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Economic Transition and U.S. Assistance

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The Honorable Claiborne Pell
Chairman, Committee on Foreign Relations
United States Senate

The Honorable Dante B. Fascell
Chairman, Committee on Foreign Affairs
House of Representatives

The Honorable Patrick J. Leahy
Chairman, Subcommittee on Foreign Operations
Committee on Appropriations
United States Senate

The Honorable David R. Obey
Chairman, Subcommittee on Foreign Operations,
Export Financing, and Related Programs
Committee on Appropriations
House of Representatives

This report, the third in a series on assistance to Central and Eastern Europe, provides the results of our review of economic conditions in Poland and Hungary and the effectiveness of U.S. assistance to these countries. This report contains recommendations to the Secretary of State for restructuring the aid program. Although we have not yet begun our reviews of assistance to other Central and East European countries, or the proposed assistance to the republics of the Commonwealth of Independent States, we believe the recommendations in this report may also have application for those programs.

We are sending copies of this report to the Secretary of State; the Secretary of the Treasury; the Secretary of Commerce; the Administrator, Agency for International Development; the Director, Office of Management and Budget; and interested congressional committees. Copies will also be made available to others on request.

This report was prepared under the direction of Harold J. Johnson, Director, Foreign Economic Assistance Issues, who may be reached on (202) 275-5790. Other major contributors to this report are listed in appendix V.

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Executive Summary

Purpose

Since the communist parties of Poland and Hungary relinquished power in 1989, these countries have been making the transition to democracies and market-based economies, relying extensively on foreign aid. Although the United States now has assistance programs in 10 Central and East European countries, most of the assistance has been directed to Poland and Hungary. GAO's objectives in examining the effectiveness of the U.S. aid program in these countries were to (1) present information on the economic problems facing Poland and Hungary in the context of their reform efforts and (2) determine whether the U.S. program is designed to effectively assist Poland's and Hungary's reform efforts.

Background

As of June 1991, the industrial countries and multilateral organizations had pledged about $45 billion in aid to Central and Eastern Europe. The United States made available about $665 million for assistance in fiscal year 1990. The Agency for International Development's (AID) program for fiscal year 1991 amounted to about $309 million, including $1.6 million in 1990 funds, but excluding $100.8 million planned for obligation in fiscal year 1992. The principle underlying U.S. assistance is the promotion of democracy and free market economies. The Department of State is responsible for coordinating the assistance efforts, in which numerous U.S. departments and agencies are involved.

Results in Brief

In response to the rapidly changing political and economic conditions in Poland and Hungary, the United States developed a short-term, experimental economic assistance approach based on assumptions that (1) assistance would be required for only a 5-year transitional period; (2) regional rather than country-specific allocations of funds would enhance program flexibility; and (3) program planning, implementation, and management authority would be retained in Washington, D.C., rather than delegated to U.S. personnel in-country.

The U.S. approach to managing the assistance program for Poland and Hungary was appropriate during the program's early phase; however, as circumstances have changed and more has become known of the economic problems facing Poland and Hungary in their transformation processes, some assumptions upon which the United States based its assistance approach have proven unrealistic. The U.S. approach now hinders the host countries' planning for and prioritizing of assistance, limits the flow of information between the United States and the host countries, and complicates and may hamper management of the program.

Principal Findings

Economic Conditions Have Deteriorated

Poland and Hungary, while beginning the reform process at different levels of development, have both undertaken essential economic stabilization efforts. These include tightening fiscal and monetary policies, devaluing currency, and reducing the growth of debt. However, the short-term costs of these reforms have been high. For example, Poland's real gross domestic product fell 11.6 percent in 1990 and is estimated to have declined an additional 8 percent in 1991. Hungary's real gross domestic product declined 4 percent in 1990 and an estimated 8 percent in 1991. Declines in economic output and increased unemployment were anticipated as the short-term consequence of the reform measures that were undertaken, but the declines in output and increases in unemployment, particularly in Poland, exceeded early estimates.

External economic shocks compounded Poland's and Hungary's economic problems. In particular, trade among the Central and East European countries and with the former Soviet Union fell sharply when the Soviets set the prices of exports at world market prices and required payments in hard currency. The simultaneous economic and political transition also has been complicated by strikes, interest-group pressures, and the generally unrealistic expectations of the Polish and Hungarian peoples. The pace of reforms has consequently been hampered. Moreover, foreign trade and investment, considered key factors for restructuring and revitalizing the Polish and Hungarian economies, have not met the expectations of donors or the host countries.

Early U.S. Efforts Were Beneficial, but Program Organization Impedes Effectiveness

The United States has taken the lead in many key efforts that were critically important to Poland's and Hungary's reform efforts. For example, the United States mobilized $1 billion from the international community for a stabilization fund to bolster Polish foreign exchange reserves, and it took the lead in Poland's debt reduction. Further, unlike most donor countries, the United States has contributed most of its assistance through grants rather than debt-creating loans and credits.

Despite the benefits of these initial efforts, the effectiveness of future U.S. assistance could be impeded because the program has not been adjusted to reflect the changes in Poland's and Hungary's economic and political conditions. The U.S. program has been geared to support short-term, transitional needs during a 5-year time frame that officials from the United

States, other donor countries and organizations, and Poland and Hungary now characterize as unrealistic. For example, although the U.S. program centers on the rapid privatization of these countries' state-dominated economies, progress has been slower than hoped. Numerous joint ventures have been registered in both countries, but only 5 of Poland's 7,500 state-owned firms were privatized in 1991. Hungary has sold many of its 10,000 state-owned shops and restaurants, but as of May 1991 it had sold only 2 of the 20 most attractive large enterprises put up for sale in September 1990.

The U.S. regional approach to allocating funds in Central and Eastern Europe was initially effective in allowing the United States to easily shift resources among countries in response to evolving regional events, and encouraging countries to institute reforms quickly. The regional approach is still appropriate for sectors with regional importance, such as environmental matters, but Polish and Hungarian officials said that in other areas this approach inhibits their ability to plan their programs, contributing to the problems they have in managing the foreign assistance they are receiving. They said that they cannot rank their assistance requests in priority order without knowing more specifically the amount of resources that are likely to be available. They also said that, although they did not want some particular U.S. projects, they have accepted them for fear of otherwise losing the funding to other countries.

The decision by the State Department to retain management authority and responsibility for the aid program in Washington rather than delegate it to in-country missions—as is the normal AID practice—has created some management problems, both for the United States and recipient countries. For example, recipient countries have had difficulty coordinating among their own ministries and with other donors, and on the U.S. side, Washington-based managers have not always consulted with U.S. personnel in-country on project decisions. Coordination with recipient countries and among U.S. agencies involved in assistance efforts has sometimes been poor, and the ability of U.S. officials to monitor host country conditions and the status of the program has been somewhat limited.

Recommendations

GAO recommends that the Secretary of State, in consultation with other administration officials, direct that (1) the U.S. assistance program be restructured to recognize the longer-term needs of Poland and Hungary and (2) country-specific funding targets be set so that aid recipients can better plan for and prioritize their needs. In order to continue encouraging the efficient use of funds, the United States should ensure that the funding targets are not seen by recipient governments as firm funding commitments by the United States, and the targets should not include sectors such as the environment where needs are of a more regional nature.

Agency Comments and GAO's Evaluation

In commenting on a draft of this report, the Departments of State and the Treasury and AID agreed with GAO's recommendation that the U.S. program should be restructured to recognize the longer-term needs of Poland and Hungary, but the agencies disagreed with the other draft report recommendations that specific country funding allocations be made and that AID missions be established in each country. The agencies said that the allocation of funds on a regional basis permits moving funds among countries for the most effective impact and that allocations on a country-specific basis would inhibit reallocations. GAO agrees that funding flexibility can be a useful management tool, and points out that AID already has this flexibility in both its regional and country-specific programs. GAO has, however, modified its recommendation to call for country-specific funding targets rather than allocations. These targets would not be firm funding commitments and would allow sufficient flexibility.

The agencies said that GAO's recommendation that AID missions be established implied "full-sized, traditional" missions which would be costly and inappropriate. Further, the agencies said that GAO's in-country fieldwork was performed at a time when the U.S. in-country presence was insufficient. GAO did not mean to imply that large, costly missions be established, but was concerned that millions of dollars in assistance were being provided with a very minimal U.S. presence to coordinate and oversee the assistance. Since GAO's fieldwork was completed, progress has been made to more adequately staff the AID offices in both Poland and Hungary, as well as the Regional Mission for Europe in Washington. In view of these developments, GAO has dropped its recommendation that management authority be delegated to AID missions in each country, but GAO believes the workability of this new experimental approach should be closely monitored, and modified if necessary.

Contents

Abbreviations

AID	Agency for International Development
CMEA	Council for Mutual Economic Assistance
EC	European Community
G-24	Group of Twenty-Four
GAO	General Accounting Office
GDP	gross domestic product
IMF	International Monetary Fund
OECD	Organization for Economic Cooperation and Development
SEED	Support for East European Democracy

Introduction

The momentous changes in Central and Eastern Europe[1] during the last 2 years, as the ruling communist parties were forced to share and then relinquish power in one country after another, have created new opportunities and additional responsibilities for the United States and its allies who have responded with wide-ranging assistance packages. In making the transition from communist dictatorships to pluralistic democracies and from centrally planned to market-based economies, the Central and East European countries face an array of problems, including the need to restore or maintain political and social stability while simultaneously stabilizing and structurally transforming their economies. Because such transformations have never before occurred, there was no model for the Central and East European governments to follow in their reform efforts, or for donor countries and organizations to follow in developing their programs.

International Assistance Efforts

In July 1989, the major industrial countries agreed to provide assistance to Central and Eastern Europe and designated the European Community (EC)[2] Commission, the EC's executive arm, as coordinator of the Group of 24 (G-24)[3] countries' assistance efforts. In this capacity, the EC Commission acted as a clearinghouse for information on G-24 bilateral assistance to the region, but it did not coordinate donors' programs in the sense of harmonizing or rationalizing programs to ensure consistency of purpose and identify gaps in assistance efforts. As of June 1991, the G-24 countries and the EC had committed approximately $32 billion in bilateral assistance to Central and Eastern Europe, as shown in table 1.1. These commitments consisted of emergency, humanitarian, and economic transformation assistance, as well as export credits and investment guaranties.

[1]The term "Central and Eastern Europe" refers to Bulgaria, the Czech and Slovak Federal Republic, Hungary, Poland, Romania, and Yugoslavia.

[2]The 12 members of the EC are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

[3]The G-24 is composed of Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Table 1.1: Bilateral Donor Commitments to Central and Eastern Europe (as of June 1991)

Dollars in billions

Donor	Commitment	Percentage of total
EC Commission	$4.5	14
Germany	9.9	31
France	1.6	5
Italy	1.2	4
United Kingdom	0.8	3
Other EC members	5.4	17
Japan	2.7	9
United States	2.5	8
Others	3.4	11
Total	**$32.1[a]**	**100[a]**

[a]Figures may not add due to rounding.

Notes: Assistance figures for EC members represent the countries' bilateral assistance and do not include assistance through the EC.

These commitments represent assistance to the Czech and Slovak Federal Republic, Bulgaria, Romania, and Yugoslavia, as well as to Hungary and Poland. Data on bilateral commitments do not differentiate between the recipients.

These are the most current EC data available on all donors.

See table 3.1 in chapter 3 for a breakout of bilateral loans/credits and grants.

Source: EC Commission.

In addition to bilateral efforts, donor countries are also providing assistance multilaterally through the Organization for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF), the World Bank, and the newly created European Bank for Reconstruction and Development. As of June 1991, international institutions had committed $12.8 billion to Central and East European countries.

U.S. Assistance Program

On November 28, 1989, the President signed the Support for East European Democracy (SEED) Act of 1989 (P.L. 101-179), which authorized an assistance program for Central and Eastern Europe for fiscal years 1990 through 1992. Poland and Hungary were specifically designated for initial assistance because they took the lead in the transformation from communism to democracy and market-oriented economies. The United States made available about $665 million for assistance in fiscal year 1990. The Agency for International Development (AID) program for fiscal year 1991 amounted to about $309 million, which included $1.6 million in funds carried over from the previous year and excluded $100.8 million in funds planned for obligation in fiscal year 1992.

The five principal elements of SEED are (1) structural adjustment assistance to support economic reforms; (2) private sector development through loans, grants, guaranties, equity investments, technical assistance, and training for the local private sectors; (3) trade and investment programs to encourage U.S. private sector investment; (4) educational, cultural, and scientific activities, and support for the development of political democracy and economic pluralism; and (5) other programs such as those promoting the environment, health, and democratic institutions.

The basic principle underlying U.S. assistance to Central and East European countries is the promotion of democracy and free market systems. More specifically, the administration set forth four benchmarks upon which U.S. assistance would proceed: (1) progress toward political pluralism, (2) progress toward economic reform, (3) enhanced respect for human rights, and (4) friendly relations with the United States.

The President designated the Deputy Secretary of State as the coordinator of U.S. assistance, initially assisted by a deputy coordinator from the Department of the Treasury and one from the Council of Economic Advisers. Later, in response to congressional concerns about the U.S. program, the Administrator of AID was added as a third deputy coordinator. The coordinators' role is to ensure that U.S. assistance efforts are "complementary and synergistic" to U.S. trade, economic policy, and political and security interests and are coordinated with those of other bilateral donors and multilateral organizations. An interagency coordinating council was established under the Department of State and composed of representatives of all U.S. government agencies providing assistance to Central and Eastern Europe. The State Department established "cluster groups" within the council to analyze issues and develop consensus on policy direction and strategy. The groups include a macroeconomic policy group and a financial sector technical assistance group, chaired by the Department of the Treasury; a technical assistance business group, chaired by the Department of Commerce; a social dimensions group focused on labor transition and quality of life issues, chaired by the Department of Labor; an energy and environmental group, chaired by the State Department; and a project coordination group, chaired by AID. AID is the principal agency for delivering U.S. foreign assistance.

In reviewing specific activities for U.S. funding, the coordinating council used the following criteria: (1) assistance should be concentrated in areas where the United States had a comparative advantage; (2) assistance should emphasize projects that were practical, could start up quickly, could have an immediate impact, or could serve as demonstration projects; (3) assistance should be directed toward existing host country institutions where possible to avoid the costly and time-consuming process of establishing new institutions; and (4) assistance efforts should be coordinated with those of other donors.

Objectives, Scope, and Methodology

This report is our third in a series on economic assistance to Central and Eastern Europe. Our first report examined donor assistance to the region and host country reform efforts.[4] The second report provided information on the administration's implementation of the SEED Act and related efforts to provide economic assistance to Central and East European countries.[5]

This report focuses on Poland and Hungary since they have received the largest share of U.S. assistance and are the furthest along in the transition process. Our objectives were to (1) present information on the economic problems facing Poland and Hungary in the context of their reform efforts and (2) determine whether the U.S. program is designed to effectively assist Poland's and Hungary's reform efforts.

We met with officials of the principal U.S. agencies with assistance programs in Poland and Hungary. We also met with officials at the U.S. missions to the EC in Brussels and the OECD in Paris and with the EC and the OECD officials. In Budapest and Warsaw, we met with U.S. embassy officials; AID representatives; United Nations officials; and officials of the British, French, German, Italian, and Japanese embassies. We also met with officials in the Polish and Hungarian governments, representatives of the EC, IMF, World Bank, Polish-American Enterprise Fund, and Hungarian-American Enterprise Fund.

It was not possible to verify economic data for either Poland or Hungary. However, we identified the most reliable data available. We reviewed pertinent U.S., host, and donor-government documents, as well as reports

[4] Eastern Europe: Donor Assistance and Reform Efforts (GAO/NSIAD-91-21, Nov. 30, 1990).

[5] Eastern Europe: Status of U.S. Assistance Effort (GAO/NSIAD-91-110, Feb. 26, 1991).

and studies by international organizations and private sector groups. We used statistical data and reports of IMF and the World Bank Group. We also used information of PlanEcon, Inc., and the Centrally Planned Economies Service of the WEFA Group, economic consulting groups specializing in Central and Eastern Europe and the Soviet republics, and information from the Bureau of National Affairs, Inc., a publishing and information company. We attended a conference in Prague on business and investment opportunities in Central and Eastern Europe, sponsored by PlanEcon, DRI/McGraw-Hill, and the Ministry of Industry of the Czech Republic.

We performed our review from March through November 1991 in accordance with generally accepted government auditing standards. The Departments of State, the Treasury, and Commerce, and AID provided written comments on a draft of this report. We have updated our report where more current data are available and have incorporated agency comments as appropriate. The agencies' major comments, along with our evaluation of them, are summarized in chapter 3. The full texts of the agencies' comments are reprinted in full in appendixes I through IV. The Office of Management and Budget was invited to comment on this report but did not provide comments.

Economic Transition in Poland and Hungary Is Facing Difficulties

In contrast to the optimism that surrounded the historical events that took place in Poland and Hungary in 1989 and despite the relatively large levels of economic assistance being committed by bilateral and multilateral donors, both countries continue to face severe economic problems. Both countries became democratic within a few months of each other, but they began the transition from centrally planned to free market economies at significantly different levels of development. Nonetheless, economic conditions in both countries have deteriorated as they attempt to address the problems of economic and political reforms. Although Hungary was further along the road to reform before the collapse of communism and, according to the State Department, remains further along than Poland, increases in trade and investment—which are considered essential for economic and social stability and long-range growth—have not occurred at the pace or to the extent generally anticipated in either country.

Economic Conditions Are Deteriorating

The short-term costs of economic stabilization and transformation have been high for Poland and Hungary. The process of economic stabilization has brought with it declines in production and real wages and increases in unemployment. These difficulties have been compounded by external economic shocks, including a breakdown in traditional trading patterns and sharply higher costs for imported energy. In addition, the internal reform process in these countries is taking longer to implement than originally envisioned, further hindering economic improvements.

The transformation approaches that Poland and Hungary have taken differ. For example, Hungary is continuing with a process of gradual transformation, based upon market-oriented reforms that began over 20 years ago. In contrast, Poland is undertaking what is termed "shock treatment," in which it is attempting total transformation within a short period of time.

Economic Stabilization and Transformation Costs Are High

The short-term costs of economic stabilization are high, but stabilization is widely considered to be an essential first step in successful economic reform. Both Poland and Hungary have taken a wide range of actions to encourage stabilization, including tightening fiscal and monetary policies, devaluing currencies, and controlling the growth of debt. The stabilization measures have, on the positive side, decreased inflationary pressures, lowered government expenditures, and improved the balance of payments, but they have also contributed to declines in economic output. Poland's real gross domestic product (GDP) fell 11.6 percent in 1990 and is estimated to have declined an additional 8 percent in 1991. In contrast, when the reform process began, Polish authorities and the IMF had projected that the 1990 decline in real GDP would be about 5 percent, with a projected 3- to 4-percent growth rate for 1991. Similarly, Hungary's real GDP declined 4 percent in 1990 and an estimated 8 percent in 1991, in contrast to earlier World Bank projections that Hungary's real GDP would increase or decrease in 1990 by only 0.5 percent. Bank officials subsequently revised these projections twice, first projecting a decline of 0.3 percent and then a decline of 1.9 percent. Bank officials projected that 1991 real GDP would either increase or decrease by 1 percent.

There were corresponding increases in unemployment, from the full employment policy under communism, to 11.4 percent of the work force in Poland and 8 percent of the work force in Hungary at the end of 1991. In addition, real wages fell in Poland by 28 percent in 1990 and by about 15 percent in 1991. In Hungary, real wages fell by 6.5 percent in 1990 and by an additional 7.4 percent in 1991.

In commenting on this report, the State Department said "the publicly available statistics overstate the extent of [economic decline] because many of the positive changes occurring in the private sector are not yet picked up in the statistics." State noted that thousands of new businesses have been started in Poland and Hungary but the governments' statistical offices are not capturing the businesses' contributions to GDP. State's observation about the undocumented economic activity in these countries may be correct; however, the data we used were those used by the World Bank and IMF in assessing Polish and Hungarian compliance with their stabilization programs. These data are widely accepted as the most reliable available. Using these data, IMF deemed Poland to be out of compliance with the IMF program primarily because its fiscal deficit-to-GDP ratio was too high. The Hungarian government has been periodically revising its statistical data in an attempt to capture private sector data.

External Shocks Compound Economic Problems

In addition to the high costs of stabilization, Poland and Hungary have had to contend with a number of external shocks to their economies. These included (1) the collapse of trade arrangements under the former communist bloc's Council for Mutual Economic Assistance (CMEA),[1]

[1]In 1990, CMEA, also known as Comecom, was composed of the then-Soviet Union, Czechoslovakia, and East Germany, as well as Bulgaria, Hungary, Poland, Romania, Cuba, Mongolia, and Vietnam.

(2) the loss of markets and other consequences of the war in the Persian Gulf, and (3) the loss of low-cost energy imports from the former Soviet Union.

The CMEA trade arrangements broke down when the Soviet authorities decided that prices for goods traded with CMEA members would be set at those of the world market and that payments for such goods would be made in convertible currencies beginning in January 1991. This decision resulted in less favorable terms of trade for countries such as Poland and Hungary that were highly dependent on Soviet oil. It also made Polish and Hungarian goods less competitive on the Soviet market and greatly hampered Soviet enterprises' ability to pay for imported goods. Trade was further reduced when the Soviets decentralized the authority for negotiating bilateral trade arrangements. Shortly thereafter, the Soviet market virtually collapsed as the Soviet Union underwent vast internal political and socioeconomic change and was finally terminated altogether on December 25, 1991.

Tables 2.1 and 2.2 show the decline in the share of exports to CMEA countries from 1988 through September 1991. This decline, beginning before the CMEA trade arrangements broke down, is attributed primarily to the reduction of exports to the Soviet Union, but also to the reclassification of trade with East Germany beginning in July 1990 in anticipation of German reunification, and to increases in exports to the EC.

Table 2.1: Share of Polish Exports to Selected Countries and Regions (1988 to 1991)

Dollars in millions

	1988	1989	1990[a]	(Jan.-Sept.) 1991[a]
Total value of exports	**$13,542**	**$13,098**	**$14,523**	**$11,204**
Country or region				
European Community	30%	31%	36%	42%
Germany, of which				
East Germany	4	4	2	[a]
West Germany	13	14	18	[a]
Subtotal[b]	**18**	**18**	**20**	**23[a]**
United States	3	3	2	2
CMEA, of which				
USSR	25	25	23	22
CSFR[c]		6 6	8	7
Hungary	2	2	2	2
Other CMEA	8	8	6	4
Subtotal[b]	**42**	**42**	**39**	**35**
Other[b]	25	25	23	20
Total	**100%**	**100%**	**100%**	**100%**

[a]Exports to East Germany, which unified with West Germany in October 1990, are included in CMEA trade through June 1990. Its subsequent trade is included with that of West Germany as part of the EC.

[b]Figures may not total due to rounding.

[c]Czech and Slovak Federal Republic.

Source: Compiled from IMF, Direction of Trade computer data.

Table 2.2: Share of Hungarian Exports to Selected Countries and Regions (1988 to 1991)

Dollars in millions

	1988	1989	1990[a]	(Jan.-Sept.) 1991[a]
Total value of exports	**$9,944**	**$9,674**	**$9,549**	**$7,175**
Country or region				
European Community	23%	25%	32%	40%
Germany, of which				
East Germany	5	5	3	a
West Germany	11	12	17	a
Subtotal[b]	**16**	**17**	**20**	**22[a]**
United States	3	3	4	4
CMEA, of which				
USSR	28	25	20	20
CSFR[c]	5	5	4	4
Poland	3	3	2	1
Other CMEA	9	8	6	2
Subtotal[b]	**45**	**41**	**32**	**26**
Other[b]	29	31	32	30
Total	**100%**	**100%**	**100%**	**100%**

[a]Exports to East Germany, which unified with West Germany in October 1990, are included in CMEA trade through June 1990. Its subsequent trade is included with that of West Germany as part of the EC.

[b]Figures may not total due to rounding.

[c]Czech and Slovak Federal Republic.

Source: Compiled from IMF, Direction of Trade computer data.

Despite successful efforts to reorient Polish and Hungarian trade to western markets, the decline in CMEA trade has had a severe impact on the economies of these countries. For example, PlanEcon has estimated that 3 percentage points of Hungary's 5-percent decline in real GDP in 1990 is attributable specifically to the decline in Hungarian exports to CMEA countries. Polish officials said the shrinking of the Soviet market had created serious problems for Polish enterprises, some of which would likely go bankrupt.

The Persian Gulf war added further economic damage with the loss of markets for Polish and Hungarian goods in the Middle East. For example, Poland lost its arms market in the Gulf region, along with about $3 billion to $4 billion per year in income from Polish expatriate workers in the region. Many of these workers returned to Poland and were unemployed. In addition, Poland and Hungary had planned on receiving Iraqi oil as payment for previous sales of arms to Iraq, but they can no longer count on repayment in oil or otherwise. Poland and Hungary have also lost low-cost energy imports from the former Soviet Union.

Internal Reforms Taking Longer Than Expected

Despite the substantial changes that have taken place in Poland and Hungary during the last 2 years, the internal reform process in these countries is taking longer than was generally expected. U.S. officials said that this lag in reforms was more of a problem than the donor community had anticipated. An official at the French embassy estimated that it could take as long as 20 years to complete economic and political reforms in Hungary. World Bank and donor embassy officials told us that Poland's reform process could take even longer.

Unlike the postwar economies of Western Europe, where the basic structures and traditions of market economies already existed, the basic institutions of a market economy are only rudimentary in Hungary and must be built from scratch in Poland. Such an effort requires, among other things, a complex infrastructure of legal and financial systems, enterprise reform, privatization, demonopolization, development of social "safety nets," and tax reform. This institutional framework is generally a precondition to any large-scale foreign investment.

The nascent democratic decision-making processes in these countries have also complicated reforms. Elections, strikes, pressures from vested interest groups, and the generally unrealistic expectations of the populace have inevitably affected the reform process. The World Economy Research Institute of the Warsaw School of Economics reported that the public's expectations were inflated by its "fixation" on Western Europe's standards of living. The Institute further said that, while pressure was growing for faster improvements in Poland, the Polish standard of living would not improve in either the short or medium term. The Polish President was so frustrated with the slow pace at which the parliament was enacting reform legislation that he unsuccessfully attempted to obtain the temporary power to legislate by presidential decree. In addition, because these countries are facing problems they have never experienced before, an OECD official said countries such as Poland and Hungary tend to address problems as they emerge, rather than as part of an overall plan. For example, rising unemployment resulting from economic stabilization measures has forced government officials to attempt to address social safety net concerns that were not previously issues and had been otherwise neglected.

A third problem is that senior government officials, as they undertake new and additional efforts, frequently do not have the time or staff support to ensure that adopted reforms are actually being implemented. An IMF official said that Polish government decisionmakers were pushing for rapid reforms and a market economy, but were constantly confronted with new problems and had little time to ensure that their decisions were being carried out. For example, there are frequently lengthy delays between the government's decision to implement a reform measure and when bills for related laws are drafted for submission to the parliament. Bills generally remain before the parliament for long periods of time before they are debated and voted on. Also, since senior government officials do not trust the "old system" managers directly below them, the officials must rely on inexperienced junior staff to implement their decisions. The Polish government has consequently been asking the United States and other donors to provide expert advisers who would be stationed in Warsaw for extended periods of time.

Another major stumbling block in the economic transformation to a market economy is that privatization is taking much longer than expected. Problems in defining ownership rights, determining the value of enterprises, and working through the political process have slowed privatization efforts. A consultant to the Hungarian government's privatization agency said that the Hungarian government identified about 2,200 enterprises that were eligible for privatization but only 20 to 30 large firms per year were actually putting their shares on the market. PlanEcon reported in November 1991 that only 2 of Hungary's most attractive 20 firms had been privatized.

In commenting on this report, the State Department said that over 400 firms out of 2,200 had been privatized in Hungary. We followed up with the State Department on this matter and found that, in 1990, only 27 companies were transformed from state entities to corporate form with stock sold to the private sector. Further, we found that, in 1991, the Hungarian government had approved an additional 189 companies for corporate transformation, and that 307 other companies were in the initial stages of the transformation process. A January 10, 1992, report by the Hungarian-American Enterprise Fund identified several problems with Hungary's privatization process, including that "there is an urgent need for acceleration of privatization of state enterprises" and "bureaucratic delays remain a major problem. Inertia in the ministries, or lack of willingness to take responsibility for decisions and reluctance to cede powers, have resulted in painfully slow issuance of approvals for new businesses, joint ventures, major foreign investment and many forms of entrepreneurial initiative."

The pace of privatization will also have to greatly accelerate if Poland and Hungary are to accomplish their reform efforts and meet their privatization goals. While many small retail businesses have been started and joint ventures registered in Poland, only 5 of more than 7,500 state firms were sold in the government's first public offering of 150 companies in January 1991. A U.S. official said that Poland's ministry for privatization had 400 to 500 enterprises under review in July 1991 but that progress toward their privatization could be slowed by bureaucratic competition among government ministries.

Trade and Investment Lag Behind Initial Projections

Trade and investment are considered crucial to long-term economic stability and growth in Poland and Hungary because official aid flows to the region will not be on a scale large enough to reverse the cumulative, negative effects of decades of communism. Increases in trade and foreign investment are viewed as the "engines" of growth and as of urgent importance due to the external economic shocks that have shaken Poland and Hungary. However, barriers to increased trade remain, investment is occurring at a slower rate than anticipated, and both countries are laboring under very high levels of external debt.

Market Access Continues to Be a Problem

The loss of markets in the former Soviet Union and other former CMEA countries, as well as other external shocks to the Polish and Hungarian economies, has hastened the need for these countries to integrate their economies into the international economy. Such integration is believed to require a reorientation of trade patterns toward the West. Although both Poland and Hungary achieved dramatic increases in some exports to the West in 1990, gaining greater access to western markets continues to be a major problem.

The large and geographically close EC market is considered to be particularly critical for economic growth in Poland and Hungary. The U.S. International Trade Commission reported that the EC negotiated accords with Poland and Hungary in 1990 which provided for reciprocal most-favored-nation status and for the suspension or elimination of some EC quotas in return for improved market access for EC products. However, Polish and Hungarian officials said that the most significant EC trade barriers remained for agricultural products, textiles, and steel. Agreements were subsequently signed on December 16, 1991, on admission of Poland and Hungary, as well as the Czech and Slovak Federal Republic, to "associate member" status in the EC—a step that is expected to lead to the introduction of a free trade zone over a 10-year period and eventual full membership in the EC. According to State Department officials, these agreements brought with them some relaxation of EC trade barriers for the associate members.

The United States also represents a potentially good—though less important—market for increased trade. However, barriers to the U.S. market also exist in agriculture, textiles, and steel. In March 1991, the President issued the Trade Enhancement Initiative for Central and Eastern Europe, significantly expanding duty-free benefits for exports to the United States from Central and East European countries under the Generalized System of Preferences. The initiative also includes a component entitled "Removal of Impediments to Trade Expansion," under which the President sent a team under the U.S. Trade Representative to review internal and external barriers to expanded trade in the region and to propose specific solutions to any problems identified.

The team visited the region in May 1991 and issued a report in July 1991. The U.S. government subsequently announced that it would expand access to U.S. markets for Central and Eastern Europe. The U.S. government also urged the EC and European Free Trade Association countries[2] to remove barriers to key markets in their countries and proposed additional technical assistance aimed at developing the export infrastructure and expertise of the Central and East European countries.

Amount of Foreign Investment Has Not Met Expectations

Foreign investment is widely acknowledged by bilateral and multilateral donors as the key to providing the necessary capital for restructuring the Polish and Hungarian economies. Nevertheless, the amount of investment to date has not met the expectations of donors or the host countries. The Economic Commission for Europe has reported that actual inflows of capital as a result of investment have been small to date and that although the flow of direct foreign investment[3] may accelerate as the business climate improves, it should not be counted on as a major source of

[2] In 1991, these countries were Austria, Finland, Iceland, Norway, Sweden, and Switzerland.

[3] Direct foreign investment is investment in plant, equipment, and materiel and excludes portfolio investment.

financing at this time. Polish and Hungarian officials voiced disappointment at the small amount of foreign investment that had actually occurred.

In its balance-of-payments accounts, the Polish government reports direct foreign investment in 1990 at $89 million, which is less than 1 percent of gross domestic investment. Even if the official figures understate the amount of foreign currencies being invested in Poland, private foreign investment would need to increase dramatically if it is ever to become the engine for growth and transformation of the economy. In all likelihood, domestic savings will need to be the major source of financing Poland's transformation to a market economy.

During 1990, gross investment[4] was 21.5 percent of Poland's real GDP. Overall gross fixed investment in plant and machinery declined by about 10 percent. According to PlanEcon's reporting of official Polish statistics, investment in plant and structures was down by 9.6 percent while that for machinery and equipment declined by 10 percent. Preliminary figures indicate that gross fixed investment fell another 10 percent in 1991.

In Hungary, foreign direct investment also represents a small fraction of gross investment. In its 1990 balance-of-payments accounts, Hungary reports foreign investment of $356 million, which is estimated to be 4.7 percent of gross domestic investment. PlanEcon reports that gross fixed investment declined by 8.8 percent in 1990 and by a further 17.1 percent in 1991. While overall gross investment declined, foreign direct investment increased to $1.2 billion. Despite the decline in investment, the quality of machinery and equipment investment may have improved. According to PlanEcon, machinery from western countries accounted for 44 percent of all machinery purchased in 1990, up from 29 percent in 1987.

In its fiscal year 1992 Country Marketing Plan, the Commerce Department reports that in 1990, the United States accounted for $750 million of the $1.2 billion in cumulative foreign investment in Hungary. Large-scale foreign investment, which is relatively new in Hungary, began with a $150 million investment by General Electric in Tungsram in 1989. Germany, Austria, and Switzerland have more joint ventures, but the United States has much larger projects. U.S. firms participating in joint ventures include Levi Strauss, Kodak, Schwinn Bicycle, Guardian

[4]Gross investment, unlike net investment, makes no allowance for depreciation.

Industries, Ford Motor Company, General Motors, General Electric, and McDonald's. Between 250 and 300 U.S. corporations have representatives in Hungary.

Hungary appears to be attracting more foreign investors than Poland and other Central and East European countries because its investment climate is perceived to be more favorable. However, some donor embassy officials indicated that Hungary's reputation for having a favorable investment climate was not completely merited and that most of the investment to date had been from commercial import/export concerns. Investment in manufacturing, banking, insurance, and other sectors crucial to Hungary's economic development is taking place at a much slower pace.

An official from the United Nations Industrial Development Organization said that Poland's investment advantages included a larger domestic market than Hungary's, better access to markets in the former Soviet Union, and more natural resources. Nevertheless, the western investment that has occurred in Poland has been predominantly in small-scale manufacturing and services. According to the Bureau of National Affairs, Inc., the Polish government's 1989-91 economic report (published February 12, 1992, in Rzeczpospolita) lists foreign investment in Poland as amounting to $700 million, which the Polish government termed "negligible," and notes that 65 percent of the industrial base remains state-owned.[5]

U.S. and multilateral donor officials told us that the levels of foreign investment have been lower than expected because the Polish and Hungarian governments have not created favorable investment climates. The problems most commonly cited as hindrances to foreign investment include (1) unresolved legal issues, such as property ownership; (2) bureaucratic barriers; (3) inadequate financial systems and infrastructure, including telecommunications and transportation; and (4) a lack of indigenous management and planning skills.

Polish and Hungarian officials are aware that they need to make investment opportunities clear and attractive. For example, officials at both the Polish and Hungarian ministries of industry and trade told us that effectively addressing such problems in the energy sector would require setting energy prices at world market levels, which would allow investors to make a profit.

[5]BNA's Eastern Europe Reporter, Vol. 2, No. 4 (Feb. 17, 1992), p. 123.

In commenting on this report, the State Department noted that "the situation in [Poland versus Hungary] is quite different." State said that Poland has not attracted much investment because of its legal and bureaucratic barriers to investors, but that ". . . American companies . . . have been quick to set up operations in Hungary."

High External Debt Levels Remain a Problem

Both Poland and Hungary have labored under very high levels of external debt. Poland's gross foreign debt in convertible currencies at the end of 1990 was about $44 billion. An estimated $33 billion was owed to official bilateral creditors, referred to as the Paris Club, and $10.7 billion, including $1.2 billion of short-term revolving credit, was owed to western commercial banks, known as the London Club. Poland's gross debt service[6] in 1990 was about $9 billion, or about 80 percent of its convertible currency merchandise export earnings.

In March 1991, the members of the Paris Club agreed to forgive 50 percent of Poland's official debt. In the first stage, which was contingent on Poland's signing an agreement with the IMF to restructure its economy, the official debt will be reduced by 30 percent. In the second stage, an additional 20 percent will be reduced 3 years later, contingent upon Poland's fulfillment of the terms of the IMF agreement. As part of the initial 30-percent reduction, annual interest payments during the first 3 years will be reduced by 80 percent. Principal payments will also be limited to less than $600 million annually. Poland is negotiating bilateral agreements with its official creditors in order to implement the framework agreement of the Paris Club. As of November 1991, only the United States, France, Canada, and Austria had concluded agreements with Poland. The United States agreed to forgive 70 percent of Poland's bilateral debt, 50 percent in the first stage and 20 percent in the second, which will reduce the Polish debt to the U.S. government from $3.4 billion to about $1 billion.

However, the Paris Club agreement requires that Poland negotiate "comparable" debt reduction agreements with all other creditors. A U.S. Treasury official said negotiations with commercial lenders in the London Club had not advanced, and the managing director of the Institute of International Finance, which represents 135 international banks, complained in a letter to the IMF that "official creditors continue to pressure banks to match the Paris Club agreement—the first such agreement to forgive debt of a middle-income country." U.S. officials told

[6]Gross debt service includes interest and principal payments on short-, medium-, and long-term debt.

us that the Paris Club agreement could be scuttled if agreement was not reached with the London Club. In such an event, according to a U.S. Treasury official, although the United States might find it politically difficult to terminate the U.S.-Polish agreement on debt forgiveness, the United States would be required to comply with the Paris Club terms.

At the end of 1990, Hungary's gross foreign debt was $21.3 billion in convertible currencies (about $2,000 per capita, compared with Poland's per capita debt of about $1,200), and its gross debt service requirement for short-, medium-, and long-term loans was $5.8 billion, or about 90 percent of its convertible currency merchandise export earnings. More than 70 percent of Hungary's foreign debt is held by commercial banks. To continue to have access to private financial markets, Hungary has pursued a policy of fully servicing its debt. It has sought neither debt rescheduling nor forgiveness. Nevertheless, in July 1990, Moody's Investor Service downgraded Hungarian government bonds to below investment grade. As banks began to subsequently withdraw short-term credit lines, Hungary compensated by undertaking medium- and long-term borrowings. U.S. officials said Hungary's bond rating had recently improved.

Hungary signed a 3-year Extended Fund Facility agreement with IMF for $1.6 billion on February 20, 1991. The IMF distributed $650 million in quarterly tranches in 1991 to support Hungary's efforts to liberalize both its economy and foreign trade and to follow monetary and fiscal policies acceptable to the IMF. The G-24 agreed to provide balance-of-payments support of about $700 million to fill a gap in Hungary's financial needs for 1991. The Centrally Planned Economies Service of the WEFA Group forecasts that Hungary's annual gross debt service will grow to $7.3 billion by 1995. Although it forecasts growth in direct foreign investment, the resulting capital inflows are not expected to cover the country's foreign exchange requirements. Given Hungary's existing liabilities to commercial banks, substantial increases in bank lending are not anticipated. Thus, Hungary will probably have to continue to seek balance-of-payments support from multilateral and bilateral donors.

Structure and Responsiveness of U.S. Assistance

The initial U.S. effort to provide assistance to Poland and Hungary was appropriately structured to quickly demonstrate support for the economic and political reforms taking place in Central and Eastern Europe, but circumstances have changed in Poland and Hungary since the assistance program began in 1989. The program has been (1) guided by an expectation that assistance will be required for only a 5-year transition period; (2) based on a regional, rather than country-specific, approach for allocating or targeting funds; and (3) managed centrally in Washington, with limited authority delegated to U.S. personnel in-country. Also, most of the U.S. assistance has focused on supporting private sector development, with lesser amounts provided on a government-to-government basis for sector support or to help strengthen governmental institutions. According to the State Department, the United States "has intentionally avoided government-to-government aid agreements."

The expectation that assistance would be needed for only a short transition period is now seen as unrealistic, and we found that the program structure has created some management problems. Also, Polish and Hungarian officials expressed a concern to us that the regional approach the U.S. program has taken has limited their ability to (1) know how much assistance might potentially be available to them in order to more effectively plan for its use and (2) coordinate assistance provided by the United States and other donors.

Early U.S. Assistance Efforts Were Appropriate for Short-Term Goals

The United States demonstrated quick support for the reforms of Poland and Hungary through its initial assistance efforts begun in November 1989. These initial efforts addressed urgent humanitarian needs for food and medicine, supported programs fostering democratic pluralism, and provided visible help to specific sectors such as agriculture, the environment, and energy. Although the amount of U.S. financial assistance has been less than that of some other donors, the American leadership role and emphasis on grants have been particularly important.

The United States took the initiative in 1989 to mobilize $1 billion from the international community for a stabilization fund to bolster Polish foreign exchange reserves. The United States provided a $200 million grant to the fund, the United Kingdom provided a $100 million grant, and Austria provided a $20 million grant. France, Germany, Italy, Japan, and most other donors provided credits or loans. By building both domestic and foreign confidence in Poland's currency, the fund assisted Poland's transformation of the zloty into a convertible currency and served as an integral part of the economic program Poland negotiated with the IMF. The United States also took the lead in pushing for debt and debt service reduction for Poland among the Paris Club, the group of official western creditor countries, and announced its own expanded debt relief efforts. A senior Polish Ministry of Finance official said that the American leadership role in both the stabilization fund and the debt reduction were of critical importance to Poland and that without the debt reduction efforts, the World Bank would not have approved additional loans to Poland.

U.S. assistance was also of primary importance in focusing world attention on the massive environmental degradation in Central and Eastern Europe. The United States helped establish a regional environmental center in Budapest that received subsequent assistance from the EC and other bilateral donors. The center opened in September 1990 and is acting as a clearinghouse for environmental information, supporting institutional development, and providing environmental education.

The United States was also instrumental in establishing the Center for Cooperation with European Economies in Transition within the OECD to draw upon OECD members' expertise in support of Central and East European economic reforms. Similarly, the United States took the lead in establishing OECD's partners in the transition program, which provides a closer relationship between the OECD and those countries in the region, such as Poland and Hungary, that are furthest along in their transitions.

While ranking fourth in total assistance levels, behind Germany, Japan, and the EC, the United States ranks third in providing grant assistance. The EC reports that as of June 1991, the United States had provided 55 percent of its aid through grants; in contrast, only 23 percent of German aid, 24 percent of Japanese aid, and 40 percent of EC aid had been provided through grants. (See table 3.1.)

Table 3.1: Donor Commitments by Category (as of June 1991)

Dollars in millions

Donor	Loans and credits	Grants	Total
France	$1,384.8	$186.8	$1,571.6
Germany	7,657.3	2,287.6	9,944.9
Italy	890.4	302.1	1,192.5
Japan	2,100.0	653.6	2,753.6
United Kingdom	789.7	47.5	837.2
United States	1,123.3	1,348.3	2,471.6
EC	2,724.1	1,818.3	4,542.4
Other G-24	7,387.0	1,473.7	8,860.7
Total	**$24,056.6**	**$8,117.9**	**$32,174.5**

Notes: These are the most current EC data available on all donors.

See table 1.1 in chapter 1 for data on bilateral aid commitments.

Source: EC Commission.

Grants are the most effective type of assistance since they do not create additional external debt. An OECD official noted that Poland and Hungary should not be further loaded down with debt-creating loan and credit assistance because of their already tight debt constraints. A French official said Hungary had made use of few available export credits because of the country's debt situation. An official in Poland's Ministry of Environment said that his government had even refused some lines of credit.

Poland and Hungary Have Difficulty in Managing Assistance

Donors' assistance efforts have been hindered to some extent because the Polish and Hungarian governments are not yet well equipped to manage the assistance they are receiving and do not have clearly defined priorities and restructuring plans. Defining priorities has been made more difficult by the fact that there is no model upon which these countries can base their transitions. Organizational problems within the Polish and Hungarian governments have also impeded more coordinated and effective use of donors' assistance. Because of its almost exclusive focus on the private sector, the U.S. program has provided only minimal assistance for the institutional development of the newly constituted Polish and Hungarian governments.

Priorities Are Not Clearly Defined

A major obstacle to effective host country management of assistance has been the failure of the Polish and Hungarian governments to clearly define their assistance priorities. A State Department official said the Polish government had great difficulties making decisions and prioritizing its needs, which is one reason the United States was working with the private sector rather than through the government. U.S. and other donor officials told us that the lack of priorities hindered these countries from developing their own assistance strategies. Instead, the countries have developed somewhat general lists of proposals from which donors select a limited number of projects to fund. These lists sometimes have reflected choices negotiated within the host country governments, but some ministers have submitted their own proposals without overall government approval.

Another obstacle to effective use of assistance is that Poland and Hungary have not developed plans for restructuring specific sectors of their economies, such as energy and the environment. Donor officials indicated that until Poland and Hungary developed strategies for restructuring based upon their own priorities, it would be more difficult for donors to provide effective assistance. A State official said the Polish and Hungarian bureaucracies' delays in making decisions on investment rules and regulations were hampering foreign investment.

Organizational Problems Hinder Assistance Efforts

Organizational problems in the host countries also have hindered donors' assistance efforts. Ministries have lacked sufficient staff, administrative skills, and equipment to effectively manage assistance. For example, an EC official told us that Hungary's Ministry of Environment was organized and staffed around a relatively modest budget; donor pledges of assistance amounting to 10 times that of the Ministry's own budget made it difficult for the Ministry to effectively manage the assistance. A donor embassy official indicated that the Polish government also lacked the administrative skills to effectively handle assistance and, as a result, overlapping proposals were sometimes submitted to the same donor. A Polish official said it was difficult to keep experienced staff who could manage assistance because government pay was below that of the private sector.

Competition for assistance among government ministries in both Poland and Hungary has further hindered effective coordination of assistance, according to U.S. and EC officials. The World Bank reported that ministry officials in these countries tended to operate in isolation from each other. U.S. and Hungarian officials told us that despite the fact that Hungary established an office of assistance coordination within the international economic relations ministry, Hungarian government ministries continued to individually solicit assistance from donors. For example, the United States received four different housing proposals from four different ministries. Similarly, officials in Poland's assistance coordination office said they had difficulty managing assistance, in part because of internal competition among Polish ministries.

U.S. and other donor officials told us that a lack of complete information on donor assistance efforts was also an obstacle to effective host country management of assistance. Polish and Hungarian officials acknowledged that their governments did not know the type or extent of assistance that was being provided by donors, and they said that the existence of so many donors had created an atmosphere of confusion. Officials from the German and Italian embassies told us that the embassies of some donors did not have good information on their own programs, which complicated attempts by donors to coordinate assistance, as well as attempts by the Polish government to manage assistance.

U.S. Short-Term Focus Is Outdated

The U.S. 5-year transitional program was based on the assumption that the host governments' implementation of appropriate economic reforms, supported by limited external assistance, would attract immediate private investment to Poland and Hungary. It was anticipated that this investment would be on such a large scale that it would eliminate the need for longer-term U.S. financial assistance. Consistent with this short-term approach, the special adviser to the State Department coordinator of assistance to Central and Eastern Europe testified before Congress in April 1991 that the U.S. assistance program would begin to "taper off" in fiscal year 1993. He indicated that the administration would propose a fiscal year 1993 assistance level in the range of $250 million to $300 million, which would be reduced in subsequent years.

However, various U.S. and other donor officials now believe the U.S. 5-year time frame for assistance is unrealistic. Donor government officials said that the lengthy reform process, worsening economic conditions, and less-than-anticipated foreign investment, as discussed in chapter 2, meant that direct donor assistance would likely be required for a longer period than initially planned. The World Bank has reported that it is generally accepted that it will be years before Polish and Hungarian reforms begin to pay off, even under the best of circumstances.

There were differing opinions among the U.S., other donor, and host country officials about the length of time during which Hungary will need foreign assistance. There was more agreement on Poland, as most of the officials with whom we spoke agreed with a high-level U.S. official who said Poland will need U.S. assistance for at least another 10 years. This U.S. official expressed the view that a more effective U.S. assistance program could be designed if it were based on a longer-term focus. In commenting on this report, the State Department said that the U.S. assistance program might be of a longer-term nature than initially anticipated for Poland and that some programs in Hungary might last longer as well. The Department stated, however, that assistance from the West must still be seen as transitional, and not a 20-year effort, and that the G-24 countries—as well as top Polish and Hungarian officials—"are very sensitive to the need to avoid creating a foreign assistance dependency by those we want to help." We agree that U.S. assistance to Poland and Hungary should retain its transitional focus despite the fact that the full transition to a functioning free-market economy may take longer than initially anticipated. We also noted that although the State Department was still considering a phasedown of the program as late as April 1991, the assistance request for Central and Eastern Europe for fiscal year 1993, announced in January 1992, was $450 million rather than the lower amount previously indicated.

Assistance Is Not Tailored to Each Country

The U.S. assistance program operates with regionally based, functional projects. Funds are allocated for the Central and East European region as a whole and are not broken out for each country. The rationale for this approach was that those countries moving the fastest on reforms would be in a better position to take advantage of the various projects the United States designed. This was intended to serve two purposes: (1) to make U.S. assistance more responsive to the actual needs of the countries and (2) to encourage the Central and East Europeans to move more quickly in their reform efforts.

U.S. officials said that U.S. assistance was being provided on a "demand-driven" basis and that projects were funded in response to host country requests. The U.S. regional approach to providing assistance was intended to facilitate this demand driven decision-making process. However, some American officials said that the U.S. program tended to be more "supply driven" since the Central and East European countries were confused on their needs and priorities and thus depended on the advice of the large number of U.S. agencies and contractors providing assistance, all pushing their own agendas. A State Department official said that the United

States was setting its own priorities and making decisions on what it believed the host countries needed because the host governments had difficulty either making decisions or prioritizing needs.

Polish and Hungarian officials said they were unable to plan and prioritize assistance proposals for the United States because they lacked information on the amount of potential resources specifically available for their respective countries. A Polish official responsible for coordinating foreign assistance said the planning and prioritizing of Poland's assistance requests would differ depending on the level of U.S. assistance the country expected to receive. Another Polish official said that the U.S. regional approach promoted competition for assistance among the countries rather than the intended cooperation.

Hungarian officials also expressed the view that the U.S. regional approach was inappropriate because each recipient country was different and varied considerably in the type of problems being faced. For example, Hungary has been gradually restructuring elements of its economy for the past 20 years, has a better understanding of the market system than many other Central and East Europeans, and thus, needs assistance that is tailored specifically to Hungary. Hungarian officials said they felt obligated to accept a regionally funded energy project that focused on district heating, even though they thought it was inappropriate for Hungary because they were afraid the U.S. funds would otherwise be diverted to another country. A Polish official responsible for coordinating assistance also said that Poland did not want a particular U.S. project but accepted it for fear of otherwise losing the available funding. He declined to identify the project.

In commenting on this report, AID said that this competition was "a welcome feature of the regional approach," that AID "advocates performance-based budgeting," and that "linking assistance to performance naturally creates healthy competition for donor resources." We agree that performance-based budgeting that links assistance levels to performance can be an appropriate mechanism for more efficiently allocating resources. However, it appears that just the opposite may have occurred in the situations described by Polish and Hungarian officials where lower priority projects were undertaken simply to ensure that the funds would be used in their particular countries.

A World Bank official critical of the U.S. regional approach said that each recipient country should know more precisely what assistance will be received from each donor to adequately plan for the use of that assistance.

Other donors, including the EC, World Bank, IMF, France, and Germany offer country-specific programs. Polish and Hungarian officials said that the EC's program, which allocates assistance funds to each country and to specific sectors within each country, enabled them to plan for and use the assistance more effectively. The AID representative in Warsaw said Polish officials continuously commented on how effective the British approach (which is country specific and less bureaucratic) had been and that they wished the U.S. program was as responsive to Polish needs. A French official responsible for coordination of his government's technical assistance said France recognized the differing needs and priorities of each Central and East European country and targeted its technical assistance program on these differing needs and priorities.

Problems Related to Washington-Based Management

The decision to manage the U.S. assistance program for Central and Eastern Europe from Washington, D.C., rather than from missions located in the recipient countries was a departure from the usual AID practice for delivering foreign aid. U.S. officials said the rationale for this decision was based on several factors: (1) the short-term transitional nature of the program did not justify establishing AID missions; (2) the regional approach required Washington-based management; (3) the Deputy Secretary of State, whom the SEED Act authorized the President to designate as coordinator, and his deputies were located in Washington; and (4) the U.S.-based private firms and organizations, universities, and consultants through which the program was to be implemented could more easily be managed from Washington.

While the U.S. assistance program was initially responsive to the situation in Poland and Hungary, the decision to retain full program management authority in Washington rather than delegate authority and responsibility to the field has created certain management, oversight, and coordination problems. For example, managers in Washington have not always consulted in-country staff on project decisions; coordination with recipient countries has sometimes been lacking; and in-country coordination among U.S. agencies has been poor.

In-Country Staff Have Limited Role in Decision-Making

A U.S. official in Poland told us that decisionmakers in Washington did not seek advice on projects from in-country staff, even though these staff members have first-hand knowledge of the country's conditions and monitor U.S. assistance efforts. In some cases, decisionmakers in Washington have ignored recommended actions from in-country staff. For example, according to an October 1991 intra-agency assessment team report, despite a long-standing request from the U.S. Ambassador to Hungary for the assignment of an investment adviser to the Hungarian Ministry of International Economic Relations, the funding for this activity "was used for another activity seen as a higher priority in Washington."

Washington-Based Management Lacks In-Country Coordination

U.S. officials believe that the large number of U.S. agencies involved in providing assistance to Poland and Hungary can be more easily managed and coordinated from Washington, but in practice the assistance program has lacked coordination in working with the host governments. Polish and Hungarian government officials responsible for coordinating the donor assistance to their country complained that some U.S. agencies bypassed their offices and worked directly with their counterpart Polish and Hungarian government agencies.

In Poland, for example, the U.S. Environmental Protection Agency, which had established a working relationship with the Polish Ministry of Environment, continued to work directly with the Ministry after the Polish coordinator's office was established. Polish officials said that they had problems managing the Polish ministries, which compete with one another for donor assistance, and that the lack of in-country coordination among U.S. agencies exacerbated these problems. A U.S. official in Poland acknowledged that the failure of U.S. agencies to work through the government coordinator's office was a problem.

Hungarian and U.S. Embassy officials said their own agencies did not keep them informed of U.S. assistance. In addition, a contractor's study of donor coordination in Hungary reported that "many assistance transactions, including assistance from the [United States], occur without the knowledge of the [Hungarian government] assistance coordination unit."[1]

Polish and Hungarian officials, as well as officials from other donor countries and organizations, complained that there was no single point of contact for the U.S. assistance program and that they could not obtain complete information on the U.S. program from either the U.S. embassies or Washington. Polish and Hungarian officials also said that there were delays in dealing with the U.S. embassies or AID representatives on assistance questions. They attributed this to the Washington-based management of the assistance program.

[1]Donor M. Lion, Donor Coordination in Hungary. How Can AID Help?, April 1991.

We also heard numerous complaints about the string of short-term U.S. visitors to Poland and Hungary. Such visits by U.S. officials, consultants, and contractors are frequent because they are intended to substitute for the lack of permanent missions in the host countries. However, host country government officials said they spent an inordinate amount of time briefing these visitors about their country and, consequently, this took time away from that needed to manage their agency and implement donor assistance.

Coordination Lacking Among U.S. Agencies

In addition to a lack of coordination in working with the host countries, U.S. agencies have not coordinated well among each other. The AID representative in Poland told us that some of the U.S. agencies with programs in Poland were sending their staff to Warsaw without coordinating with his office and that sometimes he and embassy officials were not aware of their presence in the country. The operations manager of the regional environment center in Hungary noted that while the center was established at the initiative of the U.S. government to provide information and serve as a clearinghouse on environmental and related energy matters, it only learned of a U.S. Department of Energy project through newspaper reports. The contractor's study of donor coordination in Hungary stated that "on occasion, U.S. official assistance activity has even occurred to the surprise of the U.S. Embassy" and "it would help if a special effort was made by one U.S. entity . . . to keep track and stay on top of the diverse [U.S.] activities . . . and if the U.S. Embassy and AID Representative were kept fully informed [about the U.S. program]."

Despite Changes Cited in the U.S. Assistance Program, Problems Persist

A State Department official informed us in December 1991 that the situation in Poland and Hungary had changed to some extent since we performed our fieldwork in June and July 1991. He said that (1) the staffs of the AID representatives in Warsaw and Budapest had been enlarged to provide better oversight of U.S. assistance, (2) long-term advisers were being assigned in Poland and Hungary, (3) assistance teams had been established in each embassy to coordinate the U.S. program, and (4) all U.S. agencies providing assistance were required to work through these teams.

The October 1991 intra-agency reports on Poland and Hungary, however, indicated that many of the problems we identified in the assistance program persisted. The report on Poland, for example, stated the Polish government preferred that U.S. assistance be allocated on a country-specific basis rather than through a regional program. Noting that much of the Polish government bureaucracy was "still in the hands of communist-era apparachiks," the report also stated that the U.S. government needed to be "somewhat careful about turning more of the coordination function over to the [Polish government]." The report further stated that "a number of implementation mechanisms which appeared to be appropriate for quick delivery of assistance may turn out to be overly complicated for a program with limited staff resources and operating from a great distance" and "there must be somewhat of a shift in emphasis in the functions of the field representatives and the [AID] mission in Washington. Delays at the Washington end in providing responses to requests from the field have been common."

Moreover, the report on Hungary stated that periodic intra-agency assessments were necessary, in part, to "help educate the constantly shifting Washington players about the realities of Eastern Europe and the unique developmental and political problems faced by the recipients of our assistance." The report also stated that the lack of AID staffing in Budapest "is likely to become critical as recently funded activities reach the implementation stage and additional oversight and reporting requirements are imposed by Washington."

Conclusions

The scale of foreign assistance being offered by the United States and other donors creates an exceptionally complex coordination and management challenge. The U.S. approach has complicated donor and host country coordination and reduced control over the U.S. program. The U.S. assumption that Poland and Hungary will need assistance only for a short period has proved to be unrealistic. The regional focus of the U.S. program has complicated Poland's and Hungary's planning for and prioritizing of assistance. Washington-based management of the program has hampered the flow of information between the host countries and the United States, delayed U.S. decision-making regarding Polish and Hungarian requests, and complicated coordination and management of assistance.

Recommendations

We recommend that the Secretary of State, in consultation with other administration officials, direct that the U.S. assistance program be restructured to recognize the longer-term needs of Poland and Hungary. To enable recipient governments to better plan and prioritize their assistance needs, we recommend that the Administrator of AID specify funding targets on a country-specific basis, except for those sectors such as the environment where needs are clearly of a regional nature. The United States should present the funding targets as a planning objective that would depend upon the country's performance, in order to continue encouraging the efficient use of funds and ensure the funds are not seen by the recipient countries as firm commitments.

Agency Comments and Our Evaluation

The Departments of State, Commerce, and the Treasury and AID generally agreed with our recommendation that the U.S. program be structured to recognize the longer-term needs of Poland and Hungary. State and Treasury stated that some program changes had already been made and others would follow as conditions warranted. AID said that the assistance program had changed significantly since we conducted our fieldwork and, as currently formulated, addressed the long-term needs of these and other Central and East European countries. However, AID also stated that "a longer transition period does not necessarily imply that a different kind of assistance is needed." Our report draft also recommended that funds be allocated on a country-specific rather than regional basis and that AID missions, with full management authority and responsibility, be established in Poland and Hungary rather than continuing with the "mission-in-Washington" experimental model. The agencies did not agree with these recommendations.

State and AID argued that allocating funds on a regional rather than country-specific basis offers the flexibility to move funds among countries for the most effective impact and has enabled them to respond to new needs as they develop. We agree that funding flexibility can be a useful management tool, both to encourage better program performance and to respond more rapidly to changing events, but we point out that AID already has this flexibility in both its regional and country-specific programming. The rules of appropriations law already permit AID to reprogram funds appropriated for Central and Eastern Europe from one Central and East European country to another. We believe that the planning and prioritizing problems we observed in Poland and Hungary can be mitigated by communicating to these countries annual funding targets. These targets would not constitute annual operating budgets for each country, thereby avoiding any implied entitlement that such budgets might engender. We have accordingly modified our recommendation on this matter.

Concerning our draft report recommendation that AID missions be established in Poland and Hungary, the agencies said that this implied that "full-sized, traditional" missions be established which would be costly and inappropriate. AID said that because it was hiring staff at the time we performed our review, we could not effectively evaluate its Washington-based management of the program. State and AID officials acknowledged that they had experienced some management problems when the program for Central and Eastern Europe was beginning, but they said that the added staff, both in Washington and in Poland and Hungary, should go a long way toward resolving these early problems. We remain concerned that without delegating decision-making authority and management responsibility to U.S. personnel in-country, the problems we observed may continue. However, we also believe that the experimental mission-in-Washington model deserves a fair test under conditions of an on-going rather than a start-up program. Accordingly, we have deleted our draft report recommendation concerning the establishment of AID missions in Poland and Hungary from our final report.

Comments From the Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of State

Washington, D.C. 20520

MAR 9 - 1992

Dear Mr. Conahan:

Thank you for the opportunity to comment on your draft report, "Poland and Hungary: U.S. Assistance Program," GAO Job Code 472239, NSIAD-92-102. Comments are enclosed.

If you have any questions on this issue, please call Ambassador Robert L. Barry, D/EA on 647-0853.

Sincerely,

Larry J. Eisenhart
Deputy Chief Financial Officer

Enclosure:
As stated.

Mr. Frank C. Conahan,
Assistant Comptroller General,
National Security and International Affairs,
U.S. General Accounting Office,
441 G Street, N.W.,
Washington, D. C. 20548

DEPARTMENT OF STATE RESPONSE TO GAO REPORT

POLAND AND HUNGARY: U.S. ASSISTANCE PROGRAM
(Code 472239, NSIAD-92-102)

The Department of State welcomes the GAO study of the U.S. assistance programs in Poland and Hungary. However, we also note that the GAO research was generally completed before current programs were implemented, or agencies were staffed to administer projects, either in the field or in Washington. Accordingly, the report does not reflect the present situation in Poland and Hungary. Many improvements and changes have already made in program management by U.S. agencies.

With regard to the GAO's three major recommendations, we (1) agree that circumstances now require the U.S. to conduct a longer-term assistance program to Poland and perhaps Hungary, than it had earlier believed; (2) disagree with the idea that funds should be allocated on a country-specific basis; and (3) disagree with the recommendation that AID establish full-sized, traditional missions in Poland and Hungary.

The Department of State agrees that it is necessary to make changes in our assistance program, and evaluation of projects and adjustments are being made as we proceed. Other improvements will be made as we and the countries involved learn more about the technical and political difficulties involved in making the difficult transformation from a communist-lead, centrally planned economy, to a democratically directed market economy.

GENERAL OBSERVATIONS

The GAO report focuses entirely on U.S. assistance to Poland and Hungary, where the initial U.S. efforts and budget were exclusively directed. We are now carrying out assistance programs in ten countries of Central and Eastern Europe, which would never have been possible had we allocated the funds by country at the beginning of FY 1991. The concept of a regional program was designed precisely to create the flexibility necessary to respond to the rapid changes that were occurring and that could not be predicted at the start of each fiscal year. This included, for example, the sudden opening to reform in Bulgaria, the revolution in Albania, and the independence of the Baltic states.

See comment 1

We have also designed our programs to deliver assistance primarily to the private sector rather than to the government. Indeed, we have intentionally avoided government-to-government aid agreements, which contrasts with the EC PHARE program approach. This has allowed us to deliver grant assistance at a faster rate than the EC. While the EC and its members have committed substantially more grant money than has the United States, their disbursement rate is only about half as fast as that of the U.S. program. One EC ambassador complained to an interagency assessment team that his host country had a serious absorption problem concerning foreign aid channeled through the government and that this was slowing disbursements significantly. After further discussion it became clear that the absorption problem was in fact a logjam in the host government's bureaucracy caused by the demands of competing ministries for a share of the EC's grant assistance. If the United States had turned over more control of the program to that same ministry, we would never have been able to disburse assistance at twice the rate of the EC since we would have faced the same "absorption" problem. The U.S. policy of working through enterprise funds, NGOs, and PVOs not only leads to quicker disbursement, but also disbursements more in line with our goal (and the G-24's) of helping develop a strong private sector.

As the GAO report indicates, the United States has its own priority objectives in its assistance program. These objectives are set forth in the SEED Act of 1989 But the U.S. assistance program is also tailored to meet the primary objectives of the host government. The U.S. has programs in almost every one of the priority areas listed by Poland and Hungary, and other Central and East European countries in their official correspondence with us. There have been many high-level meetings in Washington, and in Warsaw and Budapest in which top officials of the United States, and those of Poland, and Hungary, respectively, have discussed the mix of assistance needed by their countries.

It is true that some Polish and Hungarian government officials, including those responsible for assistance coordination, have expressed frustration that they do not exercise more control over U.S. assistance programs. It is also frequently true that they would have shifted emphasis to government-to-government programs that would be contrary to U.S. aims and SEED Act goals. Such programs would weaken our efforts to help decentralize already overly centralized governments and our goal (and that of the region's democratic leaders) to strengthen the private sector at the expense of the former center.

The Department of State and A.I.D. are reviewing staffing of our A.I.D. offices in Central and Eastern Europe with a view to determining if additional staff are. The normal field mission concept as utilized in developing countries is not appropriate for Central and Eastern Europe, and the GAO report itself does not in our view, make a strong case for it. AID now has offices in our embassies in Warsaw and Budapest, and their employees are fully integrated members of the country team. AID has also hired a strong local staff to help in planning, assistance delivery, and project assessment.

We agree that we will be assisting Poland for more than five years and that some programs in Hungary may last longer as well, but assistance from the West must still be seen as transitional, and not a 20-year effort. The G-24 countries (and top Polish and Hungarian leaders) are very sensitive to the need to avoid creating a foreign assistance dependency by those we want to help. This is one reason why the EC has only a small staff (in most cases smaller than the U.S.) in-country, and instead sends out most of the assistance workers on temporary duty, even though it is committing more than twice as much funding to the region as the United States. The World Bank also operates mainly through temporary visits, even though its resources are larger than those of the United States and EC. Other major bilateral donors, such as Germany, use the same approach.

At the time when the GAO staff was doing its field assessments, AID was still recruiting staff and establishing offices in the recipient countries. Accordingly, the snapshot taken by the GAO of AID's field presence was too early to evaluate properly the "mission-in-Washington" concept. With the Regional Mission for Europe (RME) now getting close to full staffing, AID's ability to program and deliver assistance has been greatly enhanced.

The interagency assessment teams that have recently visited Poland, Hungary, Czechoslovakia, and Bulgaria found some problems in communications between the field and Washington, and between different U.S. agencies. In particular we have recommended that posts hold regular meetings to review all assistance programs, whether funded through A.I.D. or otherwise. The teams came back convinced, however, that the "mission-in-Washington" concept can be an effective delivery mechanism in CEE, but that it requires full staffing of the Washington component, and frequent TDYs to supplement the field presence.

See comment 2

FACTUAL OBSERVATIONS

Comparing Poland and Hungary: While both countries became democratic within a short period of time, their developmental efforts have differed, and the speed and progress of reform has differed significantly. On several occasions, the GAO report implies that the two countries face the exact same set of developmental problems. For example, the report suggests that Poland is further along than Hungary on the road to reform because of its "shock treatment" approach to transformation. This ignores the fact that the Hungarians were already farther along the road to reform before the collapse of communism.

The report also states that in both countries "investment is occurring at a slower rate than anticipated." In fact, foreign investment, and particularly American companies such as GM, GE, Guardian Industries, and Electrolux, and others have been quick to set up operations in Hungary. Poland, although it is a much larger market than Hungary, has not attracted as much foreign investment, because of Polish legal and bureaucratic barriers to investors. The situation in the two countries is quite different.

See comment 3

The report's data on privatization in Poland and Hungary understate the progress that has been made at least in the latter country. The report speaks of 20 privatized firms in Hungary. At last count, over 400 firms out of 2,200 have been privatized. Moreover, the reference to those 20 firms should have stated that these were firms for which financial advisers were picked, not the only companies being privatized.

See comment 4

Comparing Donor Commitments: The report gives a distorted picture of what the U.S. is doing to assist the region. This is because the GAO used, without proper explanation, a June 1991 EC chart on bilateral donor commitments to Central and Eastern Europe (pg 14), For instance, the figures show the United States as contributing only 8% of total commitments, compared to 9% from Japan or 31% from Germany. But this table does not distinguish between grant assistance (the form used predominantly by the United States) and loans, credits, or guarantees (used predominantly in bilateral programs by others, and of less value to the Central and East Europeans).

In reality, the U.S. grant contribution was significantly better than virtually every other country. The United States and Germany are providing grant assistance at about the same rate. The Japanese commitments were essentially tied credits, little of which were utilized by the Poles or Hungarians.

The chart also does not reflect the fact that the U.S. is delivering assistance at about twice the rate as is the EC. The report is simply misleading about who is really helping Eastern Europe when it states on page 42 that, "While ranking fourth in total assistance levels, behind Germany, Japan, and the EC, the United States has provided 55% of its aid through grants."

See comment 5

In the executive summary, the GAO report states that the United States gave $411 million in assistance in FY 1991. According to the State Department's figures, U.S. grant funding was about $532 million. Overseas Private Investment Corporation (OPIC) financing and risk insurance was an additional $430 million, and another $10 million was provided for the Peace Corps and for science and technology programs. These figures were made available to the G-24 approximately nine months ago.

See comment 6

<u>Undue Pessimism</u>: The GAO report quotes a statement that Hungary's reforms will take 20 years to complete, and Poland will take even longer. It also states that Polish living standards would not improve in either the short or medium term. While these are somewhat vague statements, they assume a much lower level of political will, or of economic determination than appears warranted. Polish and Hungarian economies are declining, as an inevitable short-term result of the very reforms being implemented. But the publicly available statistics overstate the extent of this decline, because many of the positive changes occuring in the private sector are not yet picked up in the statistics. Although in some cases reforms are proceeding at a slower rate than foreign donors had hoped, enormous changes have already occured since 1989.

In Poland and Hungary thousands of new businesses have been started, and many of these are quite successful. Nevertheless, those governments' statistical offices have little means of capturing the extent to which new business is contributing to the Gross Domestic Product (GDP), and thereby cushioning declines in living standards. Even if reform does bring a certain amount of economic pain (and human suffering), there is a pay-off for those with the courage to move rapidly toward a market economy. Although there may be some backsliding in response to political pressures, the move toward a real market economy will proceed in Poland, Hungary, and the other countries of Central and Eastern Europe.

The following are GAO's comments on the Department of State's letter dated March 9, 1992.

GAO Comments

1. We do not address whether delivering U.S. assistance through the private sector is more effective than working through the host country government, although we report that the Polish and Hungarian governments have had difficulty in managing the assistance they are receiving. Our comparison of the U.S. and EC programs is presented in the context of a country-specific versus regional approach to delivering assistance.

2. Our description of the economic conditions in Poland and Hungary notes similarities in the problems facing the two countries but makes it clear that the countries are at different stages in their transformation and provides detailed comparisons and contrasts between the two. Indeed, these differences support our conclusion that the U.S. assistance program could be more effectively designed and implemented on a country-specific basis.

3. We have revised our report to reflect this change.

4. Table 3.1 breaks out the type of assistance (loans/credits and grants) provided by the United States and other donors and shows that the United States ranks third behind the EC and Germany in the amount of grant assistance provided.

5. We have updated the assistance data. When we subsequently followed up with State Department on its data, a State official told us that U.S. funding had increased from the $532 million fiscal year 1991 figure cited by State in its comments, to $556 million. However, the State data include non-grant export credits, loans, guaranties, and insurance, as well as non-SEED expenditures from various U.S. agencies' budgets.

6. The basis for our findings on this matter is stated in chapter 2.

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON

FEB 25 1992

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and
International Affairs Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

I am responding on behalf of Secretary Brady to your February 6, 1992, letter enclosing your draft report entitled Poland and Hungary: Conditions Warrant Changes in the U.S. Assistance Program (code 472239).

The Department considers that your report provides a number of useful insights into the evolving assistance programs in Poland and Hungary. However, we generally do not concur with all of your conclusions. To make my points, I will draw on Treasury's experience in managing three elements of the assistance programs targeted on the financial sector.

See comment 1

First, we fully concur with your primary conclusion that the evolving conditions in each country require constant attention to restructuring program activity. Such restructuring has occurred in pace with changes in underlying economic realities.

For example, when it became apparent in 1991 that restructuring and privatizing state-owned commercial banks in Poland would be more protracted than had been hoped by other donors, Treasury elected to concentrate three of seven long-term advisor positions on commercial bank operational reform.

And when it became evident in late 1991 that the banker training facility situated in Katowice, Poland, would not be able to meet that country's requirements for trained professionals in the commercial banking system, Treasury undertook to assist in the establishment of a second facility, to be located in Warsaw.

We believe that the existing management structure for the foreign assistance program in Central and Eastern Europe is well-adapted to responding to changing conditions in Poland and Hungary.

Second, we believe allocating funds on a country-specific basis would be a serious mistake. The basic direction and pace of reform will be decided by the governments of the countries in the region. Allocation of U.S. assistance by individual country would prevent us from reallocating resources to countries that are able to make the most effective use of them.

Recently, as the process of banking reform in Hungary stalled, Treasury utilized the experience of one of its four long-term advisors in Budapest to provide short-term assistance to Bulgarian authorities for a debt-equity swap program.

Similarly, a tax policy advisor assigned to Warsaw has provided highly effective short-term assistance to Bulgarian authorities who are developing a revenue estimation model.

These examples underline the importance of retaining flexibility to shift scarce resources among countries as opportunities for serving reform objectives present themselves.

Finally, we are dubious that the establishment of AID missions in Poland and Hungary would lead to a more effective assistance program.

In the financial sector, the U.S. assistance program has brought in governmental financial institutions, such as the Federal Reserve Banks of New York and Chicago, the Federal Deposit Insurance Corporation and the Office of Tax Policy in Treasury. This involvement has been on a scale that is unprecedented in the recent history of U.S. bilateral assistance. These institutions are not only providing technical experts; their managers are also providing broad advice at a policy level. The U.S. assistance program is tapping these invaluable sources of experience energetically.

Were AID missions in individual countries to bear the responsibility for assessing requirements and defining resource needs, we believe it likely that assistance from U.S. financial institutions would not be utilized as effectively.

We would also stress that establishment of AID missions in individual countries is costly and would tend to introduce serious institutional inflexibilities in the reallocation of assistance from one country to another.

Treasury's experience in the multilateral development banks highlights the importance of retaining policy control over assistance programs at headquarters, where it is easier for policymakers to take politically sensitive decisions.

As the Congress is aware, the Treasury Department has only rarely been involved in the provision of technical assistance under the U.S. bilateral assistance program. This is appropriate in Third World programs where the main emphasis is on institution building and human resource development.

In Central and Eastern Europe, there is an unusually well developed institutional and human resource base. The U.S. assistance program concentrates on redirecting the energies of institutions and people in these in countries in ways that are compatible with market-based economies.

There may well be setbacks for reform efforts in the future. Increasingly difficult economic and social conditions are putting great pressures on new, democratic governments. However, the significant progress we have seen thus far, and the uniformly strong growth we see in the private sectors (as distinct from the state-owned industrial sectors) in Central and Eastern Europe, suggest that our strategy is sound and should not be altered.

I hope that these views are useful, and would be happy to discuss these matters with you in further detail.

Sincerely,

Alexis Rieffel
Acting Director
Office of East Europe and Soviet Policy

cc: Keith Smith, State Department
Frank Almaguer, AID

The following is GAO's comment on the Department of the Treasury's letter dated February 25, 1992.

GAO Comments

1. We do not disagree that the United States is able to some extent to adjust its assistance programs in Hungary and Poland. Nevertheless, our review shows that the current program structure has impeded the U.S. ability to appropriately tailor aid and respond to fast-changing conditions in those countries.

Comments From the Agency for International Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

USAID

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

MAR 6 1992

Assistant Administrator for Europe

Mr. Frank C. Conahan
Assistant Comptroller General
General Accounting Office
441 G Street NW
Room 5920
Washington, D.C. 20548

Subject: GAO Draft Report, "Poland and Hungary: Conditions Warrant Changes in the U.S. Assistance Program" (Code 472239)

Dear Mr. Conahan:

The subject draft report recognizes that "the United States demonstrated quick support for the reforms of Poland and Hungary through its initial assistance efforts begun in November 1989." The report acknowledges that the American leadership role at this time was particularly important. We are especially pleased that the report cites the successful U.S. Government efforts to address humanitarian needs for food and medicine, to foster democratic pluralism, to develop agriculture, and to deal with critical energy and environmental issues.

The report takes issue with the management of the U.S. assistance program to Poland and Hungary, and makes three recommendations regarding the type of change believed to be needed. The report recommends a shift to longer term assistance, abandonment of the regional approach in favor of a bilateral approach, and adoption of the traditional Agency for International Development (A.I.D.) model of management by field missions. GAO field personnel drew their conclusions based on observations from field work performed last summer in Poland and Hungary, when the bulk of our operations were just getting under way. In our opinion, these observations do not accurately reflect the substance of the program or the assistance management model as it operates today.

320 TWENTY-FIRST STREET, N.W., WASHINGTON, D.C. 20523

RECOMMENDATION: LONGER TERM ASSISTANCE PROGRAM

The audit report notes that the SEED Act-financed program was originally conceived to respond to what were seen as short-term needs in Poland and Hungary related to the transition to democratic states and market-led economies. We would agree with the report's assessment that it is now evident that the transition period for Poland (and for that matter most of the countries in Central and Eastern Europe) will go beyond the time-frame originally estimated for the program. However, contrary to the impression given by the GAO report, Hungary's transition is proceeding relatively well. The World Bank, in its December 1991 Country Brief, stated: "There is already evidence that structural reforms are beginning to show positive results." Although overall GDP fell in 1991, Hungarian officials expect a positive growth rate for 1992. Trade and price liberalization have been accomplished more quickly than expected, and inflation rates are being brought under control. Privatization has proceeded much farther than indicated in the report; the private sector is experiencing dynamic growth (50% increase in private industrial output during 1991), and the extent of foreign investment bodes well for the future.

See comment 1

The real issue in the first recommendation is not whether the original time-frame for the U.S. assistance program was too optimistic. Rather, it is whether the program as presently formulated addresses the priority needs of Hungary and Poland. A longer transition period does not necessarily imply that a different kind of assistance is needed. Our own assessment, corroborated by our Hungarian and Polish counterparts in the private and public sectors, is that our program is focused on the priority needs of the transition. Our assistance, however, will also promote long-term development. We are investing heavily in both business development and in the training and technical assistance that will allow the Poles and the Hungarians to build the systems and institutions that are necessary both for a successful transition and for long-term development.

For the most part, our activities in Poland and Hungary are not structured like the traditional long-term projects that are common in A.I.D. programs in Less Developed Countries (LDCs). The GAO report implies that our assistance should be structured that way. The types of projects that we undertake in Central and Eastern Europe more closely correspond to the types of projects that we undertake in a number of A.I.D.-assisted Advanced Developing Countries (ADCs). This is as it should be since the level of development in Central and Eastern Europe is more advanced. The human resource base is one of high literacy and skilled scientists and engineers, the mark of all developed societies. These countries experienced the industrial revolution and some were highly developed societies before World War Two. The leadership of the Central and Eastern European countries has committed itself to the most far reaching and dramatic reforms of virtually any A.I.D. assisted countries. Most of the countries of Central and Eastern Europe are quite capable of taking advantage of discrete technical interventions without the donor taking the lead in every aspect of the problem. For all these reasons there is a strong case for the use of target-of-opportunity assistance approaches in Central and Eastern Europe as well as in the ADCs.

See comment 2

Short term or discrete interventions do not mean, as the GAO report suggests, that there is little or no impact in the long run. There are many examples in our programs in Hungary and Poland where small inputs of technical assistance are making significant contributions to long-term development. In the critical energy sector, energy efficiency audits of industries were first conducted by U.S. firms and now local firms are performing them on a commercial basis. A short-term VOCA volunteer's mission to assist the development of an individual agricultural cooperative in Poland led to the enactment of a new law which has already spurred agricultural cooperative joint-ventures. A ten day visit by an advisor to the Polish Ministry of Finance has helped develop the initial framework for a deposit insurance system. A three month consultancy by a U.S. Treasury Department team provided the Hungarian State Bank Supervision Agency critical technical input for the development of the country's new system of bank supervision.

In Poland, the President of the Anti-Monopoly Office has praised the short-term technical assistance from the Department of Justice and the Federal Trade Commission, which provided timely expertise to support that office's efforts to demonopolize the energy sector. Short-term assistance activities conducted through the Department of Labor have helped the Hungarians draft a new employment law, and helped the Poles establish a system that will speed employment services and unemployment benefits while minimizing fraud. The computer equipment and training provided to the legislatures in Poland and Hungary are helping to increase the efficiency of these essential democratic institutions. Grant funds helped establish a network of training centers in Poland which are promoting citizen participation in local government.

Our program also features longer-term institution-building assistance projects. The Management Training and Partnerships in Health projects are two such cases. With these projects we are providing technical assistance and training to strengthen local institutions and to forge long-term linkages between U.S. institutions and Central and Eastern European counterpart institutions. The recently approved participant training project as well as the commercial law component of the Competition Policy, Laws and Regulations Project are new examples of efforts to meet both immediate transitional needs of the region, as well as to foster long-term development.

RECOMMENDATION: REGIONAL VS. BILATERAL APPROACH

See comment 3

The second recommendation in the report is that we abandon the regional approach in favor of a bilateral approach. The report's discussion of the regional approach suggests there may be a misunderstanding of the nature of that approach. The regional approach does not mean delivering the same product in each country, regardless of the differing needs and stages of transition of the various countries. The regional projects, which are the majority of the projects in the Eastern Europe program, are much like the regional projects which have traditionally constituted an important element of A.I.D. assistance worldwide. Managed by A.I.D. central bureaus as well as regional bureaus, these regional projects address development issues which are critically important to many countries in which A.I.D. operates. They may provide for single or multiple grantees or contractors. However, with very few exceptions, these regional projects require the development of specific activities designed to meet the particular needs of each country in which they will operate. Furthermore, the design of the country-specific activities under the regional approach can reflect just as much collaboration with host-country counterparts as is the case with traditional A.I.D. bilateral projects.

See comment 4

The GAO interviews with host country officials responsible for planning and coordinating donor assistance apparently left the impression that the U.S. assistance program is not designed collaboratively. One of the important advantages of the regional approach is the avoidance of the concept of country Operating Year Budgets (OYBs) which quickly become country entitlement levels that limit our flexibility to move funds to respond to the pace of reform. Although this approach may limit the possibility of joint bilateral design, project design is not done in a vacuum. We do have detailed discussions with host country authorities on country needs. Further, country authorities are actively consulted in choosing activities appropriate to meet those needs from the broad menu of projects available.

Another reason the impression may have been created that there is insufficient bilateral collaboration is because most of our program involves the private sector and much of our communication is with business people, as well as with public officials providing support services to the emerging private sector. Moreover, the GAO report itself notes that the two countries are "not well equipped to manage the assistance they are receiving." This is one of the factors which influenced the design of our overall assistance.

The report states that some Hungarian and Polish officials complained that the regional approach to programming promotes competition between countries. This is because it does not guarantee countries specific levels of assistance. This we regard as a welcome feature of the regional approach, not a reason for criticism. A.I.D. policy advocates performance-based budgeting, an example of which is the $50 million performance fund for African countries. Linking assistance to performance naturally creates healthy competition for donor resources.

See comment 5

As a point of clarification, our program is not purely regional. There are important country-specific activities authorized for individual countries by the SEED Act. For example, the legislation authorizes $245 million for the Enterprise Fund in Poland and $65 million for the one in Hungary. In addition, there are similar enterprise funds in Bulgaria and Czechoslovakia. Moreover, there are a number of activities which are not only country-specific, but also bilaterally signed with their governments. For example, we contributed $200 million to a Stabilization Fund for Poland to which numerous other donors have also contributed. In addition, we have signed bilateral agreements with the governments of Hungary, Czechoslovakia, and Bulgaria for sector grants; we plan two bilateral agricultural sector program agreements for Albania and Romania.

The architects of the assistance program for Central and Eastern Europe wanted the flexibility of a regional approach, both to link performance to assistance levels and to respond quickly to a fast changing situation. The rapid expansion of the program to the Balkan and Baltic countries, for example, would not have been possible were it not for the flexibility of the regional approach. This flexibility allowed assistance levels to respond to dramatic political changes. Similarly, without the regional approach in our privatization program we would not be able rapidly to adjust our assistance to correspond to the spurts and stalls of the privatization process in the different countries. Finally, with the up-front delays reduced, and funds flowing where and when they are most needed, we are able to deliver more assistance faster.

RECOMMENDATION: FIELD VS. WASHINGTON MANAGEMENT

The third recommendation in the report is that A.I.D. establish missions in Poland and Hungary to manage the assistance programs in these countries. The report notes cases of actions delayed in Washington, as well as communication and coordination shortcomings with the present management arrangement. However, it is important to point out that both the A.I.D. Representative Offices in the field and the Regional Mission for Europe here in Washington, which had limited staff at the beginning of the GAO review, now have significantly increased staff. The A.I.D.

office in Hungary has increased from one person in June 1991 to 18 today, including nine Americans. In Poland, the staff has increased during the same period from four to 21 people, including seven Americans. The Regional Mission for Europe, which evolved from a staff of 16 in June 1991, today has approximately 60, including contractors. Even now we are in the process of refining operating procedures to improve coordination and communication.

The progress that has been made gives us confidence that in the case of Central and Eastern Europe we can have the advantages of the Washington-based management model, such as speed of contracting and lower operating expenses (A project manager in Washington costs the U.S. taxpayer approximately one third of one stationed overseas) and still effectively manage programs in the recipient countries. The ultimate proof of the efficacy of the management structure is that our design and delivery of projects is less than one half the time of average A.I.D. projects, and our expenditure rates are twice as fast.

Conditions have changed since the beginning of the assistance program in Central and Eastern Europe, and because of our regional approach and Washington-based management model we have been able to adapt well to those changes at considerable savings to the U.S. taxpayer compared with the establishment of large Missions abroad. We continually review the structure and staffing of this model. In fact, we agreed with Congressman Obey formally to review staffing at least every six months, and are looking again at our staffing right now to see whether additional staff is warranted. With the staff and procedures now in place, and the model operating as intended and reviewed frequently and carefully, we expect to continue to be responsive to the transitional needs of the Central and Eastern European countries.

Sincerely,

Carol C. Adelman

Carol C. Adelman

The following are GAO's comments on the Agency for International Development's letter dated March 6, 1992.

GAO Comments

1. The basis for our findings on this matter is discussed in chapter 2. In addition, the Department of Treasury notes in its comments that it reassigned one of its advisers to Bulgaria when Hungarian banking reform stalled.

2. Our report does not suggest that short-term projects cannot have long-term consequences. It states that the U.S. program is structured based on the assumption that Poland and Hungary will need assistance for only a 5-year period—an assumption that has proven to be unrealistic.

3. In describing the U.S. approach to delivering assistance, we state that funds are allocated to the region as a whole, not that the projects in each country are identical.

4. We state in our report that some U.S. officials characterized the U.S. aid program as "demand-driven"—that is, responding to host country requests—but that other U.S. officials said the program is more "supply-driven," with the United States setting its own priorities and deciding what it believes the host countries need. We do not imply that U.S. officials do not confer with Polish and Hungarian officials on project assistance.

5. We have revised our report to include this information.

Comments From the Department of Commerce

UNITED STATES DEPARTMENT OF COMMERCE
Chief Financial Officer
Assistant Secretary for Administration
Washington, D.C. 20230

18 MAR 1992

Mr. Frank C. Conanhan
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Conanhan:

Thank you for your letter requesting comments on the draft report entitled, "Poland and Hungary: Conditions Warrant Changes in the U.S. Assistance Program."

We have reviewed the enclosed comments of the Under Secretary for International Trade and believe they are responsive to the matters discussed in the report.

Sincerely,

Preston Moore

Preston Moore

Enclosure

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

MAR 16 1992

Mr. Frank C. Conahan
Assistant Comptroller General
General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

Thank you for the opportunity to comment on the draft report entitled Poland and Hungary: Conditions Warrant Changes in the U.S. Assistance Program. This is an appropriate time to conduct a review of the government's assistance effort now that we are entering a consolidation phase of reform in Eastern Europe and assistance programs are gearing up in the Commonwealth of Independent States.

This is a good, candid assessment of American assistance to Eastern Europe, and we appreciate your thoughtful report on this area of critical importance. As our approach to policy evolves, we will certainly factor your insights into the process as we work with other agencies in developing assistance programs.

While the General Accounting Office report is generally factually correct, we would recommend adding more details on the development of a dynamic private sector. For example, while in Hungary in 1989 there were only 8,000 commercial firms, in 1990, 15,000 new firms were created and 12,000 more in the first half of 1991. In 1989, only 150 firms could import; two years later that figure had grown to 8,000 and is still climbing rapidly. In Poland, the private sector now accounts for 80 percent of retail sales, 20 percent of industrial production, 40 percent of imports, and 20 percent of exports. The private sector would have had virtually no role in these sectors as little as four years ago. Some car dealers in Poland and other countries report they can sell to local citizens all of the Western vehicles they can obtain.

We agree with GAO's assessment that foreign investment is the key to economic growth. While the capital flows to date may appear small in contrast to need, the report should mention that it takes a year or two to arrange a complicated investment especially when these countries are starting from virtually zero in developing commercial law. Hence, based on our awareness of many deals that are moving towards public announcement, we believe the pace will pick up. To the list of obstacles to foreign investment we would add concerns about inadequate intellectual property protection.

We do not wish to interject ourselves into the debate whether to manage the assistance programs from stateside or in the recipient country. In our opinion, a good case be made in either direction. Our one concern is that the assistance programs continue to emphasize technical assistance and support for the development of the private sector, both of which are highly leveraged forms of assistance.

The President's American Business and Private-Sector Development Initiative (ABI) announced March 1991 is a prime example of this. This program, which both the Agency for International Development and Commerce jointly manage, starts from the premise that programs supporting commercial ties from both sides of the ocean are likely to be the most supportive of market reforms.

The ABI allowed Commerce to expand the services offered by the Eastern Europe Business Information Center (EEBIC). Under this expansion, the Center, which has already fielded over 66,000 information requests and compiled a data base of 10,000 interested American firms, has added a new publication "Eastern Europe Looks for Partners" to help match American and East European firms. A few East European firms have already indicated how helpful the Center has been for them.

To help small- and medium-sized American firms enter the East European market, ABI also provided $2.5 million in grants through the Consortia of American Business in Eastern Europe (CABEE) program to five consortia to open offices in the region. The enthusiasm accorded this program by the business community suggests there is considerable potential for higher levels of commercial contacts. The Consortia are only now opening their offices in Eastern Europe so they have not yet reached their full potential. Also, the initiative allowed for the creation of a pilot American Business Center in Warsaw which would provide American businesses a home away from home; once this center formally opens this too could help Polish-American commercial relations develop in both directions.

Sincerely,

J. Michael Farren

J. Michael Farren

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