreneurs as they prepare to enter the broader competition of European and world markets; and third, SMEs offer a superb vehicle for economic democratization, involving the mass of the Hungarian body politic in day-to-day operation of a free market economy and; finally, as in the United States, it is small and medium sized business entrepreneurs who play key roles in community leadership and finance.

**Revised Strategy Objective:      Improved Performance of Small and  
Medium Enterprises (SME)**

Most of Hungary's 400,000 active registered SMEs were established after 1989. In the early 1990s, credit through the state controlled banking system was generally available and many SMEs applied for and received loans -- OTP Bank, one of Hungary's largest with branches nation-wide, made close to 98,000 SME loans in 1992 alone. Many of the new enterprises, however, were weak. Their owners often had limited management experience and marketing know how. As the Hungarian economy endured a drawn out five year recession (a longer than expected "transition depression"), many SMEs failed and banks moved to cut their losses by severely restricting further lending to SMEs. Overall volume of lending to SMEs dropped by 60%, OTP, for example, made only 41,000 loans in 1994, and collateral requirements became prohibitive. Credit, once relatively plentiful, became a major block to growth of the SME sector. Modern management practices and aggressive marketing are not yet characteristics of the sector, but are key requisites to flourishing, or even surviving in competitive markets.

The SME program proposed in this Strategy builds on lessons learned and mechanisms established under previous SEED financed activities. It will be closely coordinated with other donors that have major commitments in the sector. USAID technical advisors work directly with individual industrial and service companies and agricultural enterprises, with credit agencies and producer associations, with GOH entities concerned with SME issues and in learning centers at the regional and university level. The Hungarian - American Enterprise Fund has extended 45 loans totaling \$400,000 to micro-enterprises. USAID advisors are training branch managers, lending officers, and trainers in an effort to restore SME lending operations at the now, partially privatized, OTP Bank, a major conduit of other donor financing to the SME sector. Other examples of our SME effort include:

- Support of two Small Business Development Centers at Debrecen and Pecs;
- VOCA volunteers helped set-up four credit unions and several Farmer Circles, mutual aid groups similar to U.S. Granges;
- TQM Centers were established at the Technical University Budapest and Janus Pannonius University in Pecs;
- LOL advisors conducted 25 marketing seminars reaching at least 600 SMEs and installed a marketing curriculum at a secondary Agro-Vocational School;
- ACDI provided on-site advisors to 68 agri-businesses and detailed financial plans and credit proposals for 15 of the most bankable;
- IESC's Volunteer Executives have assisted 231 firms while the MBA Enterprise Corps has provided in-plant technical assistance to 50 firms. Many Peace Corps volunteers have also worked with companies to improve their operations.

USAID will consolidate its technical assistance and training efforts in the SME sector to : increase access to commercial banking services; improve access to market and technology information; improve business systems and practices; and rationalize tax structures for SMEs.

Status: USAID has narrowed the overall Strategic Objective to address only Small and Medium Enterprises as intermediate customers. This will be a high priority until close-out.

**Strategic Objective:           A More Competitive and Market  
Responsive Private Financial Sector**

Hungary has made substantial progress in its efforts to modernize the financial sector. A large segment of the formerly state controlled banking sector has been privatized with 22 of the nation's 43 banks now partially or wholly foreign owned. During 1995 the National Savings Institute (OTP) Hungary's largest individual deposit bank (\$372 million), and Budapest Bank (\$181 million) were privatized. Several additional banks will be added to the list of privatized (or liquidated) banks in 1996. The bad news for remaining banks, perhaps a harbinger of things to come, is that foreign banks, with only 20% of banking system assets, captured 44% of the lucrative corporate lending market in 1995.

The Budapest Stock Exchange, which reopened in 1990 after 42 years of inactivity, listed 41 stocks with \$1.9 billion in capitalization at the end of 1995. The BSE received a major boost in early 1996 with energy sector privatization and privatization of the state-owned telephone company MATAV. Capitalization jumped to \$2.7 billion. By the end of 1996 capitalization should exceed \$4 billion. Companies listed on the BSE tend to be in the export sector -- trading, food production and pharmaceuticals. Foreign investors dominate trading with about 80% of turnover.

The regulatory framework needed to ensure that financial sector operations are based on free, fair and open market competition rather than non-business criteria sometimes common in the past is well advanced. All necessary regulatory agencies, the State Banking Supervision, State Insurance Supervision, the State Stock Exchange Supervision and the Supervision of Mutual Pension Companies are now nominally established. USAID funded personnel helped draft much of the enabling legislation for the new regulatory agencies. The SBS is now engaged in its first on-site audits with nuts and bolts assistance from USAID contractors.

Foreign companies now dominate the Hungarian insurance system (12 of 14 companies are totally or partially foreign owned) and the industry is growing rapidly. In 1994, insurance industry capitalization rose some 36% (over \$260 million). Over time, the industry should significantly add to the stock of capital for long-term investment.

Improving the stock of available long-term capital is a principal objective of the USAID housing program. USAID housing advisors over the past several years have worked with the GOH on "means testing" to more effectively allocate government subsidies for housing purchases and helped draft reduced credit risk legislation in 1995 which protects foreclosure rights of institutions making mortgage loans. In addition, USAID and OTP have collaborated in testing an innovative deferred payment mortgage (DPM) scheme which significantly lowers the initial payment schedules on new home mortgages, can double the size of loans borrowers may qualify for and the percent of a purchase price that can be financed. OTP has made \$25 million in DPM mortgage loans to 3,000 buyers utilizing its own funds. OTP plans to expand the program. The \$20 million first tranche of a USAID \$60 million HIG will extend the DPM program to four additional Hungarian banks over the next several months. Assuming success with initial tranches, remaining tranches will be used to set up a secondary mortgage market. A longer-term goal is to tap GOH pension funds for mortgage related financing needs.

Status: USAID considers this Strategic Objective well advanced, but incomplete. This Strategic Objective will continue to be high priority until achieved.

**Strategic Objective:           An Economically Sustainable,  
Restructured Energy Sector**

Hungary's opening round of electricity privatization took place in late 1995. Minority shares in six distribution companies and two power plants were sold to foreign investors, generating \$1.3 billion in revenues. USAID work with the Hungarian Energy Office (HEO), the nation's independent energy regulatory agency, was critical to the sale. HEO's existence and its intervention in clearing up key regulatory issues and creating an acceptable arbitration mechanism reassured investors and the sale went forward. Hungary is committed to making energy prices cover energy costs by the end of 1996. In March 1996, prices were raised 25% and additional increases are planned in early 1997. USAID advisors are collaborating 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. Increased energy prices should in turn spur interests in curbing energy use through conservation. Eleven Energy Service Companies, staffed by USAID trained personnel, are ready to meet that demand.

Status: USAID has narrowed the overall Strategic Objective to move environmental components to the Local Initiatives Strategic Objective. We consider the energy reform objective to be nearly complete and expect to carry this Strategic Objective only through FY 1997.

**Strategic Area II: Democratic Transition**

Hungary meets every reasonable measure of a functioning democracy. In 1994, it passed perhaps the most critical test of all, when 68% of the electorate went to the polls and elected an ostensibly leftist coalition led by former Communists to office. The world watched and worried that the half-completed political and economic reform process would be slowed or, worse, reversed. There was a brief pause as the new government took stock of its position and measured the will of the people to go on with the painful change process. By late Summer Hungary and the world had its answer: the drive to be an integral part of the West would continue unabated and the pace of reform would be accelerated.

***SEED Act Goals and ENI Strategic Objectives:***

- Parliament is fulfilling its mandate as the nation's supreme legislative body. Debates are open, lively and well informed. In its first two years of operation, 1989 to 1991, it revamped the constitution and passed over 180 laws compared to an average of only four or five a session under Communism.

- Hungary's judiciary is financially independent of the executive branch. Judges are nominated by the Minister of Justice and appointed by the President with the consent of Parliament. They are substantially free of political control from either branch of government. The President of the Supreme Court is selected by Parliament.
- There are presently over 6,000 lawyers in private practice. Some 25,000 lawyers, solicitors and advisors are employed by banks and enterprises.
- Hungary has enjoyed a viable multi-party political system since 1989. Eight parties are represented in the National Assembly.
- Close to 30% of the Hungarian work force consists of union members.
- The number of NGOs has grown rapidly in the past 8 years. Over 35,000 NGOs are registered. A new NGO law before Parliament will provide tax benefits to NGO contributors.

Hungary is making progress in two areas of remaining concern: protection of minorities and freedom of the press. The 1993 Law on Ethnic and Human Rights protects the individual and collective rights and ethnic identity of all minorities. Special elections in December 1994 resulted in the election of 600 minority local bodies to represent their interests locally and, in 1995, these groups elected national officials. Tighter discipline within police ranks and more aggressive police and legal action is steadily reducing the number of anti-Semitic and racial incidents as well as skin-head attacks. Although State controlled radio and TV stations continue to enjoy a virtual monopoly of nation-wide broadcasting, more than half the population now have satellite or cable access to international broadcasts. Reform legislation which would insulate the media from State control and regulate other aspects of the media has been presented to Parliament by the government, although it does not appear that quick action will be taken. The print media is generally regarded as free though most distribution is done through the postal system as a matter of economics.

**Strategic Objective:            Increased Better Informed Citizens' Participation**

Status: USAID considers this Strategic Objective largely accomplished. Local level participation, which defines a narrower scope than the Mission's earlier Strategic Objective, will continue to be a strategic concern through FY 1999.

**Strategic Objective: Legal Systems that Better Support Democratic Processes and Market Reforms.**

Hungary's democratic and economic transformation has by necessity been based on a large amount of new legislation. Very few areas of Hungarian political, economic or social life have been unaffected. Many laws have been enacted since 1989 to facilitate the establishment and evolution of an economic environment of market-based institutions, liberalization of pricing and labor systems, and complete revision of the relationship between state and private ownership. Similarly, many important laws affecting the relationship between the State and individuals and the role of individuals in a future Hungary have been established.

**DEMOCRACY AND GOVERNANCE:** Any discussion of the role and influence of USAID in this sensitive area must be prefaced by an acknowledgment that our involvement is strictly supportive of Hungarian initiatives, with the end result being their product, that is, Hungarians have ownership from start to finish. Early on, the SEED Act funded travel of Parliamentary and political party leaders to meet with counterparts in the US and Europe to discuss organizational and procedural issues of operating in a multi-party, democratic, legislative structure. Visits of U.S. Congressional leaders to Hungary have provided opportunities for valuable dialogue on such critical issues as freedom of the press and protection of minority rights. The regionally financed Salzburg Seminars brought together political leaders and academics to discuss these and other issues central to the democratization process. USAID funded personnel consulted both with Hungarian government administrators and Parliamentarians on local government issues, the still pending Broadcast Bill and the 1993 National and Ethnic Rights Bill. USAID-Embassy views on these issues were solicited and shared at many levels.

USAID advisors were directly involved in preparing the new NGO Law and the Comprehensive Agriculture Bill, both of which are now before the Parliament. The former would greatly improve the NGO climate by setting more rigorous criteria for NGO certification and by providing tax relief to those supporting NGOs.

**PRIVATIZATION:** Hungary's outstanding privatization effort was facilitated by passage of a series of laws: Act 13 (1989) governs the transformation of state companies into joint-stock and limited liability firms; Act 7 (1990) outlines the practical steps in the privatization process; and in 1992 the Hungarian Employee Stock Ownership Plan (ESOP) law, a first in Eastern Europe, was passed. USAID advisors are acknowledged by the GOH and private sector commentators as having played a key role in drafting these laws and corresponding enabling regulations and procedures, and working through the details of their implementation.

Since 1991, USAID has invested over \$2 million in assisting in the reformation of laws and regulations that hinder reform. Notable examples of direct U.S. involvement include the Bankruptcy Law, the Anti-Trust Law, the Telecommunications Law and the Financial Institutions Law. USAID advisors also helped draft regulations related to the establishment and operation of the Budapest Stock Exchange (BSE). The BSE now has 54 brokers and its capitalization, presently at \$2.7 billion, is projected to rise to \$4.4 by the end of 1996.

**FISCAL:** USAID assistance has focused on improving internal systems and procedures at the Ministry of Finance and reducing budget imbalances through comprehensive pension reform and other policy changes. U.S. Treasury personnel have advised on the organizational details of the new Government Debt Agency and the new Treasury Department (internal MOF entities) and are now helping those units set up working procedures for better managing external debt and the government's operating budget, both critical to maintaining the recently negotiated IMF Standby arrangement. Together with labor and education the health sector is one of the largest claimants on the national budget. USAID advisors are working on cost-cutting measures in these sectors, measures which undoubtedly will require major policy and regulatory changes and quite possibly new laws.

**FINANCIAL REFORMS:** Privatization of the Hungarian banking system is well advanced. Foreign banks have played a major role in the privatization process. Close to one-half of Hungary's 43 banks are now partially or fully owned by foreigners. The bank privatization process has been facilitated by the work of USAID experts, including the past head of the United States Comptroller of the Currency, who worked on legislation establishing the State Banking Supervision Agency (SBS) in 1993. SBS internal operating procedures are now in place, again with USAID help, and the first on-site audit was recently completed. This is a critical first step in ensuring adequate oversight of the banking system and reassuring those concerned with the increasing role of foreign banks in Hungary.

**ENERGY AND ENVIRONMENT:** USAID technical assistance helped several Hungarian Environmental NGOs frame important inputs into drafting the Environmental Framework Law which levies "product charges" on the manufacture of environmentally "dirty" products such as tires and plastic. In the energy sector, USAID advisors are collaborating with the Hungarian Energy Office (HEO), Hungary's independent regulatory agency, as it sets up regulations and procedures for licensing power stations and tendering for new construction and develops methodologies for gas and electric pricing. Specialized technical assistance was provided for preparation of the National Energy Conservation Act now being considered by the Parliament.

**Strategic Objective: More Effective and Responsive Local Government**

Major constitutional reforms passed in the early 1990s gave unprecedented control of local government to local populations:

"Local communities of voters in villages, towns, and counties shall have the right to freely administer local affairs. Local self-government is independent and democratic management of local affairs concerning the voting community, and the exercise of public power in the interest of the population" (Section 42, Constitution)

Hungary's over 3,000 local jurisdictions are charged (mandated by the Constitution) with providing: a supply of safe drinking water; maintenance of public roads and public places; education; basic health care; basic social services; and to undertake and solve all kinds of local affairs not reserved by law to any other administrative body. While local governments raise a substantial share of their revenues through local taxes and fees, 60% of their income comes from Central Government grants and shared revenues.

The Hungarian electorate, conditioned by years of top-down governance and Communist party control of local and regional government, may be somewhat ambivalent about the changes. Voter turnout during the 1990 municipal elections was at or below 20% in many jurisdictions.

Embassy/USAID Hungary believe significantly increased citizen participation in decision making and governance at the local level is critical to the consolidation of democracy and the long-term stability and prosperity of the nation. Efforts to strengthen individual and collective responsibility for the well being and advancement of the community; to forge collaborative relationships between local government, business and NGO leaders can empower the community its common needs and reduce the dependence on central government budgets and the social welfare system. USAID will concentrate on approximately 20 communities outside the capital using the resources for on-going and new activities in public administration, media, NGOs, employment, energy, environment and housing. Our objective is to have in place by 1999 several successful models of concerted community action which could be replicated nation-wide under a municipal reconstruction loan being considered by the World Bank for that year.

Status: USAID considers this Strategic Objective integrally linked with NGO strengthening and overall citizen participation efforts and has included our expanded local government activities under the broader Strategic Objective 2.1.

### **Strategic Area III: Social Stabilization**

#### **Strategic Objective: Reduced Human Suffering and Crisis Impact**

Hungary's reform efforts during the early 1990s were marked by rapidly rising unemployment and five years of recession. By the time our 1994 Strategy paper was prepared a quarter of the population was living at or below the GOH poverty line. In some areas where no longer viable SOEs were liquidated, unemployment had risen to very high 50-80% levels. The social services infrastructure inherited from the Communists was extensive and expensive, impossible to sustain in an economy in transition. Government outlays by 1994 stood at 60% of GDP and social expenditure at 45% of GDP. In the early years, USAID projects provided limited assistance targeted to moderate large adverse impacts, including interventions such as an Energy Stabilization fund to help off-set significant price increases and Project Hope.

However, USAID revised its strategy in FY 1994 to eliminate this Strategic Objective, recognizing that with a per capita income of well over \$3,000, and unemployment having peaked, scarce resources would be better utilized if aimed at addressing longer term socio-economic issues by focusing on building key, necessary institutions. Several activities which originally began under this Strategic Objective have been folded into USAID's NGO programs.

Status: USAID considers this strategic objective closed.

#### **Strategic Objective: Improved Sustainability of Social Benefits and Services**

Status: USAID has folded its work at making the Health and Pension funds sustainable into the Fiscal Reform Strategic Objective and considers this strategic objective closed.

#### **Strategic Objective: Reduced Environmental Risks to Public Health**

##### ***Water Pollution***

Evidence shows that there has been a slowing of large flow surface water pollution or even a slight improvement during the last decade. This is in contrast to a long-term decline in water quality since 1960. Encouraging as well has been a significant improvement in the water quality of Central Europe's largest lake - Lake Balaton. The construction and upgrade of communal waste water treatment plants and stronger controls on industrial mining west of the lake have led to decreased levels of biological and chemical contaminants. Water pollution remains a serious threat in Hungary's poorer areas and along international borders where

cross-border environmental cooperation is minimal. The greatest water pollution problems stem from a lack of adequate water treatment and canalization in many mid-sized municipalities, leading to surface and subsurface water contamination. Nitrate contamination is becoming a potentially serious problem in many municipal drinking water supplies.

#### *Air Pollution*

Ambient air pollution in Hungary has two main sources: industry and traffic. A significant portion of the industrial air pollution problem is related to power plants and the usage of high sulfur content lignite coal and the lack of de-sulfurization equipment. Among other air polluting activities, emissions from the organic and inorganic chemical industry are considerable. Emissions of air pollutants from power production and metallurgy is decreasing, however, due to economic restructuring and declining production. Still, the air is particularly polluted (SO<sub>2</sub> and NO<sub>x</sub>) in nine heavily trafficked regions of the country that cover only 8% of the country's physical area yet affects some 40% of the population.

#### *Waste*

There are problems in the areas of both hazardous waste and municipal solid waste. The problems include more than 2,000 illegal dumping sites, inept processing of toxic and hazardous waste, weak laws governing storage, and the decentralization of landfills in the hands of financially strapped local governments. There are few initiatives to reduce waste production. Regional landfills are few and expensive. Selective collection, recycling and reuse options are only now being explored by a few far sighted municipalities.

During the period of transition, Hungary has made great strides in providing a cleaner environment for its citizens. Targeted USAID assistance has supported this progress and helped to ensure it is continued through industrial processes that prevent pollution before it starts, through clear and enforceable environmental laws and through a well-informed citizenry that actively participates in decisions about the environment.

USAID has conducted waste minimization projects at eleven factories in Hungary. At Perion Akkumulatorgyar Rt., the largest producer of lead acid batteries in the country, efforts were concentrated on reducing water usage, decreasing waste water flow and lowering the quantities of cadmium and lead discharged into the municipal sewer system. The project lowered the annual amount of lead released into the environment by 200 kilograms and the amount of cadmium released by 60 kilograms. This investment, which included \$26,000 in equipment and a series of process modifications, is saving the plant \$65,000 a year.

A project at the Borsodchem RT plant addressed the recovery of vinyl chloride

monomer (VCM), a carcinogen, from emissions into the air. The USG provided a thermoparamagnetic oxygen system analyzer to monitor the oxygen content in the gasses emitted from the plant's steam stripper column. The result of the project was an annual reduction in VCM emissions of 240 tons and a \$144,000 per year savings for the factory.

In a project designed to combat industrial cross-border water pollution, the governments of Hungary, Slovakia and Romania have pledged to cooperate in a mutual effort to reduce the emission of toxic compounds in selected cross-boundary rivers. This project sets up a cross-boundary monitoring and communication network that will foster regional pollution warning and emergency mitigation plans. It also identifies specific pollution danger zones and major industrial polluters with regional impacts and targets them and area regulators for technical assistance, training and equipment.

**Environmental Law And Policy Reform:** USAID assistance was important in the drafting and passage of the landmark Environmental Framework Law of 1995 that makes environmental standards fair, enforceable and in harmony with those of the European Union. USAID's Environmental Law Institute (ELI) was primary counsel to a group of environmental NGOs and independent scientists convened by the Parliament to secure public input and support for the legislation. This committee has been given a permanent position as a public advisory board.

USAID has been providing environmental policy advice to the Ministry of Finance since 1994. The country-based Policy Advisor and his staff assisted in the recent preparation of a preliminary environmental impact analysis of a set of product charges which the Government of Hungary is considering for tires, packaging materials, and refrigerators/refrigerants. The analysis included a review of OECD approaches for the targeted products, and discussion of the economic and social welfare issues. Draft legislation incorporating the advisor's recommendations is now pending parliamentary approval.

In 1994, an Environmental Audit Consultant was provided to Hungary's State Property Agency, the body overseeing the privatization process. The Consultant managed 26 audits of 16 firms being prepared for privatization and ultimately saved the Agency thousands of dollars in environmental liability cases. The position was deemed vital by the Agency and was folded into their permanent organizational structure and budget.

**Institutional Capacity Building at the Local Level:** USAID is working with four municipalities in northern Hungary on the implementation of environmental infrastructure projects. The four customer cities of Győr, Ózd, Edény, and Sajószentpéter identified solid and hazardous waste management as their primary

issue of concern, and sought out assistance to address the problem.

Administrative officials in each of the cities have received constant support throughout the development and implementation of their projects, both from U.S. advisors in Krakow, Poland and a contact representative in Hungary. Advice is focused on landfill management and the arrangement of investment financing for the projects.

Particular success has been achieved in the city of Gyor. Improvements to the community's waste management procedures and the operation of its large, regional landfill have yielded substantial results. By adopting all of the 16 no-cost recommendations submitted by U.S. advisors, the city expects to realize annual savings in labor, ease of operations, conservation of landfill space, and general management of \$35,000.

The Hungarian Environment Management Training Center (HEMTC) offers courses for municipal officials in revenue raising mechanisms to fund environmental investments, municipal waste management, and principles of government contracting. These EPA-developed training programs are delivered to Hungarian trainers who in turn explore opportunities to share their knowledge and the course-developed literature to individual and consortiums of municipalities.

At the Ministry of Environment and Regional Policy (KTM), USAID is assisting in the development of a strategic plan to address Hungary's environmental problems at the community level. A major component of this effort will be assisting five pilot associations of municipalities in drafting a legislative-mandated local environmental and the establishment of nationally supported Municipal Environmental Funds. Through this project the Ministry will incorporate local problems and priorities into its environmental information base and offer the municipalities guidance on data collection and environmental management tools necessary to identify and address local problems.

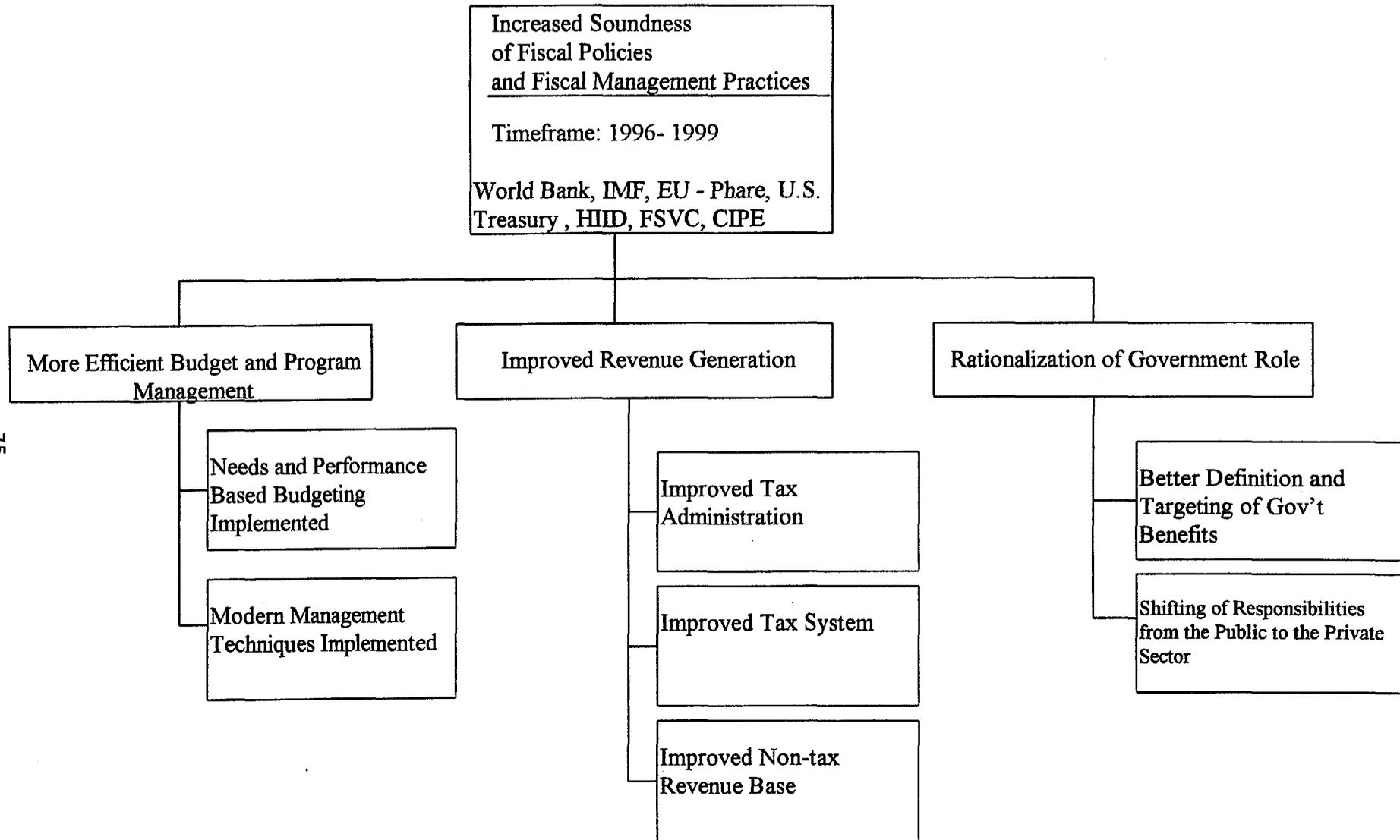
In 1990, USAID participated in the establishment of the Regional Environment Center (REC) in Budapest to serve as a clearinghouse for information on environmental activities in Central and Eastern Europe. The REC also provides programs for non-governmental organizations (NGOs) and the academic/scientific community in order to improve their capacity to conduct public outreach and education campaigns. A grant program has been established under the REC to provide much needed funding to the NGOs in the region.

Status: Because of the close relationship of local governance objectives and sound environmental policies in Hungary and in USAID's portfolio, USAID has folded key environmental projects into its Strategic Objective on Local Governance and considers this Strategic Objective closed.

## **C. Results Frameworks**

**1.2. INCREASED SOUNDNESS OF FISCAL POLICIES AND FISCAL  
MANAGEMENT PRACTICES**

# PART I: GRAPHIC PRESENTATION



PART II: PERFORMANCE ASSESSMENT

Table I - Performance Data  
Baseline, Targets, and Actual Results

RESULT LEVEL (S.O. OR I.R.) AND NO.	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		TARGETS AND ACTUAL RESULTS							
						1996		1997		1998		1999	
						YEAR	VALUE	Target	Actual	Target	Actual	Target	Actual
S. O. 1.2	Increased Soundness of Fiscal Policies and Fiscal Management Practices	Consol.Centr.Govt. Balance	Definition: XCLNBH Unit: % of GDP	1993	-7.8	-3.9		-3		-2.7		-2.3	
1.2.1	More Efficient Budget and Program Management	Difference in planned and actual central Government deficit	Definition: Unit: % of planned	1992	182.5	10.0		8.0		7.0		6.0	
1.2.1.1	Needs and Performance-Based Budgeting Implemented	Inpatient to outpatient services	Definition: Patients Unit: Ratio	1995	TBD								
1.2.1.2	Modern Management Techniques Implemented	Hospital capacity	Definition: Beds Unit: Number	1995	-	-2000		-6000		-8000		-10000	
1.2.2	Improved Revenue Generation	Tax on profits + income	Definition: Consol Centr. Gov't. Unit: % of total rev.	1995	15.4	15.0		16.0		20.0		24.0	
1.2.2.1	Improved Tax Administration	Tax enforcement	Definition: Audits Unit: number (000)	1993	296	325		350		375		400	
1.2.2.2	Improved Tax System	Tax compliance	Definition: Tax returns Unit: number(million)	1993	7.5	8.0		8.2		9.3		9.4	
1.2.2.3	Improved Non-tax Revenue Base	Non-tax revenue base	Definition: Fees Unit: % of central Gov't Revenue	1991	0.4	0.8		1		2		4	
1.2.3	Rationalization of Government Role	Central Government expenditures	Definition: Unit: % of GDP	1991	54.2	49.0		48.0		46.5		45.0	
1.2.3.1	Better Definition and Targeting of Government Benefits	Subsidies	Definition: Centr Govt. Unit: % of Expend.	1991	10.5	9.5		8.5		7.5		6.0	
1.2.3.1	Better Definition and Targeting of Government Benefits	Comprehensive pension reform	Definition: Benchmarks Unit: Achieved	1995		Framework		Pilot		Formal Imp.			
1.2.3.2	Shifting of Responsibilities from the Public to the Private Sector	Tax sheltered private voluntary contributions	Definition: Unit: % of Public Schemes	1993	nil	nil		1		4		8	

## STRATEGIC OBJECTIVE 1.2

### INCREASED SOUNDNESS OF FISCAL POLICY AND FISCAL MANAGEMENT PRACTICES

#### Part III: Narrative Rationale

##### A. Transition Hypothesis

Large and growing general government deficits in recent years have destabilized the Hungarian economy. Domestic imbalances stemming from debt-financed government spending have spilled over into the external sector, creating large, unsustainable Balance of Payments deficits. Government recourse to the banking system to finance substantial government spending in excess of revenues compromises the Central Bank's ability to pursue coherent monetary policies and reduces financing availability at reasonable interest rates for increased private investment. Low investment results in low growth.

Major problems facing the government in recent years that have contributed to government fiscal problems include: 1) poor budget and program management; 2) a jerry-built tax system that is not only unresponsive to the needs of government spending but discourages savings and investment, changes frequently in response to government revenue needs, is administered by weak tax institutions, is narrowly based with high rates and is generally regressive in the distribution of tax burden; and 3) government is unduly large and tries to do too many things.

**Increased soundness of fiscal policies and fiscal management practices will result in the stabilization of macroeconomic financial structures, thereby creating a stable business environment for rapid private sector investment and place the country on a higher growth path defining rapid, sustained economic growth and development.**

##### B. Critical Assumptions

The critical assumption is that government, both national and at the local level, recognizes the imperative to increase the soundness of fiscal policies and fiscal management practices, both now and in the future. Commitment to these principles is crucial if the technical assistance and financing planned by USAID and other donors such as the World Bank and the IMF are to be effective. USAID efforts with appropriate follow-through from other donors such as the World Bank, the European Bank for Reconstruction and Development, the EC and the IMF are critical in that USAID technical assistance will be mainly complementary to important "partners" such as the major international donors.

### C. Causal Linkages

The principal intermediate results that are necessary and sufficient to achieve increased soundness of fiscal policies and fiscal management practices are: 1) more efficient budget and program management; 2) improved revenue generation; and 3) rationalization of the role of government.

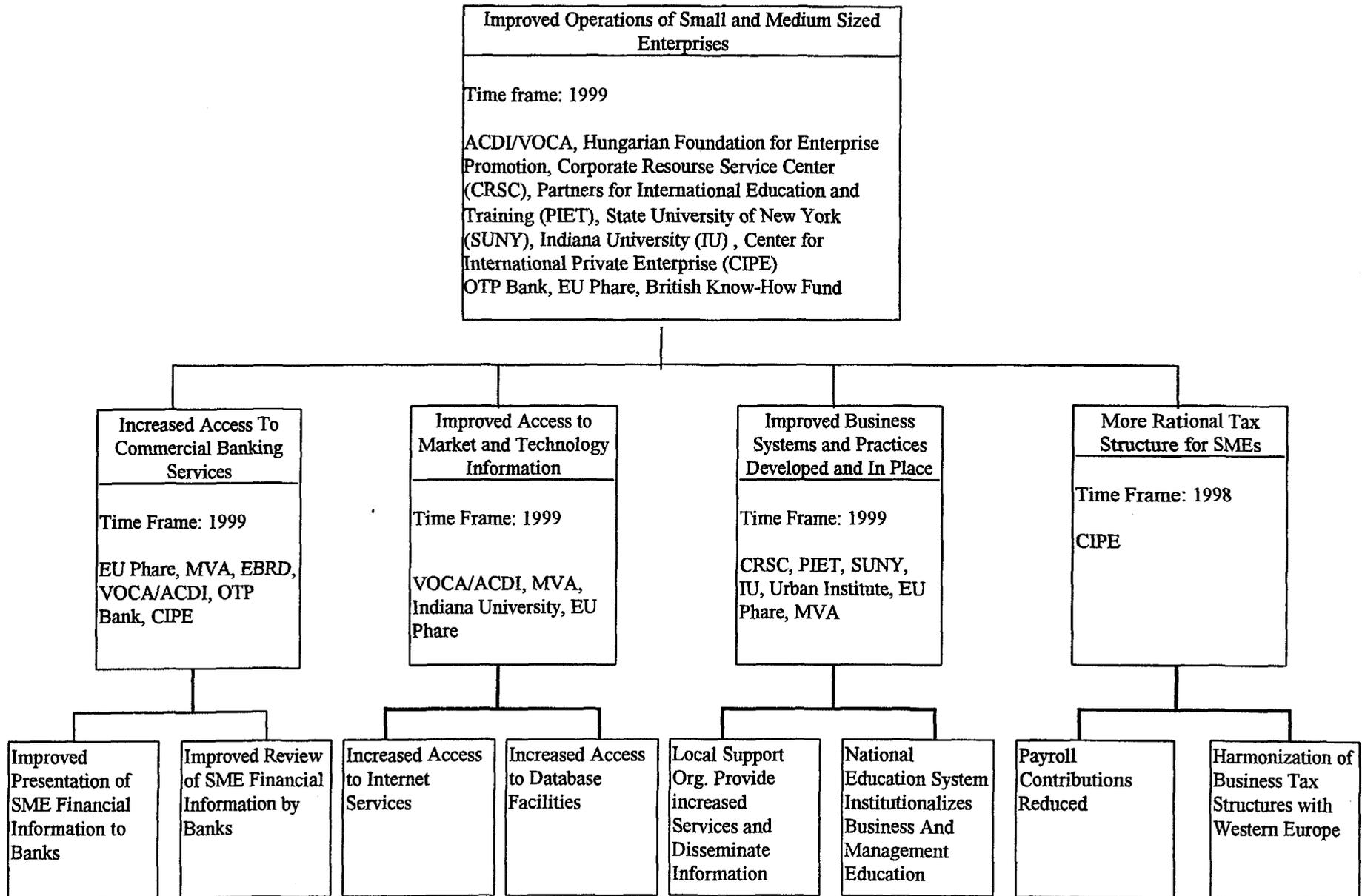
Budget and program management have been significant problems at all levels of government in recent years. Budgets have been prepared with little or no reference to the objectives to be achieved, and funding has been disbursed to operating units regardless of current spending needs. At the national level, a new Treasury Department has been created in the Ministry of Finance, which is expected to take on many of the kinds of functions performed by the U.S. Treasury and the U.S. Office of Management and Budget. USAID and its partners are developing assistance strategies to modernize and rationalize the budget process, budget management, and the use of modern management techniques in managing government programs to make them cost effective and efficiently administered.

Hungary's tax system has evolved in response to revenue needs on an *ad hoc* basis. It has developed rapidly, with inadequate attention being given to the appropriate mix of taxes needed to sustain government operations or the adverse impacts certain taxes may have on those who pay taxes, or the disincentives certain kinds of taxes have on saving and investment decisions. Non-tax revenues such as user charges are very underdeveloped as reliable on-going sources of revenue for general government operations. Tax administration and tax institutions have a number of weaknesses that can be overcome fairly quickly with a minimum of technical assistance efforts. Improved revenue generation does not necessarily require increased revenues, but improved coherence, reliability and acceptance by the public of the fairness and need for the revenue system as it is operated. Improved revenue generation will require improved administration of an improved tax system in conjunction with an improved non-tax revenue base.

Government's role in the economy is large and complex. In terms of size, government (national and local) employment was about a quarter of all employment in the country in 1994. General government expenditures have typically been around 58-60% of GDP, of which government transfer payments for a myriad of social interventions have amounted to close to 40% of total government spending. What is needed is improved focus and targeting of government spending, including reform of big ticket items such as pensions and health care. Government should not continue to do things that the private sector can do as well, or no worse. Transfer payments such as family allowances should be targeted to families in need, not received as a matter of right. USAID and other donors have ongoing activities in several areas related to social spending and reducing bureaucracy.

**1.3. IMPROVED PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES**

## PART I: GRAPHIC PRESENTATION



ART II: FINANCIAL ASSESSMENT  
 Table I - Performance Data  
 Baseline, Targets, and Actual Results

RESULT LEVEL (S.O. OR I.R.) AND NO.	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		TARGETS AND ACTUAL RESULTS							
						1996		1997		1998		1999	
				YEAR	VALUE	Target	Actual	Target	Actual	Target	Actual	Target	Actual
S. O. 1.3	Improved Operations of Small and Medium Sized Enterprises	Export/Sales	Definition: Priv./Dom. Unit: % sales	1992	10.1	11		14		18		22	
S. O. 1.3		Profits before taxes of private domestic enterprises (PBT) **	Definition: Unit: % sales	1992	-2.6	TBD							
1.3.1	Increased Access to Commercial Banking Services	Banking system credit to small enterprises	Definition: Unit: % GDP	1991	2.5	2.2		2.3		2.4		2.5	
1.3.1.1	Improved Presentation of SME Financial Information to Banks	Targeted firms with business plans	Definition: Unit: % of firms	1996	TBD								
		Targeted firms which have applied for credit	Definition: Unit: % of firms	1996	TBD								
1.3.1.2	Improved Review of SME Financial Information by Banks	SME Loans in Default	Definition: Unit: % of SME Loans	1996	TBD								
		Loans extended to SMEs by OTP	Definition: Unit: (000)	1992	97.8	30		35		40		45	
1.3.2	Improved Access to Market and Technology Information	Users of sponsored Database Facilities	Definition: Unit: number	1996	0	0		1000		4200		20300	
1.3.2.1	Increased Access to Internet Services	Users of Internet in LEAs	Definition: Unit: number	1996		0		400		3000		12500	
1.3.2.2	Increased Access to Database Facilities	Users of information in MATCH outreach program	Definition: Unit: number	1996	0	0		500		1000		8000	
		Users of Agriculture Information System	Definition: Unit: number	1996	0	0		100		200		300	
1.3.3	Improved Business Systems and Practices Developed and In Place	Targeted firms with marketing managers	Definition: Unit: number	1995	TBD								
		Targeted firms with computerized accounting	Definition: Unit: number	1995	TBD								
		Targeted firms with business plans	Definition: Unit: number	1995	TBD								
1.3.3.1	Local Support Org. Provide Increased Services and Disseminate Information	Local consultations to SMEs	Definition: Unit: number	1992	TBD								
1.3.3.2	National Education System Institutionalizes Business and Management Education	Institutions with undergraduate degrees in business	Definition: Unit: number	1991	2	30		30		31		31	
		Institutions offering MBA degrees	Definition: Unit: number	1991	0	7		7		7		8	
		Students studying Total Quality Management	Definition: Unit: number	1991	0	7000		9000		11000		13500	
1.3.4	More Rational Tax Structure for SMEs	Taxable business profits	Definition: priv. dom. Unit: % of GDP	1992	-7.1	3		3.8		4.2		4.5	
1.3.4.1	Payroll Contributions Reduced	Legislation Introduced	Definition: Benchmark									x	
1.3.4.2	Harmonization of Tax Structures with Western Europe	Opinion survey	Definition: Benchmark									consensus	

## STRATEGIC OBJECTIVE 1.3

### IMPROVED PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES

#### Part III: Narrative Rationale

##### A. Transition Hypothesis

USAID Budapest has chosen small and medium enterprises as a focus of its activities in Hungary because this sector is dynamic and has the potential for being the principal engine of growth and expanded employment opportunities over the medium term. This focus is consistent with the ENI transition goal of **fostering the emergence of a competitive, market-oriented economy in which the majority of economic resources are privately owned and managed** and falls under the objective of **improved, more sustainable private business operations**.

The SME sector is critical for Hungary's transition to a sustainable, market oriented economy for three reasons. First, the SME sector would help redress the problems of missing lead and lag industries which provide the interconnection among industries in the sector. Second, competition among small businesses will foster a culture of competition and private initiative, critical for a country aspiring to succeed in competitive international markets. Third, SMEs, for each dollar invested, provide the highest rate of employment generation, an issue which in Hungary is critical to sustaining popular support for transition itself.

The underlying hypothesis of the proposed Mission Strategy is that Hungary's private sector is composed mostly of SMEs and thus their efficiency and productivity is key to the country's economic future, including entry into the European Union. Another hypothesis is that SMEs currently face four major constraints and that should these be overcome, improved performance of SMEs will significantly increase employment and assure Hungary's competitiveness in world markets. These constraints are 1) limited access to banking services; 2) market and technology information gaps among business owners; 3) inadequate use of modern business systems and practices; and 4) an unfavorable tax system. The Mission's SME Strategy was designed to address these constraints.

##### B. Critical Assumptions

The assumptions or conditions needed to achieve improved SME performance include 1) a high degree of price stability provided by a stable macro-economic environment; 2) implementation of appropriate fiscal and financial sector reforms; 3) a stable exchange rate; 4) expanding markets to other countries; 5) creation of more productive higher income jobs as the private sector grows.

Price stability will foster an environment in which entrepreneurs can plan and more efficiently produce and sell. Appropriate fiscal and financial reforms should lower payroll taxes and remove a major impediment to increased employment and credit availability to the private sector. A stable exchange rate will encourage exports, and this will lead to a broader customer base conducive to more efficient production as economies of scale are reached. New private sector employment is needed to absorb competent personnel not needed in the public sector.

### C. Causal Linkages

At present, SMEs are characterized by limited access to credit. Credit is a necessary element to improved performance and business expansion because it allows capital investments to be paid for over time as these assets generate increased income. Working capital loans allow entrepreneurs to more efficiently purchase inventory and production materials in greater quantity and at lower prices.

Most of the 400,000 active registered SMEs have been established since 1989. In the early 90s credit was more available and conditions for accessing it were not as stringent as today. Many businesses applied for and received loans which subsequently became non-performing. After that experience, banks became far more cautious and the number of loans extended annually declined by some 60%. Typical collateral requirements amount to 150% of the loan plus one year of interest. Bad loan performance is a major reason for lack of credit. Another is the option of investing in low risk government bonds. It is expected that financial reform carried out under USAID/Hungary's Strategic Objective 1.4 also will increase access to credit. Since other donors provide a considerable amount of resources for credit, USAID's strategy to improve access to commercial banking services will be to teach SMEs to prepare better loan applications, train loan officers and other key bank personnel how to be more responsive to the sector, and provide information about available financial services to SMEs.

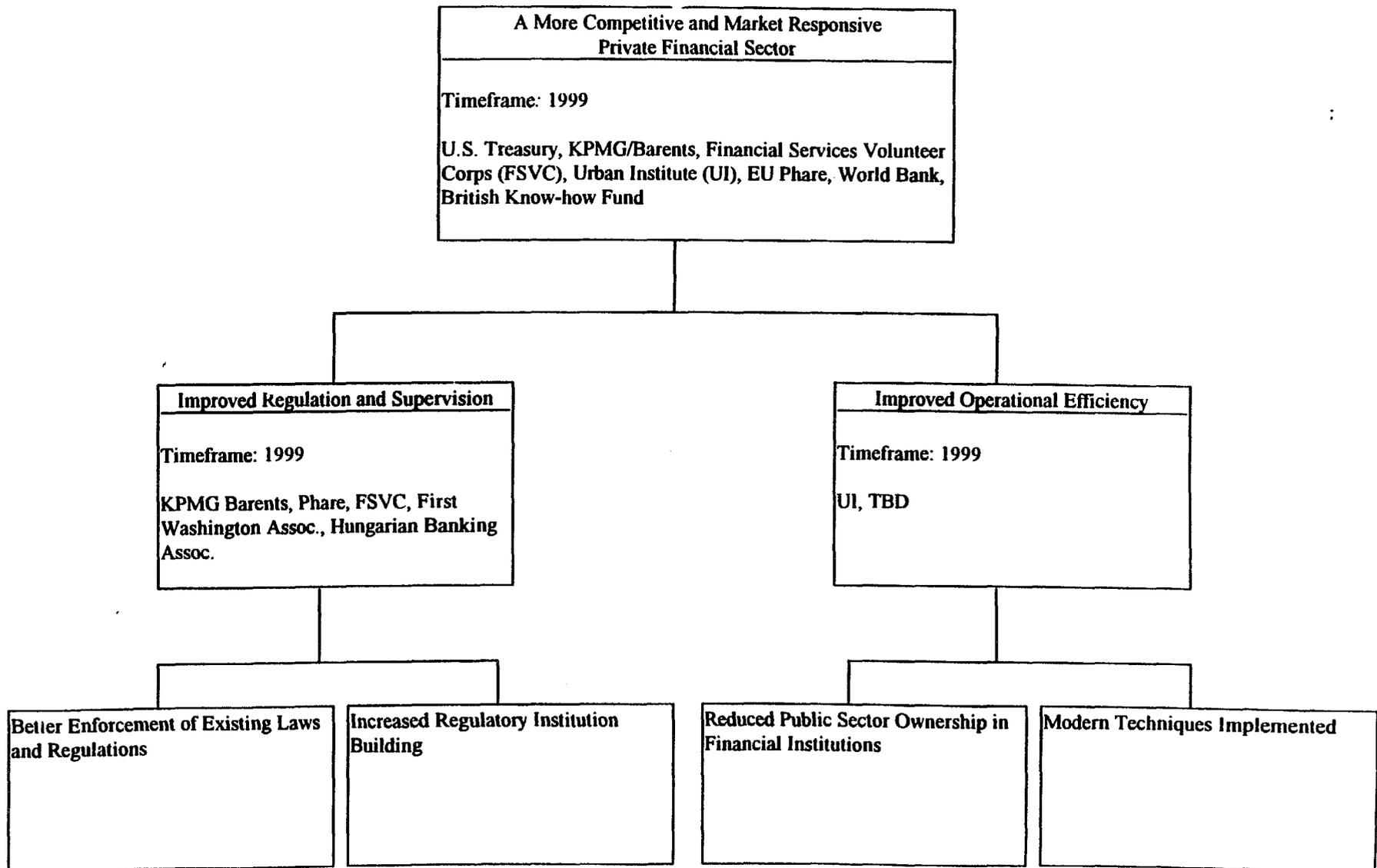
Essential to any business success is increasing entrepreneurs' knowledge of markets, technology, financing mechanisms, etc. Improved information in these areas will contribute to increased production and sales as managers identify new customers and employ advanced technology. The use of the Internet is a fundamental element of the multi-donor effort aimed at developing a sustained system of information flows to SMEs. USAID will support local initiatives by the Hungarian Foundation for Enterprise Promotion to introduce Internet availability to SMEs via 20 Local Enterprise Agencies. Other activities will support dissemination of agricultural sector information to village farmers via strategically placed computers. Such information can be used in decision making, both by producers and by banks in extending loans.

Modern systems and practices in businesses are critical to efficiency and dynamism. For example, a computerized accounting system and financial management skills enhance a manager's ability to plan investments, manage production, and identify credit needs. Marketing strategies assist producers in determining where and how to sell products and services. The Mission strategy is to strengthen financial management, accounting, marketing, strategic planning and production. Accounting and marketing were largely ignored under communist regimes, but they are key to improved operations of SMEs poised to compete in domestic and international markets. The accounting systems of small businesses commonly consist of a part time accountant who "keeps the books," rather than acting as a financial advisor. Encouraging the installation of computerized accounting systems and instructing managers in their use is an example of assistance that can lead to improved SME operations. Some of the assistance in developing modern systems and practices will be provided by local support organizations which work on-site or by training programs which pair entrepreneurs with appropriate partners in other countries. In addition, universities will train students in total quality management, prepare case studies based on local companies and make these materials available to wider audiences at universities and colleges offering business education.

Developing a more rational tax structure for SMEs is necessary to encourage employment generation, growth and a competitive position within Europe. The activities to improve the current system are being carried out under SO 1.2. These include reducing non wage labor costs and supporting efforts to bring Hungarian business tax structures into harmony with those of Western Europe, necessary for Hungary's entry into the EU.

**1.4. A MORE COMPETITIVE AND MARKET RESPONSIVE PRIVATE FINANCIAL SECTOR**

## PART I: GRAPHIC PRESENTATION



**PART II: PERFORMANCE ASSESSMENT**

Table I - Performance Data

Baseline, Targets, and Actual Results

RESULT LEVEL (S.O. OR I.R.) AND NO.	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		TARGETS AND ACTUAL RESULTS							
						1996		1997		1998		1999	
						YEAR	VALUE	Target	Actual	Target	Actual	Target	Actual
S. O. 1.4	A More Competitive and Market-Responsive Private Financial Sector	Financial sector assets	Definition: Unit: % of GDP	1991	100	100		105		110		120	
		Insurance premium volume	Definition: Unit: % of GDP	1991	2.4	2.8		2.9		3		3.2	
		Interest rate spread Enterprise Accounts	Definition: wtd ave loan, less dep rate Unit: % points	1991	6.1	6		5.7		5		4.5	
		Firms listed on the Budapest Stock Exchange (BSE)	Definition: Unit: Number	1991	20	46		60		80		100	
1.4.1	Improved Regulation and Supervision	On-site bank examinations/audits	Definition: Unit: Number	1991	0	15		16		17		18	
1.4.1.1	Better Enforcement of Existing Laws and Regulations	Yearly studies	Definition: Unit:	TBD									
1.4.1.2	Increased Regulatory and Institution Building	Expert opinion	Rating (1-5)	1995	2	2		2.5		3		3.5	
1.4.2	Improved Operational Efficiency	Return on invested capital (profits)	Definition: Financial Institutions Unit: % of GDP	1991	2.2	3.8		4.0		4.2		4.5	
1.4.2.1	Reduced Public Sector Participation in Financial Institutions	Banks privatized	Definition: Unit: Number	1991	0	5		6		7		8	
1.4.2.2	Modern Techniques Implemented	Credit Rating Agency created	Definition: Unit: Number					Yes					

## STRATEGIC OBJECTIVE 1.4

### A MORE COMPETITIVE AND MARKET RESPONSIVE PRIVATE FINANCIAL SECTOR

#### Part III: Narrative Rationale

##### A. Transition Hypothesis

Hungary's financial sector before the Soviet occupation was on the European level, not much different from Austria's. After the nationalization drive and after the introduction of central planning, the financial sector was abolished and the sector served almost exclusively as a distribution network for the central budget. Indeed, one of the principal reasons for the total economic failure of the centrally planned economic system was that banks and insurance companies were nationalized and the stock exchange was abolished. However, without banking, insurance and a stock exchange, an economy cannot function properly. Financial markets, international and local, cannot facilitate efficient resource allocation. Without proper market signals, decision-makers could not weigh the business alternatives properly; consequently, they squandered and depleted resources by channeling funds to enterprises that were uneconomical and wasteful.

In Hungary, the re-establishment of the financial system began in 1989-1990, but the inheritance of the past is still pervasive. The banking system is only seven years old. State-owned commercial banks still carry the load of the large non-performing loan portfolios accumulated in the pre-1989 period. The monopolistic insurance industry was broken up only in 1990, which means that individuals and businesses are still underinsured when compared to international standards. The stock exchange is six years old, and domestic investors find it difficult to invest in it.

**It is USAID's hypothesis that a more competitive and market responsive private financial sector, properly regulated, will result in the increased savings mobilization and higher private investment necessary for rapid, sustained growth. A workable, reasonably efficient financial system can be in place by the year 2000.**

U.S. assistance in this area is a key element in assuring this outcome. U.S. Treasury advisors are very important in advising Hungarian government officials in their preparations for additional bank privatization and government debt management. Indeed, in the financial area, one can say the US has a comparative advantage. European finance methods and techniques are becoming more and more "Americanized". Thus, USAID assistance in the field of finance is not only helping Hungarians to reestablish an effective financial system, but will aid them in acquiring modern practices and skills. Advice in this area is also seen as a valuable "second opinion" to those of European advisors, whose nations are competitors and trying to align the Hungarian financial system with their own.

Further major steps in bank privatization are absolutely essential, because foreign banks bring in needed capital, expertise and skills and because international banks come with

their international connections, which are essential for a small, and export dependent country like Hungary. USAID housing related assistance and loan guarantee program is helping encourage mortgage lending and reform policies affecting the housing finance market.

## **B. Critical Assumptions**

Improvements in the financial sector cannot be fully successful without a more sustainable economic stabilization, covered by Strategic Objective 1.2, "Increased Soundness of Fiscal Policies and Fiscal Management Practices." That is, if government policies were to reverse Hungary's stabilization plans, or the GOH not deal with the crisis at the State Health and Pension Fund, or should the GOH reverse its ongoing fiscal reform plans, sustained advances on a more viable financial sector could be difficult. For instance, if government spending cannot be curbed, available financing for private enterprises would be severely and seriously reduced.

We assume that the GOH will not reverse course on the regulatory front. It is hoped, for instance, that the planned merger of the Bank, Insurance and Stock Exchange Supervision will not take place, and more importantly, that the developing regulatory agencies will not report to the government, or be vulnerable to narrow political interests, thereby endangering crucial developments in the financial sector. We also assume that regulations and laws already on the books will be better enforced, making the banking, insurance and stock exchange areas more competitive and efficient.

Finally, we assume that the political will be forthcoming, to move ahead on the bank privatization front, and move away from state-owned banks altogether.

## **C. Causal Linkages**

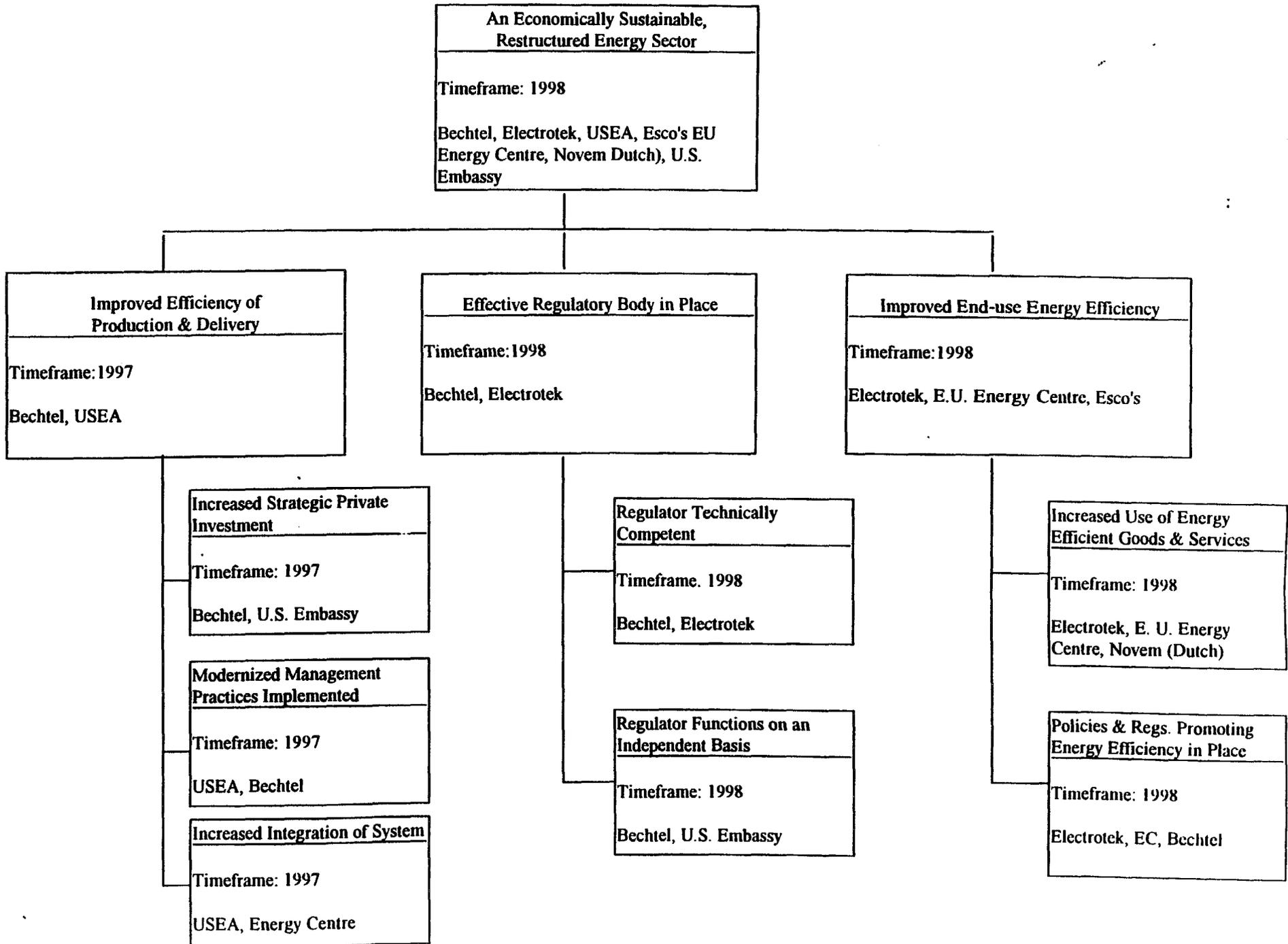
Earlier in our S.O. 1.4 deliberation, we divided the financial sector into the banking, insurance and capital sectors. Later, however, we came to the conclusion that this kind of separation is causal: if we talk about the financial sector, then banks, insurance companies and the stock exchange are natural partners. Instead, we identified four intermediate results which are more reflective of our Strategic Objective and will help USAID achieve a more competitive and market responsive private sector. These are: 1) More effective monetary policy, 2) Improved regulation and supervision, 3) Improved operational efficiency and 4) Reduced public sector participation in financial institutions.

Without a proper monetary policy, a stable environment for future growth cannot be assured. Progress on fiscal reform and an improved, more mature financial sector will facilitate an effective monetary policy, without which the Hungarian currency will not continue its progress towards full convertibility, a major condition of EU membership. An improved financial system includes a viable regulatory environment. Increased competition and expanded services in the financial sector will have tremendous beneficial effects on the economy. Here, the role of banks is very important. Hungarian banks were only marginal players in the large scale privatization of state

owned assets. Given the large propensity of the central government to spend and the existence of state owned commercial banks, this is not surprising. Most Hungarian banks do not have the skills and techniques to recognize businesses with market potential. Therefore, operational efficiency would mean that beyond the GOH budget deficit crowding effect, banks would be able to increase their lending to SMEs and others, if they undertook necessary modernization, training, cost cutting and other measures. As far as bank privatization are concerned, one need only look at Hungarian privatized banks, such as MKB, OTP, Budapest Bank, where efficiency, productivity, the range of banking services and profits improved after their partial privatization. When we consider the additional capital gained through capitalization and the tie-in to the international network of the foreign owners, the results are overwhelming. All four of the results outlined above are needed and necessary in order to achieve a more competitive and market responsive private financial sector in Hungary.

**1.5. AN ECONOMICALLY SUSTAINABLE, RESTRUCTURED ENERGY SECTOR**

## PART I: GRAPHIC PRESENTATION



**PART II: PERFORMANCE ASSESSMENT**

**Table I - Performance Data  
Baseline, Targets, and Actual Results**

RESULT LEVEL (S.O. OR I.R.) AND NO.	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		TARGETS AND ACTUAL RESULTS							
						1996		1997		1998		1999	
						YEAR	VALUE	Target	Actual	Target	Actual	Target	Actual
S. O. 1.5	An Economically Sustainable, Restructured Energy Sector	Return of investment in utility sector	Definition: Unit:	1995		1		8		12			
1.5.1	Improved Efficiency of Production and Delivery	Efficiency of generators	Definition: Unit: Weighted average	TBD.				5%		10%			
1.5.1.1	Increased Strategic Private Investment	Sector assets in private hands	Definition: Unit: %	1994	0			40%		60%			
1.5.1.2	Modernized Management Practices Implemented	Least cost planning at the Hungarian Electricity Works	Definition: Unit:	1994				In place					
1.5.1.3	Increased Integration of System	Connection between CENTRAL (CEE grid ) and UCPT E (EU grid)	Definition: Unit:	1996		trial period		full connection					
1.5.2	Effective Regulatory Body in Place	Licenses for new capacity issued in competitive bidding process	Definition: Unit: y/n	1990						50%			
1.5.2.1	Regulator Technically Competent	Price regulation	Definition: instituted w/o Ministry changes Unit: y/n	1995				yes					
1.5.2.2	Regulator Functions on an Independent Basis	HEO Director	Definition: appointment for fixed term Unit: y/n	1995				yes					
1.5.3	Improved End-use Energy Efficiency	Energy intensity in the industrial and residential sectors	Definition: Unit:	1990		TBD.							
1.5.3.1	Increased Use of Energy Efficiency Goods and Services	Energy service company (ESCO)	Definition: contracts signed Unit: Number	1995				5		10			
1.5.3.2	Policies and Regulations Promoting Energy Efficiency in Place	DSM program	Definition: in place Unit: # of DisCo's	1990				3		6			

## STRATEGIC OBJECTIVE 1.5

### AN ECONOMICALLY SUSTAINABLE, RESTRUCTURED ENERGY SECTOR

#### Part III: Narrative Rationale

##### A. Transition Hypothesis

Without a reliable, economically and technically efficient energy sector, Hungary cannot realize its goals of economic growth and be competitive in the world's market economies. The pre-transition energy sector was economically inefficient and technologically backward with no economic incentives to produce or use energy in a way that reflected its real costs. Specific end use technologies were promoted by the old government as a matter of national policy, which today are non-economic and often environmentally harmful. Under market conditions these inefficiencies are an impediment to economic growth and the competitiveness of Hungarian industry. The Government of Hungary and USAID have identified an economically sustainable, restructured energy sector as a key condition for Hungary's economic growth and transition to a market economy.

Under Hungary's strategy, a restructured energy sector is one that provides the most modern and efficient (and, therefore, lowest cost) supply of energy on a sustainable basis; institutes an efficient and independent regulatory system that promotes investment and efficiency; and provides consumers with the technical and financial tools to respond to market signals. With these elements in place energy will be produced and used efficiently, and fragile reforms will not backslide due to social and political pressures.

On the energy supply side, the restructuring of the energy infrastructure is being driven by market incentives (i.e. prices) to upgrade existing facilities, invest in new capacity or de-commission inefficient units. Rationalized prices alone will not make the supply sector efficient and sustainable without: a) increased investment attracted by a regulatory structure that attracts and inspires the confidence of private investors; b) modern managerial and planning tools to achieve cost efficiencies; and c) system integration into the western grid to trade, buy and sell power in the European market.

For energy consumers a restructured sector ultimately means a reliable supply of energy that they can use efficiently based on price and regulatory incentives, and the availability of energy saving measures. In the short-term, restructuring means energy price hikes that will most adversely affect residential consumers and small businesses. In order to sustain restructuring, these price increases need to be mitigated by opportunities for consumers to use energy more efficiently.

In sum, a restructured energy sector is:

1. operated in a free and competitive marketplace where price reflects costs, and energy is bought and sold on a market basis;
2. regulated, independent of political whim; and
3. regionally integrated with Western Europe.

## **B. Critical Assumptions**

### **Government Commitment to Price Rationalization**

USAID assumes that the Government of Hungary is committed to put in place the regulatory and price structures necessary to foster strategic private investment in the energy sector. Parliamentary law mandates that gas and electricity prices cover costs plus a reasonable profit by the end of 1996. USAID assistance is helping the Hungarian Energy Office put regulatory mechanisms in place.

### **Modest Growth of the National Economy**

A large part of the problem for energy efficiency investments has been the scarcity of capital for credit and investments. Price increases will make efficiency investments more cost effective, but the critical assumption is that modest economic growth will make more credit available and investments more attractive.

### **Lower Pollution Levels Will Result in More Efficient Energy Production and Use**

Energy efficiency and the environment go hand-in-hand. Over the last five years, air pollution country-wide has been reduced 20 to 30 percent due in part to increasing energy prices and the closing of inefficient heavy industry. The critical assumption is that assistance targeted at increased energy efficiency will concurrently result in reduced levels of SO<sub>2</sub>, CO<sub>2</sub>, NO<sub>x</sub> and particulates.

## **C. Causal Linkages**

### **Improved Efficiency of Production and Delivery**

For the energy sector to be economically sustainable it must be restructured to improve the efficiency of production and delivery. In the electricity sector inefficiencies at the system level have caused energy companies to incur significant losses, and not be able to operate their system optimally, or as competitive businesses. In the district heating sector, municipalities and consumers have had to bear the financial burden of inefficient boilers and distribution systems. As long as the cost of energy production and distribution is well above the international market price, the Hungarian energy sector will not be able to sustain itself and will inhibit economic growth.

To be complete and lasting, economic and technical inefficiencies need to be addressed on three fronts: 1) through fostering strategic private investment both in the purchase of existing plants and new capacity construction; 2) modernizing management practices to make facilities more efficient and more responsive to customer needs; and 3) in electricity, guaranteeing system reliability supply and sector standardization by improving interconnections and integration of the power system to the international grid.

### **Effective Regulatory Body in Place**

The presence of an effective and independent regulatory body is a fundamental and necessary means of promoting increased investment and competition in generation and distribution, establishing a fair rate structure, and putting energy efficiency regulations in place: all part of the effort to balance the demands and interests of producers and consumers. Pricing decisions are the foremost and most sensitive balancing task of the regulator, HEO.

Rationalized energy prices are a fundamental and necessary means of achieving energy efficiency, fostering strategic investment in the sector and ultimately bringing economic behavior in line with economic costs. Cost-based and fair pricing is the linchpin of an economically sustainable energy sector. Under socialism cheap energy prices encouraged energy intensive investments which now make many Hungarian firms non-competitive. Cheap energy as a social policy is now requiring indirect state subsidies for energy imports which have created balance of payment problems for the national government.

The legislative mandate to make electricity prices cover costs by 1997 stipulates that the HEO use a pricing formula which includes production and distribution costs and provides for a fair rate of return on investment in the final price. Legislation does not specify, however, how the HEO should determine a fair price and let the companies make cost and profit margin decisions (the U.K. model) or to determine prices based on a cost by cost analysis of each entity with an HEO-determined rate of return included in the final price (the U.S. model). To reach the 1997 goal, drastic price increases are being implemented in phases throughout 1996. It remains unclear, however, whether prices will be increased by the end of 1996 to a level that allows for cost reimbursement plus reasonable profit - as stipulated in legislation. Regardless, by 1997 the HEO will be responsible for all subsequent pricing decisions.

As the HEO continues to demonstrate its technical competence and effectively articulates its vision for a competitive sector, it is beginning to assume the role of a national independent Public Utility Commission. However, at this time it still lacks a measure of independence in pricing control, and decision making on new capacity and licensing. Under current circumstances, prices are still determined as much by political considerations as by economics. For example, HEO pricing decisions can be over-ruled by the Minister at any time. For a fully transparent system of regulated pricing the HEO needs to be independent and have sufficient

authority to make and enforce its own decisions, especially after prices are rationalized to costs in 1997.

Independence hinges on the HEO's ability to determine the details of the price regulation principles and mechanisms and rate-making systems to be applied after prices are rationalized to costs in 1997. By this time, the HEO must be able to demonstrate its ability to evaluate production, distribution and transmission costs and regulate prices so that investors can realize adequate profits at constant real price levels in a way transparent to consumers. As detailed above, in the largely successful first rounds of electricity and gas privatization, investors expressed confidence that the HEO was moving firmly in the direction of this independence.

### **Improved End-use Efficiency**

Energy consumption has a crucial impact on the economy and consumers in Hungary. The past decades of central planning have given Hungary a pattern of energy use which is much less efficient than that of Western European countries. Improving the energy efficiency of the Hungarian economy is a vital part of the move towards a modern market economy. Rational end-use energy prices are essential to promote (i.e. finance) energy efficiency projects and to stimulate necessary investment in the energy sector. But prices are not enough. There are significant market barriers that must be overcome before energy efficiency can be realized by the consumer and the sector can be economically sustainable in both supply and demand. Such barriers can be grouped in these areas:

- lack of information available to the consumer about energy efficiency;
- lack of finance available for energy projects either due to few project financing models, the high costs of credit, and too-short terms for energy loans;
- lack of a fully developed industry to supply energy efficient goods and services; and
- energy efficiency policies and regulations not fully in place.

It is vital that, coupled with price reforms, energy consumers are provided with the technical, managerial and fiscal tools to deal with the drastically rising costs of energy use. If price increases cannot be offset by mechanisms and regulations that promote a more efficient use of energy, such as progressive tariffs, demand side management and building codes, then the market-orientation of the sector will come under tremendous social pressure to slide back into state control and subsidization.

**2.1. BETTER INFORMED CITIZENS INCREASE THEIR  
PARTICIPATION IN POLITICAL AND ECONOMIC DECISION-MAKING  
AT THE LOCAL LEVEL**

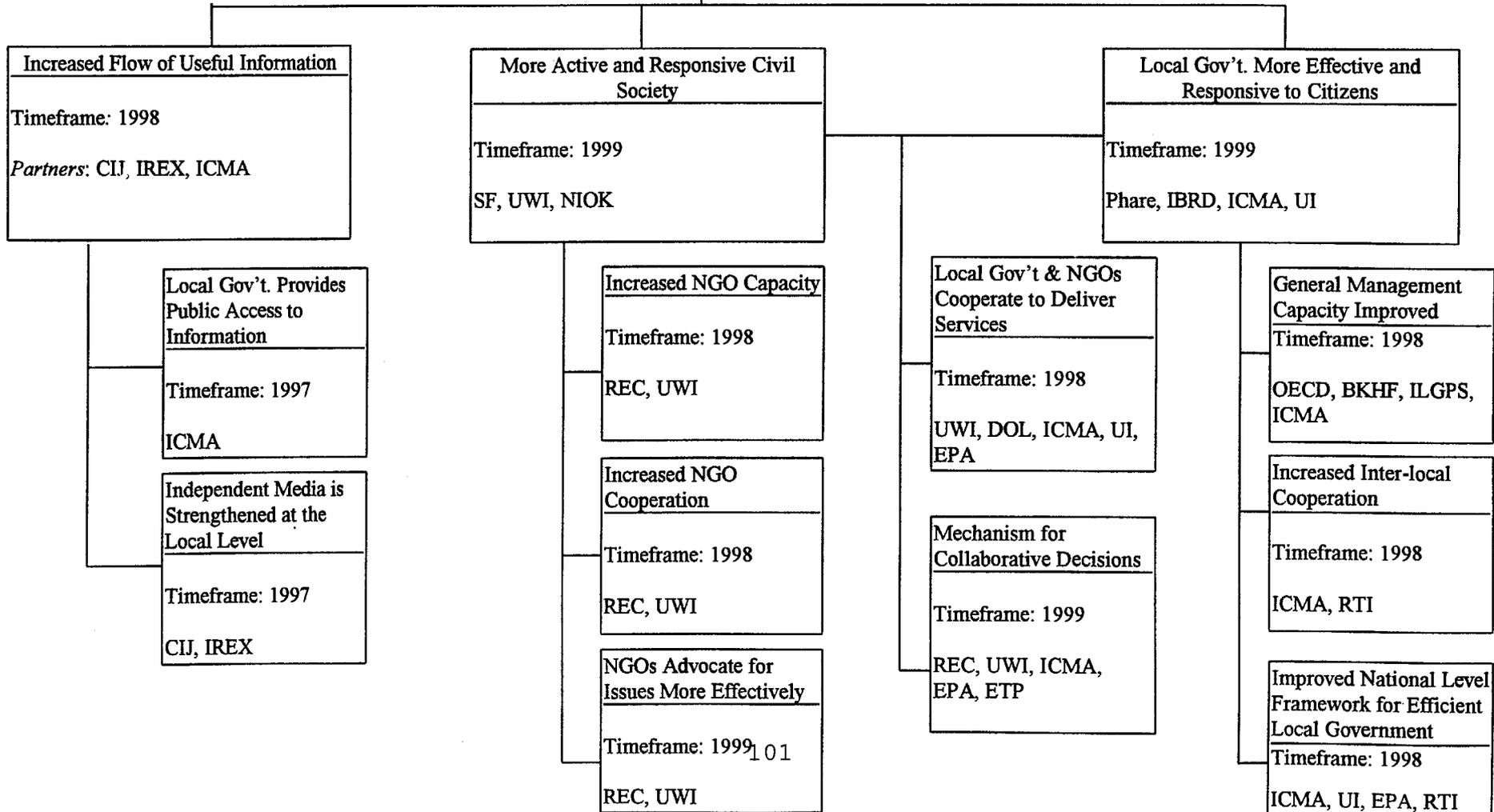
## PART I: GRAPHIC PRESENTATION

**Better Informed Citizens Increase Their Participation in Decision Making at the Local Level**

Timeframe: 1999

International City Management Association (ICMA); United Way International (UWI); Soros Foundation (SF); Center for Independent Journalism (CIJ); Environmental Protection Agency (EPA); Regional Environmental Center (REC); Department of Labor (DOL); Urban Institute (UI), Non-Profit Informacios Kozpont (NIOK); Research Triangle Institute (RTI); OECD; British Know-how Fund (BKHF); International Research Exchange (IREX), EU Phare, International Bank for Reconstruction and Development (IBRD); Institute for Local Government and Public Service (ILGPS)

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**PART II: PERFORMANCE ASSESSMENT**

**Table I - Performance Data  
Baseline, Targets, and Actual Results**

RESULT LEVEL (S.O. OR I.R.) AND NO.	RESULT STATEMENT	PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		TARGETS AND ACTUAL RESULTS							
						1996		1997		1998		1999	
				YEAR	VALUE	Target	Actual	Target	Actual	Target	Actual	Target	Actual
S. O. 2.1	Better Informed Citizens Increase Their Participation in Decision-Making at the Local Level	Voter turnout for local initiatives,	Definition: Unit:	1995	TBD	5		15		75			
		Incidence of local referenda initiated by citizens	Definition: Unit:	1995	TBD	5		15		75			
		Citizens agree more useful and better information is available	Definition: Unit:	1995	TBD	TBD							
2.1.1	Increased Flow of Useful Information	Coverage of local, civic issues in broadcast media	Definition: airtime Unit: hours per week	1990	0	TBD							
2.1.1.1	Local Government Provides Public Access to Information	Creation of joint municipal officials and citizens committees, boards and commissions	Definition: LG. Unit: number	1990	0	30		100		500			
		Initiation of public relations/media plans by local governments	Definition: Unit:	1990	0	10							
2.1.1.2	Independent Media is Strengthened at the Local Level	Services contracted out and/or reorganized	Definition: Unit: HUF (million)	1993		10							
2.1.2	More Active and Responsive Civil Society		Definition: Unit:										
2.1.2.1	Increased NGO Capacity	NGOs with at least one full-time salaried staff member	Definition: Unit:	1993	4157								
		Membership in these organizations	Definition: Unit:	1993	TBD								
		Financial or in-kind contributions to NGOs from non-governmental sources	Definition: Unit: HUF (million)	1993	27								
		NGO enabling legislation	Definition: Unit:	1995	draft law passed								
2.1.2.2	Increased NGO Cooperation	TBD	Definition: Unit:	1995	TBD	TBD							
2.1.2.3	NGOs Advocate for Issues More Effectively	NGOs engaged in advocacy-related activities	Definition: Unit: number	1993	518	550		600		625		650	
2.1.2/3.1	Local Governments and NGOs Cooperate to Deliver Services		Definition: Unit:										
2.1.2/3.2	Mechanism for Collaborative Decisions		Definition: Unit:										
2.1.3	Local Government More Effective and Responsive to Citizens		Definition: Unit:										
2.1.3.1	General Management Capacity Improved	Use of participatory strategic planning techniques	Definition: strategic plans Unit: city	1990	0	15							
		Municipal budgets used as management tools	Definition: Program budgets Unit: number of municip.	1990	0	15							
2.1.3.2	Increased Inter-Local Cooperation	Establishment of regular inter-local cooperative councils/ fora	Definition: fora Unit: county	1990	0	3 lg in 4 county							
2.1.3.3	Improved National Level Framework for Efficient Local Government	Targeting of municipal subsidies	Definition: Reduction in central Gov't subsidies Unit: %			increase use of LG. resources							

optional: use only when clarification of the performance indicator statement is necessary

## STRATEGIC OBJECTIVE 2.1

### BETTER INFORMED CITIZENS INCREASE THEIR PARTICIPATION IN POLITICAL AND ECONOMIC DECISION-MAKING AT THE LOCAL LEVEL

#### Part III: Narrative Rationale

##### A. Transition Hypothesis

USAID recognizes that the consolidation of democracy hinges on the principle of *irreversibility*, or the ability of new democracies to incrementally overcome threats to regime reversal. These threats come less from anti-democratic forces than from a government's inability to solve such governance problems as unemployment, social injustice, or the completion of difficult market-oriented reforms. Successful consolidations are a process of institutionalizing democratic processes, values and institutions, thus making democracy so broadly "legitimate" that ordinary citizens are willing to defend it against internal attack.

The key determinate of successful democratic transitions and consolidations has been the ability of democratically elected governments to provide good or effective governance, which in turn provides a stable foundation for economic growth. Broadening participation in both the political process and governance decision making to include non-governmental organizations (NGOs and public-private partnerships) serves to improve the quality of a country's governance, as well as increase the likelihood that necessary governance reforms are undertaken and sustained. In addition, effective and sustained governance is more likely to occur when conditioned by increased political participation and accountability, which not only constrains but guides local governments' exercise of authority in decision-making while increasing civil society's role. Citizen participation, more effective local governments, and a stronger civil society together will drive the democratic consolidation in Hungary and make it a lasting and positive element of Hungarian life.

Donor assistance to the democratic transition in Hungary has primarily concentrated on strengthening democracy through the development and support of national institutions and focusing direct citizen assistance in Budapest and a few heavily populated outlying urban areas. USAID assistance, however, is targeted at the local level where approximately 70 percent of the population reside in communities with populations under 50,000; more than 3000 municipal governments exist; and some 35,000 non-governmental organizations (NGOs) are operating. USAID's efforts to support the democratic consolidation in Hungary will ensure that citizens are better informed and increase their participation in decision-making at the local level. USAID activities will work toward this goal in a concerted manner by strengthening non-governmental organizations (NGOs),

making local governments more efficient and accessible, working to bring NGOs and local governments together, and increasing public information of local issues.

#### **B. Critical Assumptions**

1. Non-targeted communities will embrace the innovations introduced by USAID assistance where appropriate, and will be able to replicate them without significant additional direct USAID support.
2. The National Government is committed to maintaining and honoring the rights of self-determination and relative autonomy granted to municipalities by the 1990 Act on Local Government.
3. Political stability at the national level is necessary to provide the supportive environment for local governments and NGOs to move forward with improving their effectiveness and responsiveness.
4. The environment conducive to the further development of the civil sector will persist and continue to improve.
5. The responsibility for support of NGOs and civic issues will be gradually assumed by the developing private sector.
6. The economy of Hungary will continue a slow improvement allowing increased resources to flow through the NGO and municipal sectors.

#### **C. Causal Linkages**

ENI program objective 2.1 was adopted as the strategic objective because citizens must be better informed and increase their participation in decision-making at the local level in order for Hungary to complete the transition to, and consolidation of democracy. The three first-level, Intermediate Results (IR) provide the framework for achieving the strategic objective.

#### **Increased Flow of Useful Information**

The free and unencumbered flow of information is both a fundamental element of a stable democracy and a means to maintain that democracy through informed, pluralistic decision-making. Traditionally, in Hungary the flow of information has been tightly controlled by the central government. This was true both vertically where local governments were not privy to decisions handed down to them from centralized powers; and horizontally where citizens were not given the information nor the opportunity to take part in decision-making within their own communities. Under the current transition to democracy, formal controls on information have

largely been lifted, yet the avenues and mechanisms are not fully in place at the local level to foster the participation of an informed citizenry. In addition, independent media and NGOs have a greater role to play in both disseminating information and promoting public debate of relevant issues.

Progress towards this result will be supported by: a) ensuring that *local government provides citizens with access to information* and b) *strengthening independent media at the local level*.

### **More Active and Responsive Civil Society**

Civil society is defined as the citizenry at-large and the myriad of NGOs (institutions and organizations) that provide services, information, and advocate for issues on behalf of the public interest. In the early stages of democratic consolidation, civil society inevitably undergoes a degree of deflation as the tremendous energies that were expended during transition give way to the realities of household economic survival. Many Hungarian NGOs that were initially concentrating on global social and environmental issues are now focusing on local economic transition issues. Correspondingly, USAID's focus has shifted to the local level. As USG assistance has helped to establish and strengthen state institutions vital to Hungary's democratic transition, there is now no greater long-term challenge in the post-transition period than the establishment of a strong civil society capable of participating with government in the public realm of local-level, community-based decision making. An equally important challenge is to assist in bridging differences in class, ethnicity, and ideology which naturally existed among and between individuals and organizations but were subordinated to achieve a common purpose during the transition.

Progress towards this result will be supported by: a) *fostering cooperation between local governments and NGOs to deliver key services*; b) helping local governments and NGOs to create *mechanisms for collaborative decision-making*; c) training *NGOs to advocate for issues more effectively*; d) *increasing NGO cooperation, and e) increasing NGO capacity*, in part through the creation of NGO policies, laws and regulations.

### **Local Government More Effective and Responsive to Citizens**

This is the third necessary and sufficient result for increasing citizens' participation. While NGOs and advocacy groups provide a means for citizen action in their communities, it is equally important for local governments themselves to establish efficient and transparent processes for managing their numerous responsibilities. Local governments must also be receptive and responsive to citizen concerns, and encourage more communication through the creation of mechanisms which foster participation. Local governments can achieve this result

through improved service delivery, more effective management, increased cooperation with other localities, increased numbers of mechanisms for receiving citizen input, and through contributing to a national level framework which itself is conducive to effective local governments. Progress towards this result will be supported by: 1) encouraging *local governments and NGOs to cooperate to deliver key services*; and 2) working to ensure that the *general management capacity is improved, financial administration is improved, inter-local cooperation increases*, and there is an *improved national level framework for effective local government*.

## USAID/HUNGARY BUDGET SUMMARY BY INTERMEDIATE RESULT

SO	Level	Results	Proposed 96	Proposed 97	Proposed 98	Total
<b>1.2 Increased Soundness of Fiscal Policies and Fiscal Management Practices</b>						
	R1	More Efficient Budget and Program Management	100,000	568,750	340,000	1,008,750
	R2	Improved Revenue Generation	600,000	900,000	1,930,000	3,430,000
	R3	Rationalization of Government Role	0	31,250	30,000	61,250
<b>1.2 Total</b>			<b>700,000</b>	<b>1,500,000</b>	<b>2,300,000</b>	<b>4,500,000</b>
<b>1.3 Improved Performance of Small and Medium Sized Enterprises</b>						
	R1	Increased Access to Commercial Banking Services	283,660	555,000	185,000	1,023,660
	R2	Improved Access to Market and Technology Information	81,399	690,000	430,000	1,201,399
	R3	Improved Systems & Practices Developed and in Place	3,748,049	3,905,000	535,000	8,188,049
	R4	More Rational Tax Structure for SMEs	750,000	0	0	750,000
<b>1.3 Total</b>			<b>4,863,108</b>	<b>5,150,000</b>	<b>1,150,000</b>	<b>11,163,108</b>
<b>1.4 A More Competitive and Responsive Private Financial Sector</b>						
	R1	Improved Regulation & Supervision	603,000	2,075,000	2,250,000	4,928,000
	R2	Improved Operational Efficiency	500,000	1,125,000	1,050,000	2,675,000
<b>1.4 Total</b>			<b>1,103,000</b>	<b>3,200,000</b>	<b>3,300,000</b>	<b>7,603,000</b>
<b>1.5 An Economically Sustainable Restructured Energy Sector</b>						
	R1	Improved Efficiency of Production and Delivery	0	0	0	0
	R2	Effective Regulatory Body in Place	0	200,000	0	200,000
	R3	Improved End-Use Energy Efficiency	0	0	0	0
<b>1.5 Total</b>			<b>0</b>	<b>200,000</b>	<b>0</b>	<b>200,000</b>
<b>2.1 Better Informed Citizens Increase their Participation in Decision Making at the Local Level</b>						
	R1	Increased Flow of Useful Information	353,000	100,000	100,000	553,000
	R2	More Active and Responsive Civil Society	1,517,000	1,175,000	750,000	3,442,000
	R3	Local Government More Effective and Responsive to citizens	1,580,000	1,575,000	900,000	4,055,000
<b>2.1 Total</b>			<b>3,450,000</b>	<b>2,850,000</b>	<b>1,750,000</b>	<b>8,050,000</b>
<b>4.1 Cross Cutting and Special Initiatives</b>						
	*	Cross Cutting and Special Initiatives	2,337,892	1,300,000	1,000,000	4,637,892
<b>4.1 Total</b>			<b>2,337,892</b>	<b>1,300,000</b>	<b>1,000,000</b>	<b>4,637,892</b>

## **JUSTIFICATION FOR FY 1998 OYB AT \$8 MILLION LEVEL.**

USAID Hungary's Strategy and corresponding Results Packages for the period 1996-1999 were the outcome of an exhaustive Mission exercise to sharply focus its strategic priorities in the context of the impact that can be achieved by declining USAID budget resources and an anticipated program close-out around the end of FY1999. The resources expected as the Strategy was being developed amounted to \$40 million in additional OYB in FY 1996, 1997 and 1998, plus prior year pipeline and significant participation in resources expected to become available through Bureau deob-reob processes during the 1997-1999 period. Of the \$40 million in additional OYB expected during the 1996-1998 period, the Mission based the development of its Results Packages outcomes on a FY1998 OYB of at least \$8 million, which was determined to be necessary, though not necessarily sufficient, to complete planned activities during FY1999.

The Mission's Strategic Objective Teams did not take into account participation in FY1999 OYB resources. Accordingly, if in addition to expected use of deob-reob resources the Mission were to receive a FY1999 OYB that would restore the proposed reductions to \$7 million or \$5.6 million in FY1998, the Mission is confident that the proposed Strategy can be completed.

In response to instructions to consider a FY1998 baseline budget of only \$7 million and a possible further 20% reduction to \$5.6 million, the Mission Steering Committee discussed this unfavorable development with the four Strategic Objectives Teams expected to be active during FY 1998 and 1999, and agreed with them on preliminary allocations adjusted to this scenario. Nevertheless, all SOTs communicated the likely adverse impacts of the proposed reductions on their ability to achieve the outcome performance committed to in their respective Results Packages.

### **SO 1.2 Increased Soundness Of Fiscal Policies and Fiscal Management Practices**

Planned FY1998 Budget:	\$2,200,000
Adjusted FY1998 Budget:	\$1,750,000 (20% reduction)
Low FY1998 Budget:	\$1,370,000 (38% reduction)

The proposed reductions in resources available to this SO will have significant impacts on the ability to achieve critical intermediate results in the areas of improved revenue generation and rationalization of the role of government. Specifically, activities planned in tax policy, tax compliance, tax enforcement and pension reform will be prematurely curtailed. This curtailment will jeopardize ongoing progress toward institutionalizing best practices in these areas, needed to sustain progress on reducing the high fiscal deficits that have threatened Hungary's progress on stabilizing its economy and planned integration with Western Europe and other international commitments.

SO 1.3 Improved Operations of Small and Medium Enterprises

Planned FY1998 Budget: \$1,300,000  
Adjusted FY1998 Budget: \$1,150,000 (12% reduction)  
Low FY 1998 Budget: \$920,000 (29% reduction)

The proposed reductions in resource availability for this SO will have serious impacts on its critical Access to Information Intermediate Result, particularly as a reduced level of effort in the activities planned in this area in 1998 and 1999 will impede the pace of replication of best practices (spread effects) that constitutes the center piece of the Mission's strategy for this objective. The slowdown in adoption of best practices that will result will be reflected in serious delays in the adoption of best practices by many firms, slowing the growth of the sector, new job creation and income growth.

SO 1.4 A More Competitive and Market Responsive Private Financial Sector

Planned FY1998 Budget: \$1,550,000  
Adjusted FY1998 Budget: \$1,350,000 (13% reduction)  
Low FY1998 Budget: \$960,000 (38% reduction)

The reductions suggested for this SO, if adopted, will have serious adverse impacts on the ability of the new supervisory and regulatory agencies in the financial sector to carry out the functions expected of them in 1999. This includes harmonization of Hungary's financial sector laws and regulations with those of the EU and some kinds of cross-country licensing and branching arrangements with Western partners expected to be in place before 2000. Reducing US Treasury assistance in assuring completion of banking sector restructuring may seriously delay or derail the final stages of this important process.

SO 2.1 Better Informed Citizens Increase Their Participation in Decision Making at the Local Level

Planned FY1998 Budget: \$1,950,000  
Adjusted FY1998 Budget: \$1,750,000 (10% reduction)  
Low FY1998 Budget: \$1,350,000 (31% reduction)

The principal impact of the proposed budget reduction for this SO would be reduced local government effectiveness and responsiveness to citizens. NGO advocacy activities would also be impaired. Improved health care and municipal service delivery would be the principal areas affected. Spread effects for best practices to municipalities not directly assisted by USAID programs would be delayed or distorted.