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OUT OF CREDIT: EVALUATING THE IMPACT OF THE EU STRUCTURAL FUNDS ON HUNGARIAN SMALL BUSINESS GROWTH AND ACCESS TO FINANCE

Totalling EUR 29 billion, Hungary is in the midst of implementing its largest economic development program in its young democratic history. At the center of the European Union led development program is an effort to revitalize and reequip Hungary's languishing small and medium sized enterprises (SME), long the country's heart of employment. This paper examines the efficiency and impact of two Structural Fund's instruments to enhance SME development – ECOP 2.1.1 and JEREMIE. A survey of 1275 SME and interviews with dozens of top policy-makers paint a flawed development program in dire need of reform. Despite this, empirical analysis suggests JEREMIE funds may have dampened the effects of the financial crisis and are crucial for the continued liquidity of SME, who have been particularly hit hard by the world financial crisis.

1. INTRODUCTION

Employing a great majority of citizens living in the developing world, small and medium sized enterprises (SME) are a key engine of poverty reduction and economic growth. For millions of communities still struggling to develop, SME are often the only source of income and economic activity. These small firms provide far more stable employment and growth than their large and often foreign owned counterparts, providing a source of insulation from the turmoil of a country's transition and development. The importance of SME is particularly evident in Hungary, where the sector accounts for 99.8% of all enterprises and employs nearly three-quarters of the population.

If SME are the engine of Hungary's future economic growth, then state of the art technology and the ability to access finance are necessary to fuel this potential. Financial services, ranging from simple bank loans to more complex factoring and leasing mechanisms, allow small entrepreneurs to finance high return investment projects, to pursue costly yet critical research and development activities and ultimately, to expand their businesses. An abundant supply of financial services ensures that sufficient credit is available for the entry of new firms with innovative and growth inducing products and the purchase of the newest technologies to remain competitive.

The authors would like to thank all the SME who participated in this study and all others that contributed. Specifically, Nagy would like to thank his students at Corvinus University of Budapest, who have provided great help. Maroshegyi would like to thank the Hungarian Fulbright Commission for providing the opportunity to conduct this project. Many thanks must also be given to Fr. James Wiess at Boston College, the honorable Hajdu Laszlo, Professor Gabor Kezdi, and Dr. István János Tóth.

Given this potential, the European Union and the Hungarian government have thus placed SME near the top of the ambitious Structural Funds development program. Among the many mechanisms established to support the development of Hungarian SME, individual programs to enhance technological development and access to finance are at the core of the government's SME strategy. Within the Economic Operation Program (ECOP) of the initial 2004–2006 programming period, priority access 2.1 was established to support the technological development of SME. The main objective of priority access 2.1.1, was to “increase competitiveness, to improve SME market positions, to modernise the SME's technological and infrastructural capability and increase their capacity for innovation.”¹

In light of Hungary's chronic financial constraints, the Hungarian government earmarked HUF 200 billion, or USD 1.02 billion for a New Hungary Enterprise Promotion Program in 2007. Nearly a billion of the USD 34 billion allocated to Hungary in the 2007–2013 EU Structural Fund programming period were channeled into JEREMIE, an initiative to “enhance SME finance” JEREMIE works to integrate various credit mechanisms into one development program, and provides low cost loans, credit guarantees and venture capital to SME throughout Hungary. The Structural Fund Program, and in particular its JEREMIE initiative, has had mixed results, sparking a continent wide debate on the effectiveness and impact of EU development efforts.

ECOP 2.1.1 and JEREMIE represent two very distinct and unique mechanisms to promote SME growth. While ECOP 2.1.1 relied upon traditional one off grants distributed by the government, JEREMIE engages and leverages the financial sector, utilizing EU grants to attract and raise private capital through co-financing requirements and provides a number of low cost financial instruments to SMEs.

Given the size of both these programs, and the important role of SME in Hungarian economic growth, it is crucial to investigate the effectiveness and impact of the respective programs. Yet, despite the importance of these programs, very few comprehensive policy evaluations of the Structural Funds are available to the public, especially in English.

Early impact evaluations of the 2004–2006 programming periods fueled skepticism among experts and recipients about the effectiveness of the structural fund program. Two separate evaluations of the SME modernization program conducted by KPMG and the Hungarian government found significant deadweight loss – SME would have implemented nearly 70% of their investments even without EU funds (Béres 2009).

On the other hand, many experts and recipients argue that on the whole, the Structural Funds have boosted the Hungarian economy and its small businesses, particularly during the severe financial crisis that continues to ravage the country into 2010. The same business owners that criticize the EU tender process admit that EU funds have contributed to their firms' technological development, boosted competitiveness and improved sales.

The EU has established a number of economic indicators to measure effectiveness, both on the program and project level. The analysis of the State Audit Office

¹ ECOP 2.1.1. call for applications is available (in Hungarian) at the NDA's homepage www.nfu.hu

of Hungary and some other independent researchers, however, show that the established system of indicators does not function properly, as it cannot reliably measure the effectiveness and the results of the projects and programs. This weakness and deficiency of the indication system makes clear the necessity of independent, academic research, to measure the effectiveness of certain programs or priorities.

To fully understand the dynamics of the Structural Funds, and the impact of ECOP 2.1.1 and the JEREMIE program in particular, it is crucial to integrate robust empirical work with detailed qualitative fieldwork.

1.1. METHODOLOGY

This paper aims to determine both the efficiency and impact of the EU Structural Funds on Hungarian on SME growth and access to finance.

In order to capture the firm level experience with the impact of the Structural Funds program a survey was distributed to ECOP 2.1.1 recipients from 2004–2006. Two separate surveys were conducted at different times, the first to examine the efficiency of ECOP 2.1.1 and the other to measure the impact of EU-funds on SME access to finance.

Both surveys utilized the same set of 2889 SME recipients of EU funds from ECOP 2.1.1.² The first survey randomly selected 1275 SME and was conducted by Sándor Gyula Nagy and a team of Corvinus University professors during the spring of 2009, the height of the Hungarian financial crisis. The second survey was distributed to 223 randomly selected recipients in the spring of 2010 by Christopher Maroshegyi.

The qualitative portion of this study was conducted with relative success, despite the hesitancy of many SME to respond to both surveys. Lack of government cooperation and a dearth of data, however, prevented a robust analysis establishing causation, or even correlation, between increased JEREMIE funds and loans extended to SME in 2007. The ongoing financial crisis, which began the same year JEREMIE was announced, paralyzes any effective aggregate level analysis. Instead, this study was forced to rely on broad, aggregate level data and trend analysis.

Finally, this paper provides a set of recommendations to improve future SME programs and the effectiveness of JEREMIE.

2 The target group of ECOP 2.1.1 is: micro, small and medium-size enterprises (co-ops, one-person companies, corporations and so on) based in Hungary. The potential financial support ranged from a minimum 1 million HUF (~3800 EUR) and a maximum 25 million HUF (~95,000 EUR), depending on whether the project included infrastructure building, expansion or renovation. The proportion of financial support (related to the project's total cost) was between 35% and 50%, depending on the region where the project was implemented. Eligible costs in the application were the acquisition of technical equipments and appliances (including transport, training and installation), expansion or renovation of infrastructure, further acquisition of technical know-how and license, some kind of limited cost of personal, non-refundable VAT and a Hungarian specialty: the non-refundable VAT charged on that part of project which received financial support from the EU-funds because of the VAT scaling regulation of the Hungarian Ministry of Finance (till 2006).

2. SURVEY OF ECOP 2.1.1. RECIPIENTS

Empirical data, particularly on the firm level, pertaining to the Structural Funds is notoriously difficult to access in Hungary. Lack of data or the sheer lack of cooperation on the part of the Hungarian government has impeded the efforts of academics and this researcher alike and poses the single great problem to independent program evaluation in Hungary. Initially, then, we were forced to rely solely upon public databases hosted by the National Development Agency and MAG Zrt. This was later supplemented with data from the online database of the Justice Court of Budapest and the Information Service of the Ministry of Justice. We found 2889 SMEs which won EU-money from the ECOP 2.1.1. application, from which we have chosen 1275 on a random basis to contact. In addition, we included every winner with more than one project. We contacted these SME through telephone, fax and/or email, and asked them to participate in our research by filling out an online survey anonymously. Thanks to these methods, we received 148 answers.

In terms of those who responded to the survey, companies from less developed regions were far less willing to respond to the survey. The same tendency can be seen in the case of micro-enterprises, who are less developed than their medium and large company counterparts. Micro-enterprises are underrepresented in relation to their actual proportion of overall grant recipients. In the research, were necessary, we filtered out the distortion of the answers with the method of statistical weighting. So we can say that the results of the research on the target group are statistically relevant regarding the patterns of region of origin, size of the enterprise and amount of money won.

Unfortunately, this study was unable to establish a control group to determine what the ratio among the losers is, but it is still obvious, that the vast majority of the SME have resorted to the service of an application writer or adviser and paid a considerable fee for it (*Table 1.*).

Table 1. Did you utilize the service of a grant application consultant? If yes, how much did you pay?

YES	91.22%	
NO	8.78%	
	fee proportional to the amount won	5.57%
	average fee in HUF	616,000
	average fee in EUR	~ 2,200

2.1. IMPLEMENTATION OF THE PROJECT

25.68% of the respondents did not have any kind of difficulty during the project implementation, while three-quarter of SME have experienced some kind of problem (and more than one: in average a recipient experienced 1.2 problems during project implementation, see *Table 2.*).

Table 2. What kind of difficulties did you encounter during the project implementation?

Preparing the project progress reports	54.55%
Obeying the environmental standards	3.64%
Obeying the EU transparency standards	11.82%
Acquiring the collateral needed to receive the EU-funds	32.73%
Other	17.27%

The results clearly show that the biggest difficulty was preparing the project progress reports, which requires high administrative efforts. The second biggest problem was acquiring the collateral (bank guarantee) needed for the EU-money. Among the other difficulties, inflexibility, excessive bureaucracy, slow administration, long delays of the intermediate body and their failure to maintain various deadlines were mentioned.

Nearly 30% of the winners could not implement their project according to the originally planned timetable and budget. This could be regarded as a good result, but taking into account that this ratio means more than 850 SME did not implement their project according to original plans, this ratio is not so successful. Amongst the others the continuous delays, bureaucracy and the special Hungarian VAT-reclaim regulations were mentioned (*see Table 3.*).

Table 3. Were you able to implement the project with the originally planned timetable and budget? If not, why?

Delay in the signing of the contract	67.44%
Slowness and difficulties of the construction and the procurement	27.91%
Slowness and difficulties of acquiring the collateral or the co-financing	11.63%
Others	11.63%

Among the micro enterprises the number of projects experiencing the above mentioned problems was 25% higher than the average. In the less developed regions (as North- and South-Plain, North-Hungary and South-Transdanubia) the final beneficiaries signalled 20% more difficulties, than the average. This show, that the smaller companies and enterprises in less developed regions can handle the project management problems much harder.

13.51% of the respondents signalled that they couldn't use the entire amount of money awarded for the project. The causes for that were: changing of exchange rates, decline of prices of acquired equipments or modification of the project.

56% of the respondents indicated that they had some kind of transaction cost related to the project which were not eligible to be covered different reasons. On average 6,1% of the project cost had to be financed by the SME, above and beyond the co-financing required. These costs were:

- Cost of administration and management 22.84%
- Non-refundable VAT 57.27%
- Cost of financing the project (e.g. cash-flow credit) 10.46%
- Others 9.43%

54% of the respondents signalled that the transfer of the EU-money did NOT follow the operative legal regulations (by their opinion). The (presumptive) causes are:

- | | |
|--|--------|
| ■ Unjustified completion of documents | 32.50% |
| ■ Delays caused by the bureaucratic system and mechanism of EU-funds | 41.25% |
| ■ Both together | 22.50% |
| ■ Others | 3.75% |

2.2. THE RESULTS OF THE PROJECT

The results showed clearly, that the global and Hungarian market situation has worsened for all SME, and the EU-money was the only factor, which has (on average) increased its market position against all problems and transition costs. This is a bit surprising but very important finding of this research, however we must note that the answers were based on subjective business sentiments.

After statistically weighting the results we have got the following result: 41.28% of the final beneficiary SME were unsatisfied, and think it was not worth winning and implementing the project, 90% of these respondents do not want to apply to any EU-funds in the future. The other 58.72% of the SME were satisfied, but nearly 50% of them do not want to go through the same bureaucratic and administrative measures to win and implement another EU-project, and are not planning to apply in the foreseeable future.

It is interesting again to highlight the regional differences in the results. SMEs in Central- and Western-Transdanubia and in North-Hungary were more likely to think it was worth applying, as compared to SME in Central Hungary. This result shows that in less developed regions the enterprises regard the possibility of EU-funded project more attractive than in the more developed Central Hungarian Region, even if they have problems and difficulties with the financing and with the administrative procedures. The companies in Central Hungary regard the EU-funds less helpful and can use it less perhaps because they are more developed and because of the lower intensity of financial support (related to the project's total cost).

One third of the winners has applied (or was planning to apply) for new projects since winning EU-money from the ECOP 2.1.1. The average time between the winning and our survey was 4.5 years. The causes for applying again were: need for further development or for maintaining jobs, while some signalled potential loss of competitiveness in the event of not applying (because the competitors were applying for and winning EU-money). Among the motives for NOT applying are the usual: high bureaucracy and administration, problems with co-financing and cash-flow financing, and the falling demand for industrial goods caused by the recession.

52.03% of the SMEs experienced some kind of synergic effect due to the project, for example purchasing new technology or any kind of new construction or renovation works.

To the questions "In your opinion, is the direct influencing of decision makers necessary to win a project?", the answers are in accordance with Corruption Perceptions Index of the Transparency International. The SME are rating the system

as susceptible to influence, meaning “if one has connections to the decision makers, he has a better chance to win”.

2.3. EXPERIENCES IN NEW HUNGARIAN DEVELOPMENT PLAN

For the 2007–2013 financial period of the EU a new development plan had to be adopted following the EU regulations. The New Hungarian Development Plan (NHDP) is much more complex and has much more funds available than the 2004–2006 period. The entire NDP 2004–2006 had about 3 billion EUR at disposal. The NHDP has about 24 billion EUR, which is about 3 billion per year. It has an Economic-development OP (EDOP), which in aims and means is quite similar to the ECOP of the first NDP. In 2007, it introduced a new application, the EDOP 2.1.1. which is (partly) the continuation of the former ECOP 2.1.1. SME application.

This type of application is the called “automated” application, which requires much less administration, its decision making is fast and mostly automated. How is that possible? To win the application the SME simply has to prove that it followed Hungarian law (paid taxes, employed legally, fulfilled the environmental regulations and so on) for two years, that it has a project within the financial limits of the application, and can account for distributed money with invoices on machines, equipments and so on. The eligible costs are limited to minimize bureaucracy and speed up pay-outs. The whole project evaluation system is quite detached so it keeps out corruption. Next to the apparent advantages, however, there are some disadvantages.

Together with two colleagues (Ms. Lenóra Répássy and Mr. Gábor Somody) we carried out a research based on interviews with application writers and advisers, with EU departments of commercial banks and with final beneficiaries of new EDOP 2.1.1. to highlight the strengths and weaknesses of this new application system, and to see whether the identified problems of the ECOP 2.1.1. of the first NDP were corrected.

Strengths:

- Simplified application procedure: the necessary paperwork can be done in two days. The biggest “challenge” is to acquire a precise price quotation for the equipments, which would be purchased in the project.
- Fast decision-making: the average time needed need to complete a project proposal and receive a decision is 3–4 weeks, making it the fastest application procedure in the whole system.
- Decreased bureaucracy and administration during management: the so-called project progress reports have been simplified, the indicator system is clear and can be fulfilled with reasonable efforts.
- E-application: from the handing in of the project proposal, through the project development reports till the financial monitoring everything is handled online.

Weaknesses:

- Unnecessary data-requirements remained: there are still some kind of data required during the project implementation period, which is regarded as unnecessary by our interviewees. For example paper used for copying, amount

of used water or electricity. Despite this, the data-requirements and administration are on a low, acceptable level.

- Real economic development effects are questionable: following the opinion of some experts the real economic effect of this application system has not been proved yet. Some said it is politically motivated to focus on rapid spending of EU-funds, which can be well communicated.
- Possibilities for evading contracted obligations: there are existing possibilities for evading the contracted obligations by the winners. Without giving ideas, one can identify two main ways of cheating:
 - manipulating the indicators (using legal or mostly legal ways)
 - targeted (sometime organized) theft of EU-funds (exploiting the eased conditions with a through of criminal acts)

These anomalies highlight the dilemma of the application system. Should the system regard all SME as potential criminals, and therefore the whole system should be over bureaucratized in order to avoid possible fraud, but also harden the life of “normal” enterprises OR should the system focus to ease the life of the SME and with it the life of potential criminals? The answers will diverge in different member states of the EU. In Hungary the system is making steps to the second version after failing in the first one.

3. JEREMIE IMPACT EVALUATION

Empirical data, particularly on the firm level, pertaining to the Structural Funds and JEREMIE is notoriously difficult to access in Hungary. Lack of data or the sheer lack of cooperation on the part of the Hungarian government has impeded the efforts of academics and poses the single great problem to independent program evaluation in Hungary.

As per EU stipulations, all recipients of EU-funds in Hungary have been listed on the NDA's vast and often incomprehensible website. All relevant data is provided in Hungarian only – preventing English speaking researchers from outside of Hungary from conducting any review of the program. The NDA provides a number of quite powerful public databases on their website, include EUTER, a database which details implemented projects and project amounts on an interactive map of Hungary. Another powerful database allows a user to review the recipients of each Operative Program and Priority axis in any of Hungary's 7 regions. To our dismay however, EDOP 4.1 – 4.3 was not included in the database, and no public records of the final beneficiaries of the JEREMIE funds are provided on the site.

3.1. EMPIRICAL EVALUATION RESULTS

This project has thus been forced to rely on a broad trend analysis examining the effect of JEREMIE's announcement in 2007 and the level of total and SME loans extended. This broad analysis reveals upward trending levels of loans extended which was sustained through 2007 and 2008 despite the impact of the financial crisis on

monetary institutions. This may indicate that announcement of JEREMIE – and the promise of a massive influx of funds in the near future – provided confidence for financial institutions to continue their lending levels despite increased risks.

Table 4. JEREMIE Timeline

Event	Time	Allocation, 2007–2013 (HUF Bn)	Actual Disbursement, as of May 2009 (HUF Bn)
Venture Finance Hungary (MVZrt) is established	August 2007	200*	-
First Call for Micro Loan Tenders	October 2007	57	6.4
First call for Loan Portfolio Guarantees		27	.924
1st micro-loan distributed	January 2008	-	-
Launch of SME Program	November 2008	50	.654
Notification of Venture Capital Program	December 2008	35	0
Launch of SME Working Capital Program	January 2009	140	.147

*Start up capital originally allocated. Private and national contributions led to higher actual allocation when the separate programs were announced.

Table 5. JEREMIE Timeline (EDOP 4.1. Call to Tenders)

Tender Name	Date Opened	Date Closed	Amount (HUF bn)
GOP-2007-4.1/A Micro Loan Program	Oct. 15, 2007	Oct. 16, 2009	40
GOP-2007-4.1/B Micro Loan Program	Nov. 7, 2007	Oct. 16, 2009	40
GOP-2007-4.2 Portfolio Guarantee	Nov. 7, 2007	Oct. 16, 2009	60
GOP-2008-4.1/C New Hungary SME Loan Program	Nov. 18, 2008	Oct. 16, 2009	25
GOP-2009-4.1 New Hungary SME Working Loan Program	Jan. 1, 2009	Dec. 31, 2009	43
GOP-2009-4.3	Feb. 23, 2009	April 6, 2009	30.5
GOP-2009-4.3/2 New Hungary Venture Capital Program	Aug. 28 2009	Aug. 28, 2009	36.5

Upon review, it is apparent that aggregate loans extended to SME peaked in 2008; the first year JEREMIE began distributing funds (*see figures 1 and 2*). This may in fact be traced back to the announcement of the JEREMIE fund and its various programs throughout 2007–2008, which totaled well over HUF 200 billion. Anticipating the quick distribution of loans, and especially portfolio guarantees, financial institutions may have been more willing to extend their current stock of capital to SME. The actual distribution of allocated funds has been painstakingly slow, however, and in the Q2 2009, only 9% of funds allocated for micro and SME loans were extended.

Overextended from years of blistering growth in aggregate loans to SME, faced with rising defaults and skeptical over JEREMIE delays, financial institutions significantly cut back on loans to SME in 2009. It is noticeable, however, that loans extended to SME fell at half the rate than for total non-financial corporations in 2009, indicating that JEREMIE funds may have dampened the effect of the crisis for SME.

While the impact of JEREMIE may not be reflected on the aggregate level, one industry expert believes its positive impacts on the financial markets can nonethe-

less be seen as early as 2007. Dr. Jozsef Berecz, Managing Director of DBH Group investment – a recipient of HUF 3.5 billion in JEREMIE venture capital funds – noted that many financial institutions began supporting start-ups in 2007 to prepare for upcoming JEREMIE tenders. In one project, two firms, Inostart and Valdeal, raised HUF 500 million in public and private equity to provide technological and financial support for start-ups with the hope of preparing them for JEREMIE funds in the future.³

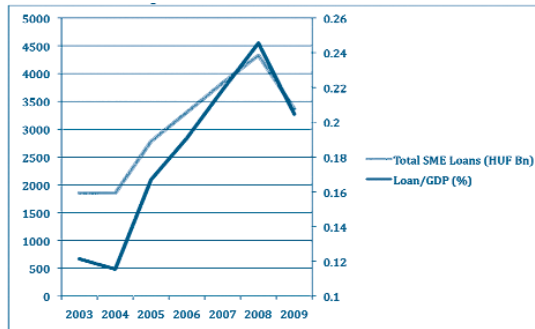


Figure 1. SME Access to Loans

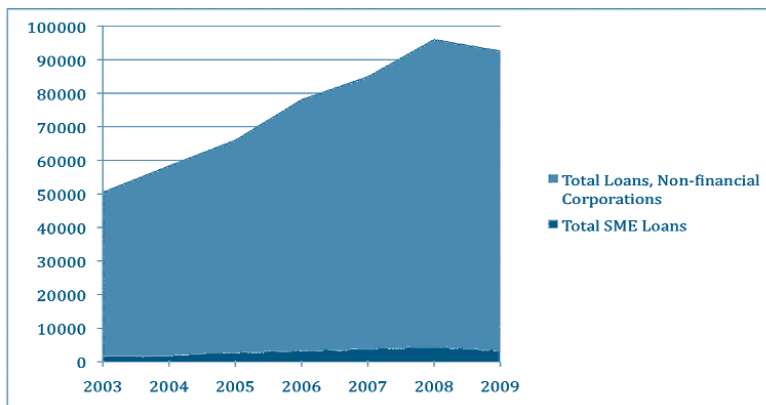


Figure 2. Aggregate Loans Extended

To Berecz, however, most of the positive impacts of JEREMIE will only be seen after 2013. Berecz considers JEREMIE a 'bell-weather' initiative, and believes that if the program succeeds, it will change the culture of financial institutions in Hungary. Were JEREMIE to succeed in extending affordable credit to SMEs while still affording financial institutions a healthy profit, banks will see a positive track record and

³ Indeed, the purpose of the following chapter is to empirically test these claims and establish a correlational link between the announcement of JEREMIE and an increased volume of loans to SME.

begin to expand their SME operations. Firms like DBH have a proven track record both abroad and in Hungary, and Berecz predicts that the same profitability and success will be translated to JEREMIE's venture capital funds.

4. FILLING IN THE DATA GAPS

Current data is inconclusive on the impact of JEREMIE funds on SME access to finance. To fill in the data gaps and gain a deeper insight into the program's impact on the firm level, it is necessary to turn to qualitative data. This project employed a two-pronged approach in collecting qualitative data to isolate individual firms' and actors' experience with the Structural Funds and JEREMIE. First, a survey of SME receiving EU funds was conducted to establish baseline firm-level financial statistics, financial constraints and finally the impact of EU-funded projects. Second, we conducted dozens of interviews with policy makers, members of civil society and academia to gain an insight into the problems of Structural Fund implementation.

It is important to note that survey respondents are not recipients of JEREMIE funds but rather the EDOP 2.1.1 program.⁴ The financial survey was distributed to the same as the efficiency survey, a year later, in March, 2010.

4.1. FINANCIAL CHARACTERISTICS OF RESPONDENTS

A great majority, 81%, of SME indicated that they had implemented projects aimed at business development since 2007. Nearly three-quarters of SME relied on either EU-funds or other state subsidized loans, such as JEREMIE, to finance their projects. Most SME utilized more than one source of finance to implement their projects. Nearly a third of SME that claimed they had used EU funds to expand their business also utilized bank loans to carry out their project. This reflects that banks are often unwilling to finance an entire project at terms acceptable to the SME, forcing business owners to look elsewhere to for credit.

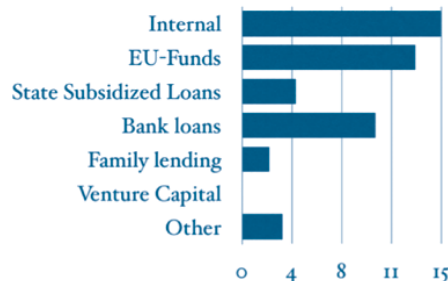


Figure 3. How were your business development projects financed?

⁴ The EDOP 2.1.1. application is available (in Hungarian) at the NDA's homepage, www.nfu.hu. EDOP 2.1.1. falls under the technological development priority access of the EDOP, with the express intent of providing funding to modernize SME' technological, infrastructural and innovation capacity.

The most striking aspect of Hungarian SME' financial situation is their overwhelming dependency on external financing for day-to-day operations. Nearly three-quarters of SME indicated that external financing is important or very important simply to maintain their operations. This is a worrying phenomenon that likely reflects the negative impact of the continuing financial crisis, which has eroded sales and assets for many firms. Most importantly, this highlights the critical importance of adequate supplies of credit for Hungarian SME.

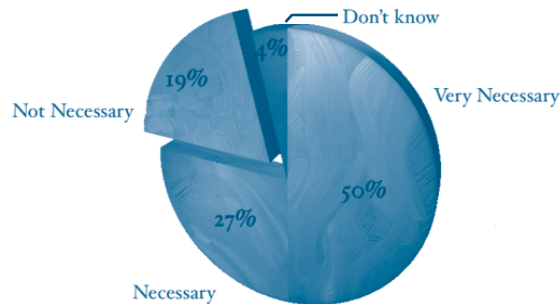


Figure 4. How necessary is external finance to the day-to-day operations of your firm?

Strikingly, nearly half, 48%, of SME noted that they experienced difficulties in accessing finance. A number of factors were attributed to their firms' financial constraints, with high financial transaction costs and interest rates most likely cited to be had effected or severely effected firms' access to finance. Half of SME complained that high loan financing costs were negatively affecting their company. Other constraints cited were high bank collateral costs, loan servicing costs and the lack of willingness on the part of banks to lend to SME.

One firm indicated that interest rate costs eat up 15% of their assets and prevents the firm from pursuing further expansion. So high are the costs of borrowing, the firm indicated that interest rate costs were preventing them from hiring two extra employees which would allow the firm to boost sales and productivity. A number of firms expressed concern that the high financing costs would soon bankrupt their business. One had already been forced to lay off 15 employees and is still on the brink of bankruptcy. Another noted that financing costs were siphoning off most of their internal funds, "with no end in sight."

4.2. SME EXPERIENCES WITH STRUCTURAL FUNDS

Business owners were asked to rate the effect of commonly expressed problems on their own company. These included co-financing requirements, loan collateral requirements, costs of financing projects prior to receiving EU funds, and administrative costs. 75% of respondents stated that securing sufficient co-financing costs was a major impediment in project implementation. Another 54% found it difficult to cover the costs of financing the project. These results clearly show that financing constraints are negatively impacting firms' ability to implement projects.

More alarmingly, the results of the survey reveal that the EU funds have had little effect on firms' access to finance. Less than a quarter of respondents indicated that access to finance has improved, and not one believed that access to finance has greatly improved after the allocation HUF 4 trillion to projects since 2007.

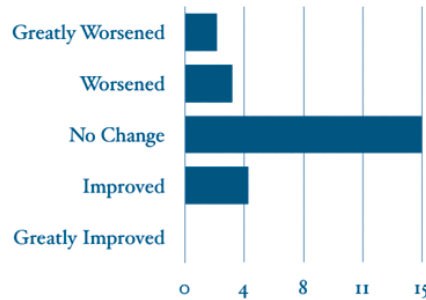


Figure 5. How has your firm's access to finance changed since completion of your EU-funded project?

The EU funds have had significant impact on SME sales however, with 88% of firms reporting stronger sales thanks to the Structural Funds. This is significant given the negative impact of the latest crisis among firms who have not received EU funds. In fact, a recent Flash Eurobarometer revealed that falling demand and sales have been the biggest concerns for Hungarian SME. Improved sales figures to have medium to long-term positive impact on firms' access to finance, as banks will become more willing to lend to SME with stronger sales. In fact, a number of experts interviewed in the financial field have noted that implementing EU-funded projects establishes a positive track record, improves transparency and establishes a credit history, all crucial for SME to access finance to reluctant banks.

4.3 MAIN FINDINGS OF THE SME SURVEY AND INTERVIEWS

The survey reveals a clear need to improve the financial system at the local level for Hungarian SME. Despite increasing levels of funds available for SME lending, the money simply is not reaching those in need. High transaction costs and interest rates – rather than a lack of available funds at financial institutions – constitute SME' largest financial constraints.

SME owners count EU-funds as a mixed blessing. Nearly every SME experienced difficulties in obtaining the EU-funds and successfully implementing the projects. In their follow up notes many have expressed frustration with delays in fund distribution and the red-tape that slows down implementation. SME may receive funding to buy a certain type of computer in 2008, but by the time they receive the funds in 2009, that machine will have been obsolete. Co-financing requirements have put many SME between a rock and a hard place, forcing them to take out high interest loans without guarantee that the EU will release all of the funds for the project in the end.

On the other hand, EU-funded projects have clearly increased firm sales. Most SME have applied for funding more than once, and some even more. Most business owners recognize the potential of EU funds, and many offer only small points of reform. EU-funds have had a strong effect on sales, which is confirmed by the results of the initial survey that show that EU funds have been instrumental in keeping SME afloat during the latest financial crisis.

5. MAIN FINDINGS AND RECOMMENDATIONS

- Interviews conducted with policy officials throughout the year reveal a complex, bureaucratic, non-transparent and top-heavy institutional framework, although survey respondents reveal some improvements in the program's administrative burdens.
- The monitoring system for both ECOP 2.1.1. and JEREMIE is insufficient and non-transparent. Monitoring indicators fail to show the real effects of EU-funds on micro-level.
- Loans extended to SME significantly trended upwards from 2003 to 2009. The impact of the financial crisis reversed this trend in 2009, but a deeper decline may have been prevented by JEREMIE funds.
- Financial constraints continue to persist and hamper SME operations in Hungary, despite the growth in lending since 2003. Less than a quarter of respondents believe that access to finance has improved since they completed their EU-funded projects and nearly half of expressed difficulties in obtaining financing.
- More than 75% of SME experienced difficulties in implementing their EU-funded project, while nearly a third of projects were delayed or over budget.
- EU-funds were cited as the only factor, which has, on average, improved the market position of Hungarian SME during the recent financial crisis.

5.1. RECOMMENDATIONS ON THE PROGRAM LEVEL

1. The Hungarian Government should strengthen laws to ensure dissemination of program data. Contracts with private consulting firms should be announced and the results made public.
2. Increase JEREMIE transparency at the financial intermediary level. Streamline distribution to intermediaries and reduce auditing burden.
3. The pre-financing of any privately owned enterprises without bank guarantee or collateral should be revised, possibly withdrawn.
4. New monitoring methods should be introduced with the aim of further easing the administrative burden of the SMEs.
5. Vigorous academic research should be carried out to examine and analyze the real economic effect of the “automated” application systems. Establish an Institute for Structural Fund Evaluation that centralizes and coordinates research efforts.

5.2. RECOMMENDATIONS ON PROJECT LEVEL

1. Partial rebuilding of the institutional system handling the EU-funds (from managing authorities inside the National Development Agency to several intermediate bodies), with the purpose of “best practice” implementation.
2. Rethinking the priorities and the means for economic development (including JEREMIE, pre-financing – without collateral or other guaranties).
3. Strengthening the monitoring system (new methods, better cooperation and data transfer between authorities).
4. Fighting political and “private” corruption in institutional system handling the EU-funds.

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