CIPE

Center for International Private Enterprise

CROSSED PATHS:

Straightening the Road to Private Sector Growth

With contributions by:

The Budapest University of Economic Sciences
Financial Research, Ltd.
The Foundation for Market Economy
The Institute for World Economics / Blue Ribbon Commission Foundation
The Kopint-Datorg Foundation for Economic Research
The Public Policy Institute

THE LEGAL & REGULATORY REFORM IN HUNGARY PROJECT

SPRING 1994

The Legal & Regulatory Reform in Hungary Project Advisory Board

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Straightening the Road to Private Sector Growth

With contibutions by:

The Budapest University of Economic Sciences
László Szakadát, Project Manager

Financial Research, Ltd.
Éva Várhegyi, Project Manager

The Foundation for Market Economy
László Kállay, Project Manager

The Institute for World Economics / Blue Ribbon Commission Foundation
Miklós Szanyi, Project Manager

The Kopint-Datorg Foundation for Economic Research
Katalin Máté, Project Manager

The Public Policy Institute
Mihály Laki, Project Manager

Medián Opinion & Market Research, Ltd.
Endre Hann, Managing Director

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Acknowlegement

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Here is a sampling of the recommendations to be found within:

- **In order to channel more personal savings into privatization, the dumping of government securities must be restricted.**
- **A customer-friendly network of local branch banks must be established where local bankers and small entrepreneurs can prepare business plans together.**
- **The corporate tax should be decreased to 30 percent and the minimum tax must be eliminated.**
- **Capital investments, especially as regards the application of advanced technology, must be promoted with tax allowances and accelerated depreciation.**
- **Basic social security reform is inevitable. The mandatory social security contribution, which entitles contributors to the basic services, should be decreased to between 15 and 25 percent.**
- **Venture capital companies, following the successful example in some Asian countries, and regional or sectoral companies should be formed to promote investment into small enterprises.**
- **In order to boost the market for and turnover of land, a new system of land valuation and registration must be developed and adhered to. An inevitable prerequisite for a workable mortgage finance system is the establishment of an up-to-date, legitimate land registry system.**
- **A national network of mortgage loan and land loan financial institutions must be established having the overriding mandate to serve the needs of the entire agricultural community.**
- **"All in one", one-stop offices must be created where representatives of all the applicable agencies and authorities, together with the banks, are housed under one roof so that a candidate may establish a company with minimal effort.**

PREFACE

In the five years since the collapse of communism in Central Europe, Hungary has been proudly held as a model of reform and economic progress. As the nation prepares for a new government, it is essential that these reforms and progress continue. *Crossed Paths: Straightening the Road to Private Sector Growth* offers policy recommendations crafted by leading Hungarian policy experts under the guidance of an Advisory Board consisting of prominent Hungarian business, academic and legal experts. Continued attention to these vital issues is needed if Hungary is to remain the standard-bearer for reform and economic development in Central Europe.

I. INTRODUCTION

This publication is a condensation of the results of a series of policy research and analysis projects begun in February, 1993, as the first phase of the Center for International Private Enterprise's (CIPE) Legal & Regulatory Reform in Hungary Project. The subject matter of these projects was determined through extensive interviews with leaders from the Hungarian business, academic, legal, and media communities, many of whom now sit on the Project's Advisory Board. From these interviews came a list of the most pressing economic issues to be analyzed and the organizations best suited to perform the analysis:

- **The Budapest University of Economic Sciences - Impediments in the Real Estate Market;**
- **Financial Research, Ltd. - The Financial Sector;**
- **The Foundation for Market Economy - The Informal Sector;**
- **The Institute for World Economics/Blue Ribbon Commission Hungary Foundation - The Privatization Process;**
- **The Kopint-Datorg Foundation for Economic Research - The Tax System; and,**
- **The Public Policy Institute - Private Sector Development and Local Government.**

Concurrently, Medián Opinion & Market Research, Ltd., undertook a seventh project to conduct two opinion polls. One poll was a survey of the attitudes of the general public toward market reforms and private sector development. The other poll measured the opinions of entrepreneurs and managers based on their day-to-day encounters with various obstacles to doing business in Hungary. The results of both these polls are used throughout this publication to highlight the recommendations of the grantee research organizations listed above.

This paper does not represent the final culmination of the Project, however, but instead signals the beginning of Phase II. During this second phase, the results of the hard work so far contributed to the Project by the researchers and Advisory Board Members will be disseminated to a wide audience of professionals, in both the public and private sectors, involved at every level of policy making in Hungary. But the effort to reach the widest possible audience did not begin and will not end with this publication.

Prior to this, beginning in March, 1993, the Advisory Board and the Grantee Project Managers engaged in a series of meetings to discuss issues of ongoing relevance to the Project with other leaders invited from the business, academic, legal, and media fields. A continuing feature of these meetings was the guest speakers program. Under this program, a representative from either government, parliament, or a political party was provided an individual opportunity to describe the economic program of his or her political faction. Speakers who appeared include: Attila Chikán, economic advisor to the Alliance of Young Democrats; László Békesi, MP, Hungarian Socialist Party; Mihály Kupa, independent MP; Márton Tardos, MP, Alliance of Free Democrats; and, Iván Szabó, Finance Minister, Hungarian Democratic Forum. The transcripts of these meetings, along with contributions from the Grantees, provided the content basis for the CIPE Newsletter, which is edited and published by the staff of CIPE-Budapest and distributed to hundreds of policy makers in Hungary and other Central and Eastern European Countries.

And in 1994, as a follow-on to *Crossed Paths: Straightening the Road to Private Sector Growth,* the complete versions of the Grantees' policy analyses and recommendations, from which the material presented herein was drawn, will be published in a companion text this summer. Further, in September of 1994, in conjunction with the Advisory Board and the grantee research organizations, CIPE will conduct a national conference to provide a forum for the discussion and development of the Project's published findings.

The analyses and recommendations exposited in this publication and others are presented in the hope that they will be of some assistance and value to the decision makers whose task it is to define the economic future of Hungary.

II. PUBLIC OPINION ABOUT THE MARKET ECONOMY

The historical change: a change in the system - the extraordinary experiment of Hungary's transition from a single party system into a multi-party democracy; from a socialist, centrally planned economy based on state ownership into a market economy based on private property and private enterprise - that has generated mixed, sometimes contradictory, feelings among the citizens of Hungary.

Some of these poll results indicate that many people do not make the distinction between the effects of a functioning market economy, which have yet to be realized in Hungary, and the difficulties generated by the process of transition itself. To a great extent the difficulties currently experienced in Hungary and the region are being generated not by market or capitalistic forces but by the miscalculations of the previous economic system.

In contrast to the general hopes in 1990, polls show that at the end of last year two out of three people were not satisfied with the direction of many of the changes. The proportion of those believing in a fully free market economy has fallen to only 33 percent, compared to 43 percent at the beginning of 1991. Almost every second person thinks that some "mixture" of a socialist and market economy would be the most attractive option. From among the various social groups polled, only entrepreneurs desire an even freer economy. But even they would restrict foreigners from acquiring too much of certain types of property in Hungary.

For those committed to a market economy, it is a warning sign that those who would welcome the ascension of private enterprise over state ownership or control are in the minority and their numbers appear to be decreasing, falling from 42 percent in 1992 to 37 percent in one year. Most Hungarians welcome the dominance of the private sector in those activities and services in which private enterprise has traditionally had a large role (e.g. catering, food retail, other certain types of services), but are clearly against too much penetration of the private sector into the insurance and banking sectors.

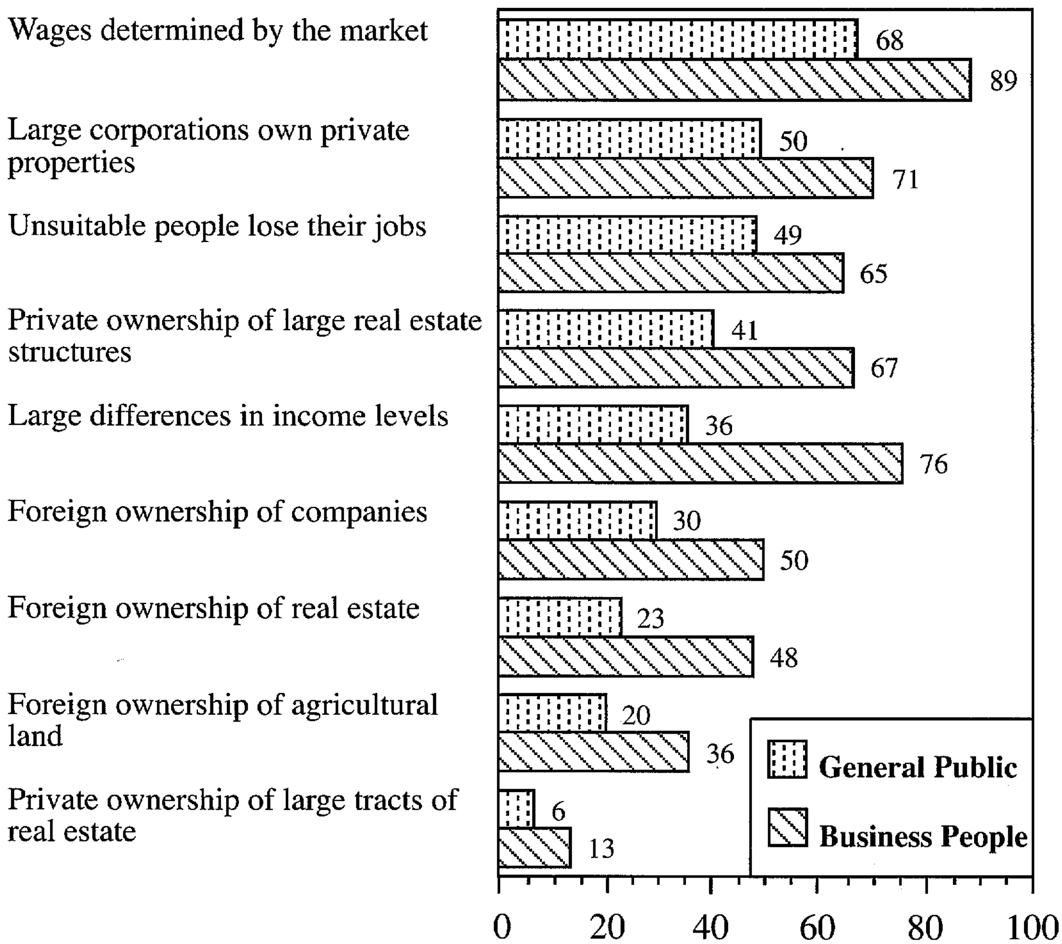
At the same time, against a backdrop of general dissatisfaction, people do not out of hand reject those elements necessary for basic change in the system. Although their number has slightly decreased, the majority (70 percent) still approve of the establishment of a multi-party system and are not against political efforts to form a market economy. While many insist that certain activities and services remain under state control, the majority still consider career opportunities to be better in the private sector. Also, there are many people willing to start an individual enterprise. And although there may be many constraints to doing so, even today, as in 1991, every sixth person says that he/she has serious plans to launch a business of their own.

To explain the changes in the social feelings and these contradictory opinions would no doubt require further very deep investigation. However, decreasing confidence levels may not always be explained by claiming that a large number of people jumped into the "big adventure" with more illusory hopes than essential knowledge. Another more probable explanation for increasing disillusion can be found within the practical reality of trying to do business in an environment where the legal and institutional framework required for the normal operation of a

Figure 1.

Views About a Free Market Economy (September 1993 as a percentage of the answers of interviewees)

Should the following be allowed?



market economy did not develop fully during the last few years, resulting in confusion among those in business as they tried to sort out regulatory contradictions and constraints.

Regarding the Government's relationship with the banking and tax systems, approximately two-thirds of the general public, and more than 90 percent of entrepreneurs with direct experience, think that not enough official support is given to new enterprises. Further, more than 80 percent of the entrepreneurs surveyed are not satisfied with the loans available for start-up enterprises (18 percent reported launching their enterprise with an "official" loan), and they have no better opinion about the external financing opportunities, either. In a nutshell, the widespread perception is that the tax system is unfair and restricts growth.

Other major constraints to business development cited by the majority of entrepreneurs include the inaccessibility to telephones, the slow pace of banking operations, and the almost absolute lack of market information. The only thing generally appreciated by the entrepreneurs was the work of the Court of Registration.

The above opinions indicate that there is much to be done and that time is of the essence. If Hungary is to remain in the forefront of economic, social, and political progress, it must be demonstrated, through sound policies which establish a friendly environment where private enterprise can flourish and, most importantly, people can make money both as employer and employee, that a market economy is a desirable and necessary future.

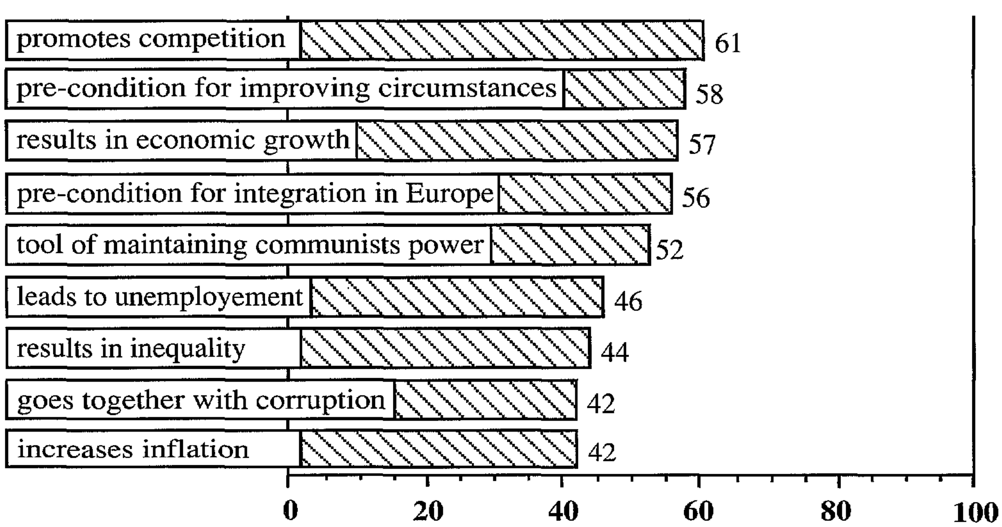
III. PRIVATIZATION AND NEW ENTERPRISES

Excluding the impact of external pressures which greatly influenced supply and demand in the fledgling Hungarian economy - the collapse of the eastern markets, recession in the west - the benefits of the market economy will not present themselves in Hungary until the weight of the private sector reaches "critical mass" in the overall national economy; not until those in private business believe that the prospects for durable prosperity are improving. As in most former socialist countries, Hungary's transition simultaneously follows two paths that sometimes cross each other. Progress on one path is driven by the sale of state-owned property. Progress on the other depends on the multiplication and growth of newly-born private enterprises. Both processes are accompanied by the never ending criticisms and disputes among politicians and between the experts and citizens who are either directly or indirectly involved in the privatization process.

Research shows that in 1993 privatization in Hungary reached a milestone in the comparative levels of supply and demand as the ratio between the two changed significantly. Between 1989 and 1992, the state-owned properties offered for privatization included a relatively high number of companies which were more valuable than the Hungarian average. Because of this, foreign investors were attracted, dominating demand. During this period, using various methods, including liquidation, state-owned enterprises representing more than

Figure 2

Views on Privatization
(September 1993, based on a sample of 1500 people)*



*** Scale of 100 degrees. If all interviewees had fully agreed with the given statement, the value of indicator would be 100 and if none of the interviwees had agreed, it would be 0.**

50 percent of the total value of assets on hand were privatized, but in terms of volume this was the smaller part. The remaining state-owned assets currently on hand, therefore, represent only 30 to 40 percent of the original value and approximately 60 percent of volume.

On the other side, demand has also changed. One reason is that the 20 billion HUF of domestic savings standing against the approximately 2,000 billion HUF in state-owned assets and the 1,000 billion HUF in land to be privatized has multiplied. While foreign demand has been decreasing recently, potential domestic demand was further increased through the issuance of preferential instruments. Paradoxically then, a large amount of assets with relatively low actual value are subject to artificially swollen domestic demand. This situation, however, does nothing to help achieve the final objective of matching good owners (i.e. capable, responsible. and capital worthy) with good assets (i.e. competitive or potentially competitive) and can only slow the privatization process further.

During the next few years, the total withdrawal of the State from small- and medium-sized enterprises must be the objective. However, the number one pre-condition for that is a general improvement in business prospects and confidence: interest rates must go down, opportunities for establishing reasonable profit margins must increase, and investment incentives must be enhanced. At this point, lowering the asking prices of state assets alone will not accelerate the pace of privatization.

- **The operating expenses of state-owned enterprises must be reduced.**

The results of the so-called self-privatization schemes, completed without the direct participation and control of the state bureaucracy, indicate that this privatization method is the most effective, successfully utilizing the ambitions and talents of the corporate management in place at the time. The majority of companies which self-privatized, very often implementing the business plans of the management performing the buyout or that of the company staff, are able to operate more efficiently than before. The companies which are still managed by the state are operating not only in an atmosphere of ownership uncertainty, but have also lost a significant proportion of their value while the search for private ownership continues, disusing their assets and the staff possessing the bulk of the technical expertise and operational experience in the process. It cannot be ignored that in-place corporate managements is one of the most important sources of potential owners, therefore:

- **The continuation of all schemes must be encouraged that actively involve a successful in-place management and staff in the privatization.**

- **And due to the changes in the supply side, it is not sure that the techniques applied to date are enhancing the privatization process. Therefore alternative means of privatization have to be developed.**

- **Private asset holding/managing companies have to be contracted in order to efficiently operate the as yet unprivatized state assets.**

While the mass privatization methods applied by the Government to date apparently attempt to accelerate privatization, none of them create real owners. Mass privatization methods involving compensation did not achieve the intended political aim (the compensation for social injustice caused by nationalization) or the economic aim (extension of purchasing power to the middle class). Only one-sixth of the issued compensation vouchers have been used to purchase state-owned assets, mainly productive land and homes, and not corporate stocks. And a great number of compensated people have sold their vouchers for cash, with inflationary effect. At the same time, the assets offered for sale through compensation vouchers have significantly reduced competition in other privatization methods. In order to eliminate the negative impacts of compensation voucher turnover...

- **The withdrawal of vouchers from the privatization process must be accelerated using all possible means.**

An acceleration of the pace of privatization may not be expected from the Small Entrepreneur Share Purchase Program (Hungarian abbreviation: KRP) either. In contrast with compensation, the KRP may not be considered a free distribution of assets, but it still creates a great deal of ownership uncertainty in the companies involved in the program. In the case of compensation, it is acceptable that the state defines which stocks may be converted into vouchers, since no payments are made by the voucher holders. In the case of the KRP scheme, under which the small entrepreneur would have to put at risk some portion of their future income, such control of the investment by the state is not justified. Therefore,

- **State funds to be used for the KRP should rather be spent on the extension of the availability of loans to small enterprises.**

Other methods for involving the growing middle class in the privatization process should be developed and given priority. On the basis of the decreasing ratio between the value of the remaining assets to be privatized and the personal savings rate, savings should be directed towards privatization more intensively. At the moment, however, this process is very much hindered by the current practices of government securities dumping and the granting of tax allowances to the purchasers of government bonds. As a result of this crowding effect caused by deficit financing of government securities, the trading of corporate equity represents less than 10 percent of the daily turnover on the Budapest Stock Exchange. Therefore, in order to channel more savings into privatization:

- **The dumping of government securities must be restricted.**

Liquidation is an essential instrument in withdrawing the state from the economy. Although the state generates no revenues from liquidation, according to most assessments generally 30 to 40 percent of the activities of a liquidated company may be continued under the supervision of the new ownership. The protracted liquidation procedure unduly accelerates the ultimate and total collapse of a company which might have been otherwise rescued, resulting in unnecssary devaluation of state-owned assets and increasing the danger of corruption. On the other hand, fast and decisive liquidation is the most practical way to effect the withdrawal of non-competitive companies from the market. In addition to the withdrawal of the state from the market, rigorous enforcement of the bankruptcy laws assists privatization by lending clarity and stability to the general economic situation. Therefore,

- **The present bankruptcy rules must not be eased.**

But because there is no fast and decisive liquidation procedure, and as international experience shows, it is rather doubtful whether or not the debtor conciliation schemes and reorganization attempts applied to state-owned enterprises by the Government will be successful. The uncertainty of ownership endemic to state-owned companies which are heavily in debt will increase in the debt conciliation period and if the "patterns of behavior" of the company do not change, there is a good chance that debt will only continue to increase. If the budgetary limits of these companies are not constrained and if the attitudes of lending banks remain the same, debtor conciliation will not be successful. Consequently, debt problems will remain unsolved unless the state-owned financial sector begins operating strictly on a market basis and with some real skill. Debt consolidation schemes have a chance for success only if...

- **The banks and companies whose debts have been written off are privatized quickly.**

While the change in the supply structure is an objective process, the forced acceleration of the process will also have to be paid for. The latter may not be totally justified and explained by the need for budgetary revenues. This is not only because no significant budgetary revenues may be expected from the sale of distressed small- and medium-sized enterprises, but also because the Government is on a faulty path if it uses privatization revenues to fill budget gaps instead of to promote the expansion of the private sector.

The need for a privatization program is a relatively new phenomenon in the Hungarian economy, that is, having very few domestic historical examples to go by. When the need appeared in 1989 and 1990, tendencies toward significant control of the process through political power quickly appeared and have, to some extent, continued. The same may hardly be said about the foundation of new private enterprises, however. In decades prior to 1989, though without much political support and within a very restricted legal framework, tiny quasi-enterprises were established and many endured, especially in agriculture. In the '80s, private business opportunities even increased.

And following the recent political change, a company foundation wave unprecedented in Hungarian history swept across the country. In 1990, there were less than 30,000 organizations with a legal economic identity. In the next two years, that number more than doubled and the number of individual enterprises went up from more than 400,000 to above 600,000. Although it was obvious that many of the new enterprises were only "pseudo" enterprises created to avoid taxes, many experts expected a fast and sustainable growth in the number of people joining the private sector.

But over the past twelve to eighteen months, these expectations have cooled. Although the number of companies is still increasing rapidly, new companies have fewer assets, reduced access to credit, and are less willing or able to expand. Many private enterprises which were established a longer time ago and have grown from small to medium-sized in the meantime, are now experiencing hard times or have gone bankrupt. Research has proved that the halt in the enterprise "boom" is mainly attributable to recession in the west. The largest company foundation wave of this century took place parallel with a most serious economic recession. Similarly to politicians and experts, a significant number of entrepreneurs formed wrong opinions about prospects during this economic cycle and are now forced to put off necessary capital investment and to reduce the number of employees.

Table 1

Motives for Starting Enterprises
(September 1993, based on a sample of 500 business people)*.

	On a scale of 0-100
Favorable market opportunities	57
One good idea or innovation	50
Freer lifestyle	47
Loss of job, uncertain situation at workplace	33
Capital available for investment	32
Success of other entrepreneurs	27
Desire for adventure	13
Favorable credit conditions	8

*** If a given motive had been the most important in the decision of each interviewee, the value of the indicator would be 100, and if it had not been involved in the decision at all, the value would be 0.**

At the same time, the Hungarian private sector is losing the ability to be the driving force behind solid economic growth. Entrepreneurs feel overburdened by high taxes, social security contributions that are even higher and there is the widespread perception among entrepreneurs that if their tax loads were reduced their willingness to invest would increase commensurately. However, this last part may not occur automatically. According to the surveys on the subject, as long as entrepreneurs remain pessimistic about the economic outlook, most would not immediately invest their available income even if taxes were reduced.

Realistically, the most that could possibly be hoped for is that tax avoidance would decrease. The same thinking also applies to loan interest rates: interest rate decreases will not automatically raise the demand for loans.

The majority of entrepreneurs simply are not looking to expand any time soon. The more established entrepreneur is not willing to place assets at risk, many entrepreneurs who gained their experience under socialism are professionals in keeping down performance and not increasing it, and the younger generation will need more time to acquire the skills required to run a business.

One danger threatening politicians and economic policy makers is that they often overestimate the chances and inclinations of the private sector to grow. The reason for this is that they usually meet only one of the two different types of Hungarian private entrepreneurs. One group is relatively small, but extremely vocal, and includes younger, well-educated, politically active and optimistic people. The other group, which is normally overlooked, consists of quieter, older and, usually, more pessimistic entrepreneurs who currently form the majority of entrepreneurial society. The latter group generally has lower on-paper qualifications and look at political institutions with a total lack of confidence, preferring to avoid political parties, business associations, other offices which may provide assistance, and banks. Their main source of information and support are family, friends, and closely proximate business relations.

These observations indicate that to support the development of the private economy, the conscientious establishment of "user-friendly" institutional and market and ownership conditions is at least as important as improving monetary and fiscal policies. Some of the most important steps in this direction are:

- **The removal of administrative barriers from the sale and purchase of land.**

- **The establishment of a customer-friendly banking network of local branch banks in which local bankers and small entrepreneurs prepare business plans together.**

- **The clarification of the present chaotic market conditions which have been disturbed by masses of occasional illegal and semi-legal players. To reduce this chaos, a significant role will have to be played by local governments and entrepreneurs' organizations.**

- **The improvement of entrepreneurial infrastructure, i.e., entrepreneurs should be given an advantage in getting telephones.**

- **More local and central budgetary funds should be allocated to the training of entrepreneurs, i.e., market research, business planning, basic cost analysis.**

IV. TAXATION OF ENTERPRISES

The statement that the reduction of taxes is not enough to increase private sector activity on its own in no way implies that the Hungarian tax system, which was developed and has been in force since 1988-1989, is enterprise friendly. On the contrary, the tax system contains many clearly anti-enterprise elements. In addition to the internal structural contradictions of the tax system, the efficacy of taxes as an economic policy tool is also in doubt. Through international comparison it may be seen that in Hungary the ratio of tax revenues to GDP is at the same level as in developed countries having the highest central re-allocation system. So far in the '90s, a bit more than 60 percent of the total income was centralized and re-allocated through the budget. During the "tax reforms" of the past couple of years, tax allowances were cut and extension of the tax base was attempted. Reforms tried to date clearly are not working. As tax rates have increased, so has the size of the budget deficit. Therefore:

- **In order to reduce tax rates, which are high by international comparison, basic budgetary reform is inevitable; the expenditure side of the budget must be restructured.**

The internal structure of the tax system has changed considerably in the past few years. The most striking change has been that the proportion of tax revenues generated through profit taxation has decreased. And since 1991, this amount has also decreased in absolute terms. The decrease is due to a decline in production, widespread tax avoidance and tax fraud, and the relative non-expansion of the private sector. Also, the Hungarian tax system allows capital investments only from after-tax profits, refurbishment is also considered as an investment, and the system of cost accounting was made stricter.

Decreasing the corporate tax rate, even by a spectacular 10-15 percentage points, will not cause fatal damage to the budget. The 4 percentage point corporate tax reduction in 1994 (down to 36 percent) is little more than a symbolic gesture towards entrepreneurs in light of other concurrent increases, such as the elimination of allowances that applied to starting enterprises. The minimum tax, which was introduced this year and must be paid regardless of profit position, strikes very heavily at starting enterprises, automatically generating a loss right at the beginning of operation that may well have a killing effect in these recessionary times.

A typical feature of the Government's economic policy, the objective of which is not clear at this moment, is that while no tax allowances are given to enterprises, subsidies are supposedly available through budgetary funds for regional development, technical development, and employment. However, in order to generate these funds, it has been necessary to nearly treble the contributions of entrepreneurs into these funds since 1990. This solution makes it more expensive to achieve the desired economic policy objective because it requires the maintenance of a bureaucratic apparatus and the assessment is not normative.

Table No.2

Percentage Breakdown of All Tax Revenues According to Tax Type for the years 1990-1993.

	1990	1991	1992	1993* Projected
Corporate taxes	**15.5**	**14.3**	**9.4**	**8.8**
Profit tax	12.5	10.4	4.8	3.9
Contributions into other funds	2.5	2.2	2.4	2.1
Local taxes	0.0	0.8	1.3	1.4
Other taxes	0.5	0.9	0.9	1.4
Personal income tax	**13.7**	**16.9**	**16.3**	**16.8**
Consumer and sales taxes	**36.2**	**32.4**	**33.7**	**35.4**
Customs and import duties	4.7	5.2	7.0	5.2
Foreign trade tax	7.9	2.8	1.4	1.2
VAT	13.6	12.7	13.0	17.4
Excise tax	10.1	11.7	12.3	11.6
Tax on wages	**33.5**	**35.3**	**39.5**	**37.7**
Social security contributions	33.5	35.0	35.7	34.3
Unemployment insurance fund	0.0	0.3	3.8	3.4
Other taxes and levies	**1.1**	**1.1**	**1.1**	**1.3**
Total taxes	**100.0**	**100.0**	**100.0**	**100.0**

Source: Central Budget Volume I. 1992. (Bp. 1991. Nov. p. 237.) Central Budget 1991. (Financial Training and Publishing Company, 1991. page 180.; the 1993 Budget of the Republic of Hungary (Bp. Sept. 1992. Volume I. pp. 314-347.)

At present there is a need for a tax system in Hungary which enhances the growth prospects for private enterprise, provides a stable and reliable economic environment, decreases tax-avoidance and tax fraud, and at the same time is simple and transparent. To achieve these goals, the following changes have to be enacted:

- **The corporate tax should be decreased to 30 percent and the minimum tax must be eliminated.**

- **Capital investments, especially the application of advanced technology, must be promoted with tax allowances and accelerated depreciation.**

- **In order to ensure longer-term and more secure enterprise calculations, frequent, and often contradictory, changes in the corporate tax code must be stopped.**

- **The contributions into individual budgetary funds must be reviewed and eliminated whenever possible.**

Parallel with the reduction of the corporate tax rate in 1994 from 40 to 36 percent, the personal tax liabilities of the Hungarian population have increased. While the average income doubled between 1988 and 1992, the payable personal income tax nearly trebled. Again, tax rates went up but revenues did not.

The increase in the general level of the personal income tax is in part a consequence of the multiple withdrawal of exemptions but is mainly due to the fact that the annual modifications of the tax tables do not take into account inflation. Even more, in an economy where inflation is high, it is absolutely unusual that in 1994 the same tax rates will apply to lower income bands above 220,000 HUF. The personal income tax rate, which is increasing faster than real income, will make labor even more expensive and, in addition to the negative social effects, will impact negatively on the competitiveness of Hungarian enterprises.

In light of projected rapid increases in the budget and current account deficits, the introduction of a capital gains tax on foreign deposits this year may be considered a wrong step. Moreover, the personal income tax allowance for the purchase of government securities is a clearly harmful measure against the business sector. Therefore:

- **The average personal income tax liability should be between 28 and 32 percent.**

- **Interest and share income are currently subject to a flat withholding tax which must be eliminated.**

- **The personal income tax table should be decreased to 3 to 4 tax bands, with a maximum rate of 36 to 40 percent.**

- **At the same time, the allowance after the purchase of long-term state securities must be eliminated and the allowances tied to investments into new and existing enterprises must be restored.**

Nowadays, the largest tax burden on entrepreneurs is the social security contribution, which rose from 25 to 44 percent over the last ten years. As a result, there has been a considerable outcry from entrepreneurs. For example, entrepreneurs are now required to pay the sickness benefit for the first 10 days of an employee's illness. According to surveys, half of the entrepreneurs therefore employ fewer people than they actually need and it is general practice to report lower wages than are actually paid or, alternatively, to avoid taxation altogether by employing informal sector labor. Recently, many employers have been requiring that their employees apply for an entrepreneur's certificate. In the opinion of entrepreneurs, it is mainly due to these very high social security contributions that of the approximately 700,000 registered unemployed, approximately 150,000-300,000 work "on the black", or, in other words, in the informal sector.

Yet, changes in social security, health and pension contributions should not be so drastic as to endanger their basic social functions.

- **Basic social security reform is inevitable. The mandatory social security contribution, which entitles contributors to the basic services, should be decreased to between 15 and 25 percent.**

One of the newest features of the Hungarian tax system is the large proportion of taxes related to turnover and consumption which exceed levels in developed countries. The average of all value added tax (VAT, or sales tax) rates increased from 23.7 percent of total tax income in 1990 to 29.0 percent last year. Although VAT is generally considered to be one of the most effective methods of generating tax revenue, as it is usually the most easily collected, it is also the most expensive to collect, for both the tax authorities and entrepreneurs. VAT must be recorded in each phase of production and its payment and reimbursement are complicated, requiring a special apparatus.

The VAT system also provides many opportunities for abuse. Invoicing does not take into account real movement of goods and reimbursement takes place on that basis. Although VAT is a transitional consideration for most entrepreneurs, those who must deal with large amounts of VAT, those engaging in export/import activity and those who have customers who do not pay invoices in a timely manner, experience often serious liquidity problems if they are not promptly reimbursed for VAT payments made.

According to the majority of entrepreneurs, because the present VAT rates are too high, demand is reduced to a point which encourages sales without a receipt. Frequent modifications in the rules and time consuming administration places an unnecessarily heavy burden on entrepreneurs in the case of both VAT and social security contributions. A result of this is that even very small enterprises are forced to hire either a special employee or an external expert to keep track of VAT obligations. On the basis of all these factors, the business sector should insist that...

- **The two VAT rates, 10 percent and 25 percent, be drawn closer together in order to eliminate the current system's price distorting effect.**

- **The two rates be decreased to somewhere between 6 and 10 percent and 15 to 20 percent, respectively.**

- **VAT and social security contribution administration obligations be simplified and made less time-consuming.**

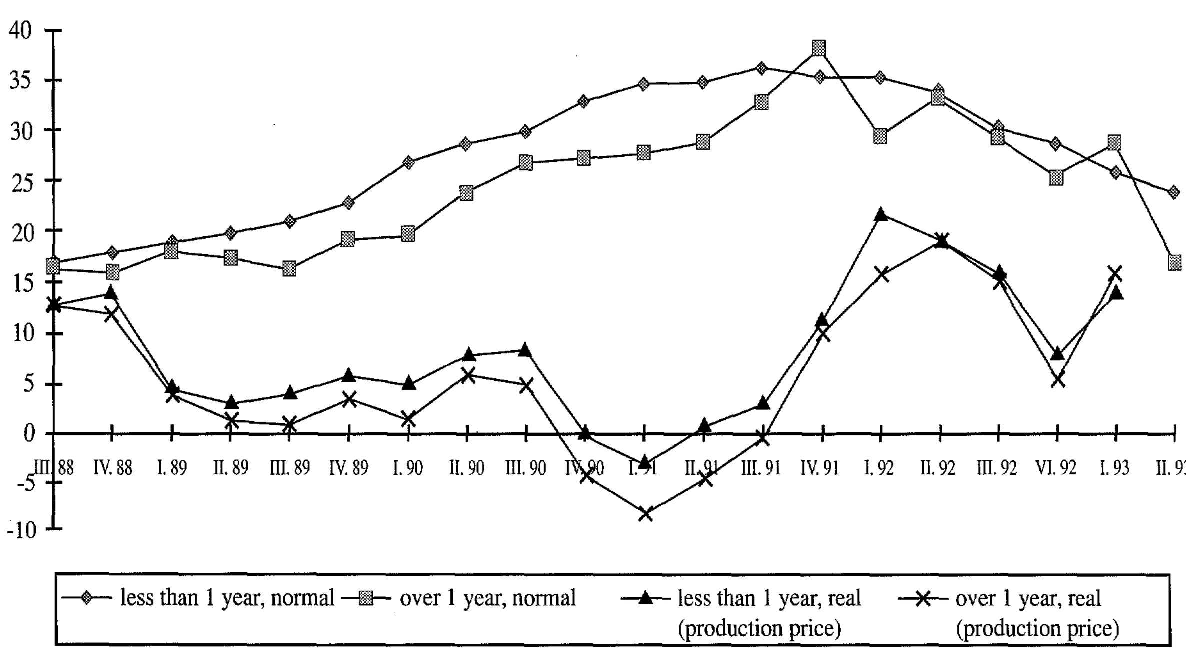
V. ENTERPRISE FINANCING AND THE REAL ESTATE MARKET

In the changing Hungarian economy, the financial sector must, and has yet to, face the new challenge of financing newly established and growing small private enterprises. The current Hungarian financial intermediation system and, within that, the dominant banking system, was established to finance only the large state-owned enterprises and cannot meet the requirements of those small enterprises having less than HUF 2 million capital, less than HUF 50 million in sales and less than 10 employees. This profile describes three-quarters of Hungarian enterprises.

Entrepreneurs consider one of their main problems to be the difficulty in obtaining capital and loans. For Hungarian enterprises the average proportion of external liabilities is only 40 percent, compared to the 50 to 70 percent registered in developed European countries. And, within that, bank loans represent an especially low proportion, 11 percent (in small companies with sales of less than HUF 50 million, bank loans form only 5 percent of liabilities). This situation continues despite the pressure brought to bear on the state banks by the private sector. Entrepreneurs must have improved access to credit due to the lack of other opportunities for obtaining capital.

Figure No.3

Interest on Bank Loans to Entrepreneurs



But by taking capital supplementing loans, entrepreneurs may fall into a debt trap where they would be able to meet the high debt service requirements only by taking on new loans, forcing banks into a more restrictive lending policy and the application of higher interest rates which would further reduce an entrepreneur's chances in obtaining a loan. There is a large number of small entrepreneurs who do not wish to take bank loans either because of the high interest rates or because they do not feel confident enough to fill in a loan application. All interested parties, entrepreneurs associations, the banks, and even the Government must cooperate in solving the financing problems of small and medium-sized enterprises, but...

o Action must be initiated by the Government.

Currently, domestic banks extend loans to entrepreneurs almost exclusively from their medium- and long-term liabilities. During the last few years many enterprise supporting lending funds were created with preferential interest rates and maturities for the primary purposes of restructuring and reorganization: lending funds financed by the World Bank and PHARE, to promote privatization; Existence Loans, or E-loans, provided to an investor in order to purchase shares in a state-owned company; Employee Stock Ownership Plan (ESOP) loans to enable employees to buy shares in their employer's company; and, loans to support starting enterprises, e.g. German and Japanese Start loans and Small Enterprise Promotion loans for import/export development. These preferential funds offer 25 to 30 billion HUF in loans per year, but only half of the available amounts have been accessed to date. The utilization of these credit lines is made difficult because the funds are only available under very strict conditions; connected with sectors or markets specified by the foreign lender, require a very long, bureaucratic and complicated assessment of creditworthiness, and the minimum amount is set too high as compared to the size and needs of small enterprises.

The attitude of the banks themselves towards these instruments is somewhat contradictory, even though the risk for the banks is relatively low. On the one hand, there is pressure from the Government as guarantor to make good loans and, on the other, there is heavy political and social pressure to make loans, period. Similarly, although the banks stand to gain new customers with such transactions, they are as yet unprepared to serve a large number of small entrepreneurs. Standard classification procedures to safely assess the business plans of enterprises, which have little or no bankable history, are missing and the limited interest margin that they can charge does not correspond with the work and risks involved in the assessment of these types of loans. Banks consider the E-loans as being especially risky and think that with these loans the Government forces them to make owner's decisions which do not fall within what they consider to be classical financial institution activities.

Loan assessment is made even more difficult because the exchange of information between banks is not satisfactory, due in part to the "banking secrets" provisions of the Banking Act, and because the majority of entrepreneurs have only very limited or minimum business skills. In order to reduce risks, banks try to increase the amount of funds risked by the borrower to a level above the minimum requirement set out in the preferential loan instrument. But these attempts usually fail. Other barriers to successful intermediation are, one, the presumably temporary weak status of the economy and, two, Government policy-making, which is so unreliable as to make it almost impossible to prepare long-term business plans.

The above contradictions only worsen the usual difficulties faced by commercial banks in the financing of high-risk small enterprises.

Table No.3

Conditions of Long-term Loan Instruments to Enterprises.

Loan Type	Amount Available	Leveraging Required	Maximum Term (years grace period)	Interest + Interest Margin %	Amount Available Used by Sept.1993 in Billions of HUF
Existence (E-Loan)	No pre-set amt.	2% up to 5m HUF	15 (3)	3	14.6
Employee Stock Owner-ship Plan	No pre-set amt.	2% up to 5m HUF	10 (2)	3+4	6.8
German Start	100m DEM	10%	15 (0)	16.5 + 4.0	10.1
Japanese Start	13bn JPY + 10bn HUF	10-30%	Not specified	16.6 + 2.0	1.1 + 3.6
Agricult. reorg.	No pre-set amt.	N/A	7 (0)	70% interest subsidy	1.0
Agricult. export	100m USD + 50% MNB match	N/A	10 (5)	Not specified	6.0
Industrial restructuring	140m USD	N/A	10 (5)	Not specified	1.5
Agricultural modernization	70m USD	N/A	10 (5)	Not specified	0.0
Product market development	100m USD + 20% MNB match	N/A	10 (5)	Not specified	0.35 + 0.13
EBRD SME dev.	150m ECU	50%	10 (0)	22 + market margin	0.3
Export promotion	No set amt.	30%	Not specified	Not specified	10

- **As most important pre-conditions to the success of the Hungarian economic transition, efficient money and loan markets must be established and developed and the banking system must begin operations based on market principles. Banks, however, must not be forced into involuntarily taking on activities which do not fall within their portfolio.**

Forced small enterprise intermediation not only places unwanted tasks on banks, causing institutional resentment, it also results in dissatisfaction on the part of enterprises. For some time, entrepreneurs had little or no access to information about World Bank and other similar foreign credit lines as there were no appropriate information channels. In addition to having collateral, loan source information is essential to an enterprise seeking credit. This dearth of information is the main reason that until autumn 1993, of the approximately 20,000 entrepreneurs applying for microloans through the Hungarian Business Development Foundation, for Start Loans or E-loans, less than half actually received a loan. Of those receiving loans, however, many obtained several.

The collateral required by the various preferential loan instruments, e.g., fixed assets or lease rights, are not always acceptable to the banks and interest margins are usually insufficient to justify the risk. The banks collateral requirements are therefore prohibitively high, 150 to 200 percent, which the majority of entrepreneurs cannot meet. The establishment of Credit Guarantee Ltd. can only ease the problem very slightly.

From their own funds the banks extend only short-term loans, and very few of these, secured by the maximum value of assets and sales revenues of the enterprises, making it almost impossible to take advantage of a favorable business opportunity requiring a loan. The contradiction between entrepreneurs' demand and current banking practices seems almost impossible to resolve. If the state-owned banks continue to apply overly restrictive lending policies, the development of enterprises will be severely hindered. But because of the soft financial position of the state banking system, the implementation of viable risk management strategies has proved difficult.

The solution to this conflict should be sought outside the banking system. Since the majority of private enterprises were not created as a result of organic market development but as a result of the attempts to change the system quickly, the current regulatory system places artificial restrictions on re-investment. Therefore, the financing difficulties being experienced by private enterprises will only be eased if:

- **The Government introduces a tax system which does not prevent entrepreneurs from accumulating capital.**

- **In this vein, the Government pursues a more aggressive anti-inflation policy and provides a tax allowance for investment from the corporate tax base, a personal income tax allowance for investments into one's own enterprise, and an exemption for several years of up to 35 percent of the income of a small enterprise.**

- **A mutual assistance system is formed for the prevention of bankruptcies which provides loans under special conditions and in compliance with the rules jointly formed by the Government and the chambers of commerce, and also provides free consultation to entrepreneurs who face difficulties due to outstanding debts.**

- **Venture capital companies, following the successful example in some Asian countries, and regional or sectoral investment companies are formed to invest into small enterprises and companies established with state funds.**

These recommendations do not suggest that the banking system should or may be excluded completely from financing small enterprises. However, the banking sector can only comply with the requirements if:

- **Only the best performing banks are involved in the preferential lending projects.**

- **As in the case of preferential loans, a clearly defined risk sharing agreement is concluded between the banks and Government.**

- **The Government influences the interest rates on preferential loans only through subsidies and risk sharing agreements.**

With active cooperation and intense involvement among the Government, the financial sector, and organizations representing the interests of the business community, new institutions must be created to improve financing opportunities for enterprises, to wit:

- **Credit associations for entrepreneurs.**

- **Non-profit guarantee funds and mutual insurance funds to take over the role of the Government guarantee funds as soon as possible.**

- **Company information and loan recording systems.**

It is obvious that a significant obstacle to co-operation between entrepreneurs and financial institutions is the problem of collateral. Generally, the banks will not finance even splendid business ideas without a great deal of acceptable collateral and will not consider increasing their risk exposure even if offered first class real estate as collateral. In Hungary, this behavior is logical under present conditions since mortgage finance practice is still at an underdeveloped stage and much of the real estate to be pledged as collateral may not yet be considered liquid. If the borrower defaults, the collection of a debt is not assured even if it is secured with a mortgage.

The banks are not interested in enforcing their mortgage rights mainly because a foreclosure procedure can take three to four years to complete. As a result of compensation and privatization, the land registry offices have to deal with such a high number of cases and volume of data that, at least in Budapest, the registration of real estate may take as long as one or two years. Theoretically speaking, a mortgage holder could find himself in the untenable position of having to initiate foreclosure before registration is complete.

Foreclosure may only take place through court execution and decision. Due to the burden on the courts, it often takes up to two years to obtain a decision. Once the decision is delivered and an auction is ordered, the final price may not be lower than the loan amount outstanding despite a reliable property valuation to the contrary. It would be of no consequence to the court that the property would be unsalable at that price.

Consequently, in order to promote the enforcement of mortgage rights and to increase the banks' willingness to make loans:

- **A uniform system must be established for defining mortgage rights which includes not only real estate, but also such items as machinery and rental rights.**

- **In order to boost the market for and turnover of land, a new system of land valuation and land registration must be developed and adhered to. An inevitable prerequisite for a workable mortgage finance system is the establishment of an up-to-date, legitimate land registry procedure.**

- **A greater role must be given to the enforcement of mortgage rights outside of Court execution.**

Mortgage finance has a special role in agriculture because at the moment the lack of capital is the greatest problem hindering agricultural development. Agricultural finance is primarily hamstrung by primitive mortgage legislation and the lack of institutional conditions in the economy. Presently, there is no comprehensive regulatory scheme for the issue for mortgage bonds or providing for which records must be entered on the property registration sheets. Certain features of lending transactions, i.e., return, maturity, and risk, would require a separate structure for agricultural mortgage finance. The lack of modern land valuation standards hinders the comparison of lands of differing quality and, therefore, the secondary trade of mortgage bonds.

The changes in the ownership structure which occurred due to compensation do not favor the formation of a viable mortgage loan system. Also, as a consequence of the transformation of the state farms and cooperatives and the compensation program, large agricultural properties are being broken up into small plots. In many cases, ownership and usage is separated, reducing agricultural capacity by taking land out of production, as only 10 to 20 percent of the new owners of these smaller plots actually intend to cultivate the land.

The development of a commercially viable mortgage finance system for the agricultural sector requires, among other things:

- **The establishment of a national network of mortgage loan and land loan financial institutions having the overriding mandate to serve the needs of the entire agricultural community.**

- **The establishment of a stable funding source, whether public or private, for such a land credit institution.**

- **The amendment of the Securities Act to include provisions regulating the issuance of mortgage bonds and the establishment of the security status of these bonds and, further, regulating the registration of these bonds at the appropriate registration office.**

- **The introduction and application of modern land valuation standards which take into account the yield and profit potential of the land for inclusion in the land registration system.**

- **Amending Real Estate Registration Act 31, 1992, to provide for the inclusion of rental rights in the property registration system.**

Outside the agricultural sector, the domestic real estate market has reflected three new phenomena in the last few years. Namely, the appearance of property investment funds, the sale of retail outlets through a process called "pre-privatization", and housing privatization. It should be expected that property investment funds will contribute to the reduction of risk in the real estate market, but any favorable impact will be offset by existing regulatory problems.

- **The Act on Investment Funds should generally be made more clear and the responsibility of fund managers should be further defined.**

Pre-privatization is the name given to the process whereby the state gives a first option to a small "storefront" retail operation to buy the state-owned premises out of which it has been operating. Those who exercised that option in hopes of becoming totally private entrepreneurs, have found that they have not acquired true ownership rights, but only the lease rights and without clarification of whether they are to be considered the legal successor of the former tenant or not. However, surveys indicate that despite these uncertainties, a significant number of entrepreneurs involved in pre-privatization were able to obtain loans.

Mortgage finance will also be indispensable in the privatization of housing as well, but the operation of the market will be restricted by the maintenance of controlled rents. Similarly, further problems may be caused if the Housing Act does not clearly define what is and what is not public space in the multi-flat buildings owned and being privatized by the local governments. Loans will definitely be required for the modernization of privatized flats but it is a concern that the banking network is not prepared to perform timely assessments of large numbers of loan applications.

VI. THE INFORMAL SECTOR

In transition economies, increased support to the private sector, especially small enterprises, is necessary because of one special consideration: To stop the growth of the informal sector, or as it is generically referred to, the black market, and to begin reducing its size as soon and as much as possible.

In our post-socialist society, the inclination for informal sector growth is especially strong as this sector's roots go back to the days of the centrally planned economy. By eliminating the performance principle, through shortages, and the establishment of income limits, the erstwhile socialist regime encouraged its citizens to seek their fortunes outside the legal economy or, as it was called in those days, in the second economy. Maintenance of this behavior through the transition period following the change in the system has been encouraged by new motivations such as the changing distribution and wage systems. This has in turn generated a great deal of strong social tension and corruption, inevitable companion attributes to privatization. Privatization itself often becomes a method of informal capital accumulation. It is no wonder that people struggling with inflation on fixed incomes or on the unemployment rolls feel like the "losers" when faced with the "successful" examples of their neighbors who appear to be doing quite well by cheating the system. It is no wonder then that as the line between what is right and what is wrong begins to blur, the idea of joining the informal sector becomes more acceptable. The unclear legal and institutional environment, in which old and new regulations are mixed up and often cancel each other out and where loopholes in legislation are common, only helps the spread of the informal sector.

Due to the hidden character of the phenomenon, attempts to define the size of the informal sector would be prohibitively complicated and any result would be unreliable. However, by comparing the findings of several methods used by domestic experts, the estimated size of the Hungarian informal sector at the beginning of the 1990s represented somewhere between 25 to 30 percent of GDP. These figures do not include income from informal privatization. Most certainly, the informal sector has only increased in size since then.

While a portion of untaxed income is attributable to individuals working outside of legal purview, the major portion is generated via legal enterprises duly incorporated under the Company Act. Consequently, the reduction of the informal sector will only take place if the Government makes it desirable, advantageous and easy for wholly informal enterprises to make their activities legal and removes the disincentives for legal growth of already existing enterprises. Prohibition through the exercise of police power may fail or lead to a totally opposite effect.

- **The authorities must make a clear distinction between crimes against property and activities aimed at avoiding taxes on the basis of supply, social safety considerations and common law.**

Currently in Hungary, as compared to international norms, the difficulties encountered in founding an enterprise are about average. While it is much easier to establish a company here than in most other developing countries, it is certainly a much more complicated procedure than in the United States. Empirical experience shows that every fourth person who turns to a solicitor with the intention of founding an enterprise steps back from their plan as soon as they learn exactly the size of the burden they would have to take on. Before a simple, individual enterprise may be launched, five to seven different offices and institutions must be visited: The Ministry of the Interior; the local government offices; a special shop selling official forms and documents; the tax authority; the Social Security office; a bank, and the Court of Registration. Administration costs run into thousands of forints and the procedure for preparing the documents necessary for filing with the court takes about one week. If the enterprise is a bit more complicated, if, for example, a contribution in kind is involved, administration requirements, costs and time are multiplied. The situation becomes even more complicated if an enterprise is being founded in order to effect a privatization, since in such cases the State Property Agency (SPA) and the consultation firm assigned by the SPA must also enter the process.

Table No.4

Barriers to Enterprise Establishment According to Entrepreneurs (as a percentage of the 160 interviewees responding)

Bureaucratic procedures	80
Social security obligations	70
Administrative paperwork	25
Accounting regulations	20
Workplace safety regulations	5
Site selection regulations	5
Product quality regulations	5
Product purity regulations	2
Environmental regulations	2

In order to simultaneously protect consumers and promote the business climate, there must be regulations related to the foundation of companies. So the main issue is not necessarily the quantity, but the quality of the rules and the practical, entrepreneur-friendly operation of the institutional system.

- **The regulations related to the foundation of companies must be made more transparent and simplified to in order to maximize incentives for legal enterprise operation.**

- **"All in one", one-stop offices must be created where representatives of all the applicable agencies and authorities, together with a representative of a bank, are housed under one roof so that a candidate may establish a company with minimal effort.**

However, it is tax rates, rather than bureaucratic barriers, that deters most of those who are willing to found and register a company. Uncontradicted research proves that many legally registered companies perform at least part of their activities informally as a hedge against increasing tax liabilities. An analysis of the period between 1989 and 1993 indicates that the extension of legal opportunities for tax reduction reached a peak in 1991. That year was extraordinarily favorable for individual entrepreneurs just starting out and Hungarian-owned companies in general. Since 1992, tax liabilities on new and expanding enterprises have increased considerably; tax allowances on investments into the fixed assets of the enterprise or into business quotas in limited liability companies, for example, are no longer available.

Table No.5

Entrepreneurs' Opinions on the Tax System (as a percentage of interviewees)

	Fully agree	Slightly agree	Do not agree at all	Do not know
The tax system is generally too burdensome on entrepreneurs	80	15	4	1
Regulations change so frequently they are almost impossible to follow	64	26	8	2
A serious company should not risk playing about with the law	54	26	17	3
The tax system forces entrepreneurs to play about with the law	49	34	15	2
Really shrewd entrepreneurs always find ways to avoid the law	44	35	18	3
The majority of entrepreneurs avoid tax laws	37	35	16	12
Due to too detailed regulations, it is easy to find a loophole	20	43	29	8
In such a difficult economic time, it is natural that the Government takes as much as it can from entrepreneurs.	16	17	66	1

By international comparison, tax liabilities are too high and are the primary driving force behind the growth of the informal sector, which in turn regularly results in shortfalls in projected corporate tax revenues. Hungary has reached the point where...

- **All further tax increases, personal and corporate, will only give further impetus to the growth of the informal sector.**

The trap presented by this situation can only be overcome with very consistent policies. The most important elements of such policies involve...

- **Avoidance of further tax increases.**
- **Heightened regulatory control over state reallocation of tax revenues and contributions.**
- **Reducing expenditures through budgetary reform.**
- **Reducing tax liabilities through the widest possible introduction and application of regulations having the intent and objective of developing enterprise growth.**

VII. CONCLUSION

Inevitably and necessarily, there must be a nexus, a point where the paths to privatization and to private sector growth cross; at times these paths will closely parallel one another and at other times they will diverge completely. There are issues to be resolved, however, along the entire lengths of both paths. And as these paths cross, parallel, and diverge from one another, policy makers must also puzzle out necessarily interrelated conundrums such as how to reconcile tax revenue with social spending and how to withdraw the state from the marketplace without throwing too many people out of work or into the informal sector.

This publication does not pretend to be an all inclusive listing of all the cures for all the ills either currently or potentially facing private sector growth in Hungary. Hopefully, though, there can be found within these pages ideas that will serve to either smooth or straighten the road that Hungary must travel during this historic period of transformation.

Please let us know what you think of the recommendations you have just read. Any questions and comments can be directed to either address listed on the back inside cover, but preferably to the CIPE-Budapest office.

Lastly, as stated in the introduction, this document signals the beginning of the second phase of the Legal & Regulatory Reform in Hungary Project. During this phase, CIPE will concentrate on assisting all the participating organizations and individuals in getting the messages prepared by the Grantees out into public debate. Between now and the national conference in September, a book containing the complete studies upon which the above is based will be published. Also, representatives from the CIPE Speakers Bureau will travel throughout Hungary to address the memberships of the various business organizations involved in this Project.

The Center for International Private Enterprise (CIPE) is an affiliate of the U.S. Chamber of Commerce that promotes private enterprise and market-oriented reform worldwide through initiatives such as the ***Legal & Regulatory Reform in Hungary Project.*** This Project, and many others CIPE is conducting throughout Central and Eastern Europe, is principally funded by the United States Agency for International Development (USAID).

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William S. Kanaga, *Chairman*
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John D. Sullivan, *Executive Director*
Steven B. Rogers, *Deputy Director*

David Lange, *Program Officer*

1615 H Street N.W.
Washington, D.C., 20062
Tel. (1-202) 463-5901
Fax (1-202) 887-3447
Telex 277559 CIPE UR

CIPE-BUDAPEST

Eric L. Johnson, *Director*
Erika Simó, *Program Manager*
Irina Kurányi, *Office Manager*

Eugene A. Spiro, *Progam Advisor*

Eötvös Street 44. 1/Groundfloor.
Budapest, Hungary 1067
Tel. (361) 269-5654
(361) 132-1353
Fax (361) 112-1470