

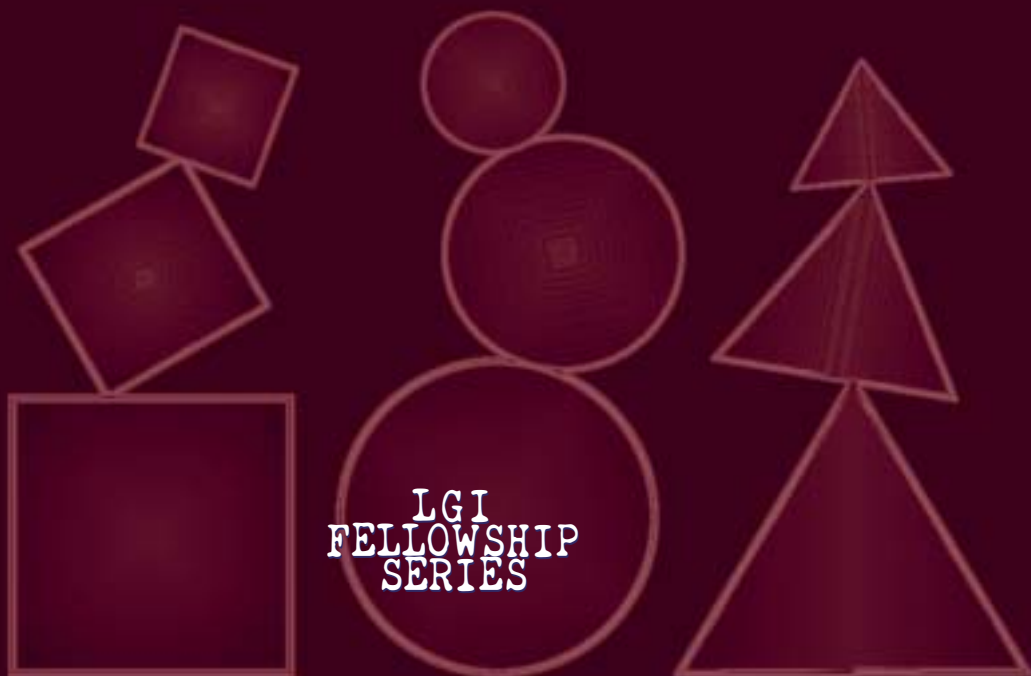


Local Government  
and Public Service  
Reform Initiative

# EVOLVING INTERGOVERNMENTAL RELATIONS FOR EFFECTIVE DEVELOPMENT IN THE CONTEXT OF REGIONALIZATION

BY CLAUDIA PAMFIL

LGI Studies





Local Government  
and Public Service  
Reform Initiative

EVOLVING INTERGOVERNMENTAL  
RELATIONS FOR EFFECTIVE  
DEVELOPMENT IN THE CONTEXT  
OF REGIONALIZATION

*by*

CLAUDIA PAMFIL

OPEN SOCIETY INSTITUTE  
LOCAL GOVERNMENT AND PUBLIC SERVICE REFORM INITIATIVE

*Address*

Nádor utca 11.  
H-1051 Budapest, Hungary

*Mailing Address*

P.O. Box 519  
H-1357 Budapest, Hungary

*Telephone*

(36-1) 327-3104

*Fax*

(36-1) 327-3105

*E-mail*

lgprog@osi.hu

*Web Site*

<http://lgi.osi.hu/>

First published in 2003  
by Local Government and Public Service Reform Initiative, Open Society Institute–Budapest  
© OSI/LGI, 2003



TM and Copyright © 2003 Open Society Institute



OPEN SOCIETY INSTITUTE



Local Government  
and Public Service  
Reform Initiative

ISSN: 1586 4499  
ISBN: 963 9419 56 7

All rights reserved. No part of this book may be reprinted or reproduced or utilized in any form or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

Copies of the book can be ordered by e-mail or post from OSI.

Printed in Budapest, Hungary, March 2003.  
Design & Layout by Createch Ltd.

# Foreword

This paper is the result of a research fellowship funded by the Local Government and Public Service Reform Initiative of the Open Society Institute (LGI/OSI) under the LGI Fellowship Program.

The author collected and structured existing studies, publications and program reports, as well as expert opinions from countries visited (Poland, Hungary, Slovenia, Romania) to be used in the local and regional economic development approaches in CEE countries. Examples from within the EU are provided in order to offer candidate countries diverse approaches to regionalization currently in use.

The paper combines methodological, theoretical and technical aspects in order to emphasize the need for correlation between process and content referring to flexible approaches that are appropriate in the new context of globalization and decentralization. In the same respect, the paper tries to respond to the need to harmonize different requirements coming from local community groups, the private sector, national institutions, regional priorities and international institutions, when all must be considered in order to design appropriate policies and frameworks for implementing viable development measures.

The author—more of a researcher-editor, in fact—wishes to express her thanks to the following persons who made real contributions to the development of the paper, by offering their precious time, ideas and available materials: Janusz Szewczuk (Program Development Director, LGPP, Warsaw, Poland), Zbigniew Pluta (Enterprise Center ZSRG, Szczecin, Poland; Prezes), Zdravko Pekar (Director, Economic Department, University of Ljubljana), Stane Vlaj (Senior Lecturer, Director of the Institute for Public Administration, Ljubljana, Slovenia), Ewa Kurjata (Osrodek Integracji Europejskiej, Biuro DS. Bałtyckich; Szczecin, Poland), Marek Jefremienko-Przłubski (Jefremienko S.C., Warsaw, Poland; Municipalne Usługi Doradcze), Dominik Gorski (Przewodniczący Rady Miasta Szczecin Local Council, Poland), Grzegorz Jankowski (I Wicewojewoda Zachodniopomorski, Szczecin, Poland), Henryk Wozniak (Deputy Director, Department of International and Interregional Cooperation, Gdansk, Poland), Jan Kukutka (Mazowieckie Biuro, Warsaw, Poland; Zastępca Dyrekt), Marcin Szpak (DS Consulting SP. ZO. O., Gdansk, Poland), Marcin Modrzejewski (Urząd Miasta Kosciierzyna; Poland), Krystyna Wróblewska (Director, Department of International and Interregional Cooperation, Gdansk, Poland), Zbigniew Ptasiwicz (Director, Mazowieckie Biuro, Warsaw, Poland) and others that may be omitted by mistake.

Special thanks are addressed to Partners Romania Foundation for Local Development for its permanent support.

# Contents

- Foreword.....5
  
- Introduction.....9
  - Development.....9
  - Globalization.....10
  - Regionalization.....10
  - Urbanization .....11
  - Toward a Correlated Strategy.....11
  
- 1. Effective Development .....12
  - Development Assessment .....12
    - Human Development.....14
    - Environmental Degradation .....14
    - Income Inequality and Volatility.....14
    - External Factors.....15
  - Principles of Effective Development .....15
  - Development Priorities.....17
    - Human Capital .....18
    - Natural Capital.....19
    - Dealing with Globalization.....19
    - Improving Governance and Controlling Corruption .....20
  - Conclusions—Focus on Quality.....21
    - Key Points .....22
  
- 2. Regionalization.....23
  - The Aims of Regionalization.....23
  - Forms of Regionalization.....27
    - Regional Decentralization.....27
    - Political Regionalization (Institutional Regionalism).....29
    - Regionalization without Creating a Regional Level.....30
    - Federal States and Regionalization .....33
  - Obstacles to Regionalization.....35
  - The Consequences of Regionalization—Intergovernmental Relations.....40
    - Key Points .....51

3.	Planning for Effective Development.....	53
	General Methodological Approaches for Development Strategies .....	54
	Strategic Participatory Planning.....	56
	Planning a Chaordic System .....	57
	Testing the Strategy.....	59
	Anticipation and Flexibility .....	60
	Maintaining Adaptability to Change.....	61
	Implications for Policy Development.....	63
	Key Points .....	64
4.	Functions and Roles in Economic Development .....	65
	Regulatory Function.....	65
	The Stabilization Function .....	70
	The Distribution Function .....	71
	The Main Roles of Economic Development Actors .....	72
	National Government.....	72
	Local Governments .....	73
	Economic Development Organizations .....	75
	Partnership Networks .....	79
	Key Points .....	81
5.	Intergovernmental Relations' Impact on Development.....	81
	Centralized Control and Its Regional Impact .....	83
	Decentralization of Fiscal Policy .....	84
	Intergovernmental Relations Regarding Revenues .....	87
	Intergovernmental Relations Regarding Expenditures.....	88
	Intergovernmental Transfers .....	89
	Sub-National Borrowing .....	93
	Impact on Regional Financing.....	95
	Redistribution Effects on Individual Economic Segment.....	97
	Key Points .....	101
	References and Bibliography.....	101
	Index.....	105
	Biography.....	107

# Evolving Intergovernmental Relations for Effective Development in the Context of Regionalization

*Claudia Pamfil*

## INTRODUCTION

### Development

Development is about people and their well-being. Accordingly, development must be inclusive of future generations and the earth they will inherit. It must engage people, for without their participation, no strategy can succeed for long. This means that measures of development must include not just rates of growth, but the dispersion, composition and sustainability of that growth.

Over the last decade, *World Development Reports* has highlighted:

- the crucial roles of governments and markets in poverty reduction (World Bank 1990);
- an emerging consensus under the rubric of a market-friendly approach, calling for a reappraisal of the roles of states and markets (World Bank 1991);
- the essential roles of states and markets in environmental protection (World Bank 1992), in infrastructure provision (World Bank 1994) and in the legal and government framework and financial systems (World Bank 1997).

Evidence from the last decades expands the development story, especially concerning institutional requirements for success and provides a rich set of hypotheses regarding policy making. First, investments in people need to be concerned with the quality and distribution of those investments. Second, *ad-hoc* development decisions can hurt environmental sustainability in the absence of appropriate actions. Third, while market openness and competition continue to provide benefits, the financial risks must be managed with attention to country-specific factors. Fourth, good governance and institutional factors should be given priority and not postponed for later stages of reform.

## Globalization

As international corporations cross borders around the world and build qualitatively better networks, internationalization is being replaced with “globalization” (OECD 1994), specifically:

- globalization of markets—smaller trade barriers, sophisticated communication and transportation routes
- globalization of firms—the high and growing volume of direct foreign investments, growth of world trade, increasing number of cooperative agreements between research and development firms, distribution, marketing and provision of all kinds of resources.

The global process characterized by the total mobility of human, physical and financial capital threatens the comparative advantages of individual regions and restricted mobility of human and physical capital. A study by the Organization for Economic Cooperation and Development (OECD) notes that the significance of regions is increasing primarily in terms of specific human resources and technological infrastructure. Under globalization, there is a danger that disparities between regions will be enhanced.

Geographic concentration is most significant in crafts, in the high-tech sector (electronics, biotechnology) and in certain kinds of services, such as finances, fashion and the film industry.

On the other hand, research increasingly tends to hold that growth often begins accidentally. But even an accident must be “assisted,” and, therefore, the significance of regional development programs and investment agencies should not be underestimated.

## Regionalization

The process of European integration has played a major role in revitalizing the regional concept. With the introduction of European regional policy in 1975, community construction could be directly implemented at the local and regional levels, and the rapid growth of structural funds stimulated local and regional authority interest in Europe. The commission divided up territory into statistical areas in order to assess regional economic situations (the Nomenclature of Territorial Units for Statistics—NUTS I, II and III).

Since community policy in this area was aimed at remedying or preventing regional imbalance by helping economically handicapped regions, it allowed regions (and in fact any authority capable of representing the areas in question) to promote regional interests. Community regional policy triggered the establishment of all the current associations of regions that now lobby the commission in Brussels.

An increasing number of associations of regions, or bodies which represent them, have established offices in Brussels. Varieties include peripheral maritime regions, traditional industrial regions, central Alpine regions, wine-growing regions and national capital regions. This has culminated in a demand for participation in institutions. The Maastricht Treaty responded by setting up the Committee for Regions.

Despite large regional policy expenditures, regional inequalities in Europe have not narrowed substantially over the last two decades and by some measures have even widened. European regions have become increasingly polarized in terms of their unemployment rates. Income differences across states have fallen, but inequalities between regions within each state have risen. European states have developed increasingly different production structures. Nearly one quarter of its citizens live in regions (NUTS I, II) eligible for assistance under “objective 1” of the structural fund allocation system, the main instrument of EU regional policy. These funds are available for regions where the per capita GDP is below 75% of the EU average. If a similar measure was used for the United States, only two states, Mississippi and West Virginia, containing only 2% of the US population combined, would qualify.

Of extreme importance, however, are the steps toward accession that Central and East European Countries (CEECs) will take on their own. The process of seeking accession to the EU, which involves meeting numerous requirements, certainly enhances administrative reform—strengthening the decentralization of funds and the regional policies of CEECs. Supporting the transfer of funds to local governments in preparation for joining the EU requires large-scale institutional, operational and legislative changes. In the field of regional policy and cohesion—provided that the CEECs create the necessary administrative and budgetary framework and work toward building adequate structures of financial control—CEECs should, in the medium term, be able to use regional and structural funds to support their development effectively.

## Urbanization

We live in a world that is on the threshold of having the greater part of its growing population living in urban areas. The status of world urbanization was 37.5% in 1975, 47.5% in the year 2000, and it is forecasted to reach 61.0% in 2025. Although these numbers show that the 21st century will be an “urbanized century,” it is the *rate of growth* that lends a dramatic touch to the changes that cities are undergoing.

Rates of urban growth are occurring parallel to and in the context of a period of transition: in a chaotic environment resulting from insecurity, employment instability and anxiety in the face of changing structures. Urban inhabitants suffer exclusion, lack of solidarity and hopelessness on top of job insecurity and all sorts of other fears. For city dwellers to become citizens, they must have access to services, be able to house themselves and their families properly, as well as sustain them. Expression and community participation are also necessary ingredients of urban citizenship.

## Toward a Correlated Strategy

The future does not arrive all at once. If transition strategies are not put in place and implemented in a timely way, marginalization will occur as a new political map of the world is drawn showing pockets of well-being (in each country and city) surrounded by masses of the poor and the

excluded—despairing and resentful in their struggle for survival. The task will be to set up action strategies that address local, national and regional circumstances.

Thinking about the future and formulating a transition strategy are urgent tasks facing planners and public administrators. First and foremost, it is an undertaking in which every citizen and representative organization, as well as the private sector, should take part. Only partnerships that democratically bring together the central government, regional and local government, the private sector, workers and employers, civil society and all other players in a negotiating process will overcome probable conflicts stemming from a legitimate clash of interests.

## 1. EFFECTIVE DEVELOPMENT

The final decade of the 20<sup>th</sup> century saw striking progress in parts of the world, but also stagnation and reversals, even in countries that had previously enjoyed rapid growth. As prosperity spread and the quality of life improved for many in society, poverty is estimated to have persisted stubbornly or worsened for others. Greater population pressures, little access to education and degraded natural resources made the poor increasingly vulnerable to the volatility of growth.

Between 2000 and 2010, the population of developing (including transition) economies is projected to grow from five billion people to six billion. If countries follow a business-as-usual scenario, the number of people in the developing world (excluding China) living below the poverty line could swell by some 130 million.

### Development Assessment

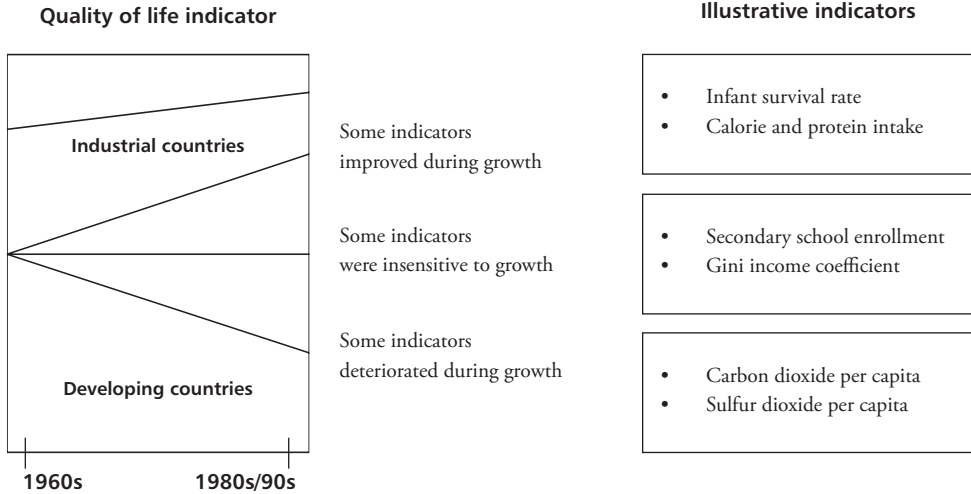
The reliance on GDP as the sole measure of development is seriously limiting. GDP growth can be of high quality or of poor quality. Some processes and policies generate GDP growth along with the growth of human and natural assets that directly affect people's welfare beyond their productive roles. Others generate poor quality growth that is not associated with improvements of human and natural assets. To integrate the quality of growth in assessments of development, multidimensional indexes of welfare are needed.

In an ideal assessment of development, progress would be measured by human and environmental advances before considering intermediate indicators, such as GDP. Such an analysis can be supplemented with indexes of human development and environmental sustainability, keeping in mind serious data limitations on some variables.

Three indicators of progress since 1981 have been used for analysis: human development, income growth and environmental sustainability. This analysis shows that GDP growth is correlated:

- Positively with reduction in poverty, income inequality, infant mortality and increase in life expectancy, with considerable differences in strength;
- Negatively with decline in carbon dioxide emissions and increased water pollution.

*Figure 1*  
GDP Growth and Changes in Quality of Life, 1960s and 1990s  
(applicable for countries with positive GDP growth)



SOURCE: Dhareshwar 2000.

This preliminary correlation suggest that GDP growth is a crucial, yet partial, indicator of development, as when it is imperfectly associated with certain aspects of human development, and at times when it is associated with an increase in environmental damage.

It is very important to note that the above relationships are between *growth* of income and *changes* in human development and environmental sustainability. Relationships in most cases are much stronger with *levels* of income and indicators, particularly for human development indicators. Alternatively, regional and local specific factors, such as endowments, location, social and economical infrastructure and quality of public services could be determinants of levels of both income and human development indicators. In that case the cross-country correlation between income and quality of life indicators would need to be qualified.

Growth based on relatively balanced accumulation is likely to be less volatile and to be sustained over the long term. First, a comparison of reformers and non-reformers showed that reforms helped to accelerate growth in the 1990s. Different analysis show that the *rate* of economic growth declines as the stock of physical capital increases. The accumulation of human capital assets, by increasing access to education and health care, can arrest this decline. When natural capital is also considered as a factor of production, human capital can substitute for natural capital to some extent and reduce dependence on it as a source of growth.

## *Human Development*

Robust economic growth is accompanied by improvements in measures of human development, such as higher literacy and life expectancy.

Overall, the gains in human development over the past four decades have been enormous in some areas—partly reflecting technological improvements—and modest in others. Infant mortality and adult illiteracy rates fell dramatically almost everywhere.

In the developing world, the poverty headcount index, defined as the proportion of people with an income of less than one USD per day based on 1993 purchasing power parity prices, decreased from 28.3% in 1987 to 24% in 1998 (World Bank). Poverty rates increased sharply in Europe and Central Asia.

Even greater is the poverty increase in the transition economies of Europe and Central Asia, where as recently as 1987 poverty and income inequality were both extremely low. Survey data shows an enormous increase in the number of poor as a result of sustained declines in economic output and worsening income distributions (World Bank quoting Milanovic 1997): for all transition countries, the percent of the population living on less than four USD per day was 4% in 1987–88 and increased to 40% in 1993–95. The same source mentions Poland as the country with the lowest increasing poverty rate (from 7% in 87–88 to 15% in 93–95) and Moldova with the highest one (from 4% to 67%).

## *Environmental Degradation*

The impact of economic growth on environmental conditions has been mixed and is a serious concern. In many instances GDP growth and higher incomes are associated with better sanitation and water quality, as well as investments in cleaner technologies. But growth is also related to increases in particulates and carbon dioxide emissions. With equal weights for the changes in indicators of water quality, air quality and deforestation, income growth between 1981 and 1998 was associated with environmental deterioration and depletion of natural resources.

Between 1990 and 1995, the rate of forest clearing slowed in most developing regions, but forest cover was still disappearing rapidly. Between 1980 and 1995, carbon dioxide emissions, total as well as per capita, increased across most income groups and regions (World Bank 2000).

## *Income Inequality and Volatility*

It is also important to consider how income was being shared by looking at changes in income inequality. Several dimensions of income inequality are relevant here: between countries, across households within countries and within households. As noted in World Bank (2000), the gap between the average income of the richest 20 countries and the average for the poorest 20 has doubled in the past 40 years to more than 30 times.

Comparable data on income between the 1980s and 1990s show that in-country inequality increased for countries with large populations (Brazil, China and India) but much more for CEECs (Romania, Poland, Hungary, Bulgaria, FSU).

Declines in economic growth were directly associated with sharp increases in poverty in Eastern Europe. Economic downturns appear to have enduring adverse effects on the economy. Studies suggest that bigger fluctuations in growth rates are associated with slower average growth.

Compared with the 1980s, Central and Eastern Europe saw much more volatile growth than other regions in the 1990s. Developing countries seem to have experienced higher volatility than industrial countries. Studies quoted by the World Bank explore the determinants of increased volatility, finding that:

- openness to trade and the volatility of capital flows are associated with increased volatility of growth;
- improvement in indicators of financial development are associated with lower volatility;
- constraints on policy from institutional limitations and underdevelopment of the financial sector contribute to the variability of outcomes.

### *External Factors*

In the 1990s global and cross-border issues related to financial crises, population pressures, labor migration and environmental distress continued to affect domestic outcomes. The global economic environment experienced significant change in the 1990s, becoming more conducive to development in some respects, less so in others. Import demand by OECD nations was less volatile in the 1990s than in earlier decades, partly because the cycles of North America, Europe and Japan were no longer synchronized, partly because of the increased weight of developing countries in world trade. Thanks to monetary restraint and progress in fiscal consolidation, real interest and inflation rates in the major OECD countries dropped in the 1990s, and volatility in the exchange rates of major currencies was considerably smaller relative to the pronounced dollar cycle of the 1980s. The robust growth in world trade sharply surpassed growth in world output through 1998. The international trading environment remained liberal on the whole and there was a phenomenal increase in private capital flows to developing countries.

Success in a highly globalized setting requires adequate mechanisms for managing risks and successful policies for openness and competition need effective regulatory and legal frameworks.

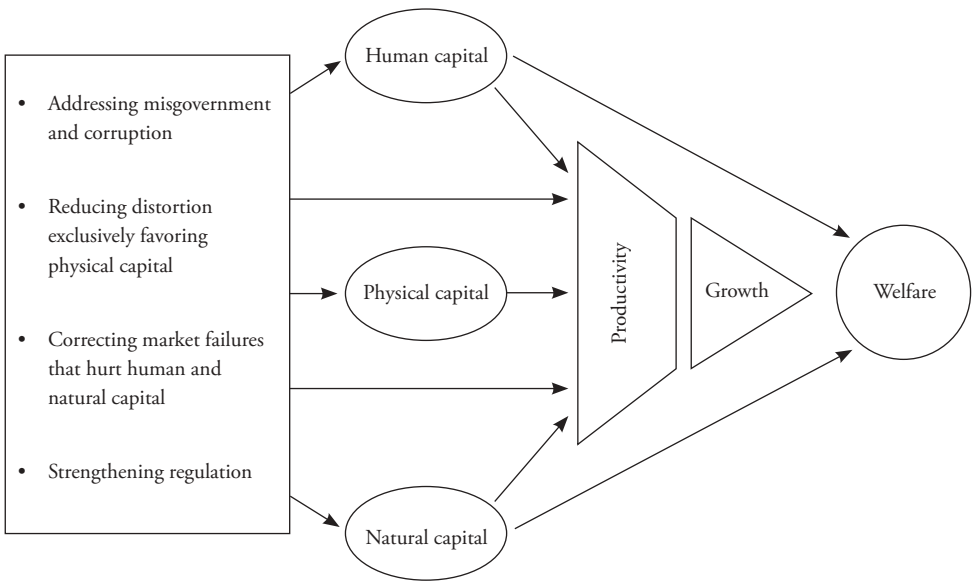
## Principles of Effective Development

Human, natural and physical capital assets are a country's main resources for growth and welfare improvements. Their distribution, growth and productivity largely determine people's income and welfare.

There are many points of view by which to assess a country’s economic conditions. Likewise, there is more than one governing approach that can be used to determine how conditions can be changed. Focusing on the quality of outcomes could help to sustain more rapid growth. Observing both sides of the growth process, quantitative and qualitative, reveals three key principles of development:

- Focus on all assets: human, physical and natural;
- Attend to the distributive aspects over time;
- Emphasize the institutional framework for good governance.

Figure 2  
The Principles of Effective Development



SOURCE: The Quality of Growth, World Bank 2000.

Actions focusing on the quality of development need to be a core part of the policy package, not add-ons to an already crowded agenda. That means that stakeholders will have to expand actions, shifting the emphasis to:

- *Asset accumulation and use*, by reducing policy distortions—for example, valuing natural resources and investing adequately in human resources instead of exclusively favoring or subsidizing physical capital. The implication is to ensure broadly based, sustainable development, not to slow growth.
- *Regulatory frameworks*, by building regulatory frameworks for competition and efficiency to accompany liberalization and privatization and giving legal and judicial reforms greater attention, while ensuring macroeconomic stability. The implication is to take supportive regulatory actions along with liberalization, not to slow liberalization.

- *Good governance*, by nurturing civil liberties, participatory processes and accountability in public institutions, promoting anti-corruption efforts and actively involving the private sector to reduce the influence of vested interests, while building capacity for policy changes. The implication is to increase the attention to coalition building in civil society, not to detract from government policy and capacity building.

These principles attract key actions:

- improving the distribution of opportunities: the improvement in human capital in the slow-growth countries is crucial to propel faster and better growth in the near future.
- sustaining natural capital: the deterioration of natural capital will reduce the potential for future growth, becoming a serious obstacle to improving the welfare of the population.
- dealing with global financial risks: the risks of financial globalization have to be managed in a way that diminishes the volatility of growth and improves its sustainability.
- improving governance and controlling corruption: the manner of governing is very important for growth processes and outcomes, as well as controlling corruption.

Furthermore, sequencing actions is unlikely to be effective—whether liberalizing first and regulating later, privatizing first and ensuring competition later, growing first and cleaning up later, or growing first and providing civil liberties later. To do the most for long-term growth, liberalization, for example, needs to go together with regulatory actions, environmental management and anti-corruption measures.

## Development Priorities

Progress on policy was substantial in the 1990s: reducing fiscal deficits, investing more in education, lowering trade and investment barriers and dismantling domestic price controls in agriculture and industry. The record was more mixed on development outcomes. But both the 1990s and the longer-term record confirm that these actions go with improved economic growth. They also corroborate the link between economic growth and poverty reduction.

Thus, on the whole, the developing world recovered from the setbacks of the 1980s, but both the depth and the breadth of the recovery left much to be desired. The record also suggests that actions by governments and others to affect the quality and sustainability of growth have lagged. Events in Europe, East and Central Asia and elsewhere underscore the fragility of advances in reducing poverty and achieving sustainable development. The numbers of poor people continue to increase, and today an estimated 1.2 billion live in absolute poverty, on less than one USD per day. The incidence of poverty is highly sensitive to changes in income distribution and to population growth. So, policies affecting broad and equitable growth and population growth deserve considerable attention.

The diversity of development outcomes underlines the importance of policy effectiveness, notably in the following four areas: quality and distribution of services, stewardship of the

environment, effectiveness of governance and management of the opportunities and risks of globalization. All three elements—human, natural and financial—rely on the quality of overall governance, which is fundamental to the quality and sustainability of the growth processes.

Why is there a failure to take up policies that have shown themselves sound? Policy-makers' lack of understanding of these policies is unlikely to be the main reason. More likely it is the political difficulty of implementing sound policies. Interest groups limit the range of feasible reforms and open a gulf between policy design and implementation. Finding the best manner to counteract these forces, through enhancing participation and stronger government ownership, is a crucial step in assuring effective policy-making and implementation.

The special circumstances facing the formerly centrally-planned economies as they strive to make the transition to market economies are another crucial factor in policy-making. These circumstances underline the importance of concentrating efforts on quality governance and anti-corruption.

Recent studies support broadening the focus of actions to encompass a comprehensive development framework, a qualitative and fuller agenda involving structural, human, social and environmental aspects of the growth process. This broader focus complements liberalization with a build-up in the assets and capabilities of the poor. It shifts attention from an exclusive reliance on government as the agent of change to the engagement of all parts of society. And it requires much more effective capacity building across the board.

With all development partners complementing one another, a more integrated framework can be implemented more effectively. Addressing the inequality of opportunities promises great welfare gains to society. If environmental damages and biodiversity losses are addressed now, growth can achieve a better natural environment and reduce poverty.

Globalization presents risks to the poor, but if those risks are addressed now, globalization could create the technological wherewithal for reducing poverty.

Corruption, inefficient governance and a lack of civil liberties threaten the gains from any reform. But if those threats are addressed now, better governance presents a greater promise of improved welfare.

The opportunities afforded by increased openness, knowledge and technologies have never been more plentiful. Equally, the challenges of poverty, environmental degradation, financial distress and misgovernment have never been greater. More growth with a focus on quality is needed. This is not a luxury. It is crucial to enable countries to seize the opportunity to improve the lives of their citizens.

### *Human Capital*

Investments in human capital—education, health care and population policies—can directly improve quality of life. They can also improve investment incentives through the effects of a healthier, more educated work force on the productivity of capital. So shifting the emphasis more toward human capital could promote faster growth in the long run.

No country has achieved sustained development without investing substantially and efficiently in the education and health of its people. But public spending does not always produce positive outcomes. It depends on the distribution and quality of public spending and incentives for private spending.

Governments need to allocate public expenditure for basic education in order to ensure its quality and equitable distribution. Public-private partnerships need to be encouraged to increase efforts in education at all levels, together with a supportive labor market and social protection policies.

### *Natural Capital*

Several indicators of the quality of natural capital, with the notable exception of access to clean water and sanitation, have tended to deteriorate in both slow- and fast-growth economies. For the developing world as a whole, depletion of natural capital (forests, energy and minerals) and damage from carbon dioxide emissions is estimated at 5.8% of GDP. This deterioration of natural capital imposes significant current costs and diminishes prospects for future growth. Faster growth has the potential to make more resources available to invest in natural capital accumulation, but actions are needed to ensure the quality of the growth process. Thus, the grow-now-clean-up-later approach needs to give way to an environmental policy that is integrated with growth policies.

Successful initiatives often involve selective state interventions and focus on collaborative approaches with local communities and the private sector. Global and national problems can be simultaneously addressed through international cooperation, including transfer mechanisms for payments to compensate for global externalities. Only a strong combination of domestic and global market-based incentives, investments and institutions can create environmentally sustainable growth. As a consequence, the pursuit of high-quality growth is possible, and desirable, without extensive degradation of the atmosphere, forests and rivers, or any other aspects of natural capital.

### *Dealing with Globalization*

To better deal with the hidden risks of globalization, countries need to maintain sound economic policies, to deepen domestic financial markets, strengthen domestic regulation and financial supervision, introduce corporate governance mechanisms and provide social safety nets.

Integration into the global financial system has undeniable technological and economic benefits for countries, but it also exposes them to shocks—great volatility in currency values, interest rates and capital flows. These shocks can bring about major output and job losses, corporate and banking distress and increased poverty. Thus, countries need suitable mechanisms to balance the benefits of globalization with its risks, while maintaining their commitment to market openness.

A sound macroeconomic policy is essential to sustained growth, but recent experience shows that macroeconomic stability cannot do it alone. It must be complemented by actions to remove the explicit or implicit government guarantees that provide incentives for short-term capital inflows, to strengthen domestic regulation and supervision of banks and other intermediaries, to rebuild the information infrastructure of financial markets and to improve corporate governance and transparency. Countries must also maintain public support for open capital markets. In democratic countries, this entails providing insurance to citizens either through the marketplace or through redistribution of public expenditures on education, health and transfer payments.

### *Improving Governance and Controlling Corruption*

Government has a key role in delivering the public goods essential for achieving balanced and sustained growth and reducing poverty. It also needs to have effective and streamlined regulatory regimes to address externalities and market failure. Misgovernment and corruption distort policy-making and the allocation of key production factors, consequences that slow income and welfare growth and increase poverty. Many development projects and investments have failed because too little attention was paid to fostering good governance and civil liberties, controlling corruption, improving bureaucracy and building institutional capacity.

Governance needs to move to center stage in institution-building strategies, requiring better analysis and measurement of the dimensions of governance and a clearer understanding of the vested interests of powerful groups. Where the legal and judicial frameworks are weak and vested interests have taken over the state policy-making and resource allocation apparatus, the social cost can be enormous. In that case the institution building needed for effective development interventions may be extensive, warranting an active approach.

Increased participation can be vital for increasing transparency, providing the necessary checks and balances and countering state capture by the elite. Collective action from such a participatory consensus-building process, coupled with the power of information, disclosure, transparency, knowledge and capacity building, can nurture the political will and technical ability to address misgovernment and sustain institution building. The engagement of civil society in participatory and transparent processes with reformists in the executive, legislative, judiciary and private sectors can make the difference between a well-governed and a misgoverned state, between a stagnant and a thriving society.

Creating a climate for successful development thus requires an integrated approach linking economic, institutional, legal and participatory elements: building transparent and effective institutions for budgeting and public investment programs as complements to macroeconomic policies, establishing merit-based, efficient and honest customs and public procurement agencies and promoting civil liberties and popular participation.

## Conclusions: Focus on Quality

Improving governance, reducing rent seeking and corruption and encouraging greater corporate responsibility can increase national savings and as result investment in people and natural capital can be financed more and better. On the other hand, increasing the charges for the use of natural resources and taxing such externalities as pollution can make more resources available for development. Third, reducing distortions that favor physical capital can be beneficial. It can allow a reallocation of national savings, in favor of human development. Fourth, reducing subsidies within sectors for services that are regressive or damaging to the environment can reallocate public resources to benefit the poor or to promote sustainable development.

These policy elements directly contribute to development. They have a two-way relationship with growth: they add to the impact of growth on welfare, they help make growth more sustained and they address the conflicts that growth might pose to sustainability.

A focus on quality highlights the role of regulatory policies and public expenditures in dealing with market failures.

The solution is not necessarily to increase the regulatory burden of the economy or to increase public expenditures, but to reallocate public expenditure following new priorities and to change the nature of regulation—eliminating regulations that are counterproductive and improving those that address market failures. The new public expenditure priorities should be channeled to promote the buildup of human capital, to prevent further degradation of natural capital and reduce regressive subsidies benefiting physical capital. Regulations should be targeted at failures in financial markets and in markets that affect the use of environmental resources.

Economies that focus on quality can deal better with difficult tradeoffs. One tradeoff is the temptation to subsidize physical capital or overexploit natural capital in an effort to promote growth. In this and similar cases, a focus on the qualitative aspects of growth helps to manage the tradeoffs.

Most countries—and many policy advisers—have stressed macroeconomic stabilization and liberalization first. Meanwhile, actions on the qualitative aspects, such as the distribution of education and the sustainable use of natural capital, are postponed. The evidence shows the fundamental limitations of this approach and the benefits of joint action.

Reformers have sometimes found it necessary to take advantage of windows of opportunity for liberalization, when vested interests and opposition to liberalization have been muted. Whether the qualitative dimensions also receive priority may depend on other conditions, including the spread of democratic institutions. In an increasingly mature and participatory setting, a country would not want to postpone the important qualitative aspects of growth to a time when the costs of addressing them will have multiplied.

Sometimes, political difficulties can impede progress, even when the importance of the qualitative aspects is clear. Interest groups may drive a wedge between policy design and implementation. Collusion between politicians and the elite may distort the allocation of public resources to reward the owners of physical capital. For example, tax holidays, implicit guarantees on infrastructure, monopoly powers and easy access to natural resources often benefit the rich, but hurt the poor.

A greater priority to the quality dimensions of growth can be accorded by taking into account the following observations:

- Explicit attention to ensuring transparency and reducing corruption will not only raise national saving and investment and promote sustained growth, but will also help to distribute its fruits more equitably.
- Some quality dimensions lend themselves to full-cost pricing or taxation, both of which generate public resources.
- Other measures to ensure quality require a reallocation of public expenditures—reducing subsidies and distortions in some areas and increasing public investment in others.
- Attending to quality does not have to mean more government intervention, but rather may mean more involvement by the private sector, nongovernmental organizations and civil society in implementing shared goals.
- Broader civil outreach can nurture civil liberties and participatory processes that can help to sustain policy changes.
- All this in turn would call for a much greater focus on skills, technological development and capacity building and the effectiveness with which this is done.

Rather than calling for more government intervention, focusing on quality calls for greater participation by the private sector, NGOs and civil society. A broader involvement by all can move the emphasis of development beyond measured GDP growth to include social and environmental progress, greater empowerment and voice and better governance. This reallocation of priorities will refine the contribution of the qualitative aspects of the growth process and focus the spotlight on what development truly means.

### *Key Points*

The policy implications for ensuring quality growth can be organized under three principles:

1. *Policies for Undistorted Growth of Physical, Human and Natural Capital*
  - Avoid direct or indirect subsidies to capital, such as tax breaks, allocation of monopoly powers and subsidies, special privileges that feed corruption and implicit guarantees on rates of return.
  - Invest efficiently in human capital and ensure access for the poor through incentives and allocation of public investments in education.
  - Sustain natural capital by clarifying property rights, avoiding unrealistically low levels of royalties for natural resources and enforcing environmental taxes.
2. *Aspects of Growth Attend to Stability and Distribution*
  - Ensure equitable access to education, technology and health services, as well as land, credit, skills training and job opportunities in open markets.
  - Ensure effective regulatory frameworks and anti-corruption measures to accompany financial openness and privatization.
  - Align reforms and restructuring to mechanisms for mitigating the costs of crises, which will likely be borne disproportionately by the poor.

### 3. *Build the Government Framework for Development*

- Involve all stakeholders—the private sector, including transnational firms and the domestic private sector, NGOs, civil society and the government—in implementing a shared development agenda.
- Empower people through participation and greater civil and political liberties.
- Support economic liberalization by promoting institutional development and better governance.

## 2. REGIONALIZATION

Regionalization is generally understood as the creation of a new level in a state territorial organization. The new institutions can be defined very broadly, including regions that are merely subordinate levels of the central government, or more narrowly the region as territorial authority. Regionalism can also mean the definition of a region by a set of human, cultural, linguistic or other features, which justify turning it into a political body with different degree of autonomy.

The trend toward regionalization as it is currently emerging in Europe makes these definitions somehow archaic due to the various and complex alternatives implemented by different countries. Regionalization is even happening in countries that do not intend to introduce a new territorial level and already have elected bodies at all levels. Regionalization corresponds more specifically to a novel approach of the objectives and function of the intermediate level.

While the definition of a region depends on the criteria used, it appears that different variables—natural, social, cultural and economic—more or less coincide, so that specific areas can be identified as regions.

Development is an inter-territorial process that combines differentiation and interdependence between the various levels. Therefore the region can be defined as an intermediate level of territorial organization of economic relations.

The region is a source of potential rather than a framework for action: the opportunities for mobilizing the resources of the regional system must be exploited. In the economic sense, the region is a spatial polarization by urban centers, industrial resources facilitating intra- and inter-regional specialization and organizational forms which guarantee solidarity, coordination and the integration of private and public decisions.

### The Aims of Regionalization

Concerning the aims of regionalization one can identify a political aim, possibly in relation to ethnic or cultural specificities, an economic aim and an aim to rationalize and modernize state structures.

Regionalization may have a political aim without imposing any particular model on the process. It is difficult to imagine regionalization having no political aims when it includes setting up regional institutions with some degree of autonomy.

The economic aim is present in all forms of regionalization, including those which do not involve creating an additional administrative level or new institutions. Regarding the importance of regional economic systems for overall economic efficiency and the fact that collective public goods occupy an important position in regional economic systems, regionalization may be aimed at tailoring existing local institutions to the needs of economic development or creating new institutions within the political and institutional context of a given country.

According to their level of economic development, EU countries are facing various problems that channel the objectives and the implementation structure of regional national policies:

- national underdevelopment (as in the case of “cohesion” countries)
- extreme internal inequalities (as in Germany and Italy)
- unemployment (mainly in United Kingdom and France)

European regional policy is also a powerful factor in regionalization because it legitimizes this level of territorial organization.

Some examples:

In **Portugal**, while the mainland regions provided for in the constitution will at some stage have to be created, this will be done largely for the purposes of adapting administrative structures to the management of the large amounts of structural funds which have been paid to this country; where regional boundaries are concerned, discussions are under way between supporters of a seven-region set-up, as proposed by the Ministry of Economic Planning and Coordination, and those advocating a division into five regions, on the model of the European Community’s NUTS statistical units for Portugal. The current regional coordination commissions, which are devolved state bodies, correspond to the five-region set-up.

In **Sweden** the debate on redrawing counties has been given new impetus by the prospect of forthcoming accession to the European Union. The demand for regionalization comes mainly from the southern regions (Western Sweden, Skane and the Stockholm region), which wish to expand relations with the border regions of neighboring countries, while local authorities in the peripheral regions are especially interested in the resources potentially created by regional policy because the economic recession in the country is affecting their financial situation.

In **Hungary** alleviation of regional inequalities is the key strategic task of regional development. Differences—between Budapest and the rest of Hungary, between the eastern and western halves of the country, between towns and villages, advanced and backward regions and municipalities—need to be reduced with regard to economic development, employment, living conditions, education, access to cultural activities, health and social services, infrastructure facilities and resources. To this end, it will be necessary to concentrate an increasing proportion of the available central resources on the regional development of disadvantaged regions. The Regional Development

Act has recently been amended, creating a regional level and associated institutions of regional development. Regional development councils have already been established in the seven designated planning and statistical regions.

In **Romania** the west of the country bordering Hungary and the Balkans is better developed than the eastern areas bordering Moldavia, Ukraine and Bulgaria, with Bucharest a relatively isolated locus of economic development. Figures in the Romanian National Development Plan show the northeast and south of the country to be the regions facing the most serious social and economic development problems, unemployment and industrial decline.

However, the most severe disparities in development are within regions. The areas most immediately affected by the post-1989 industrial decline were the more recently industrialized areas, which were located in previously agricultural areas lacking their own resources, and were therefore dependent on transfers of energy and raw materials. Meanwhile, traditional industries, such as mining and minerals, have found themselves exposed to the pressures felt on these industries all over Europe. The rural economy, under-resourced and distorted by central planning requirements, has been slow to revitalize.

Many Romanians who lost their jobs in the old state sector find it impossible to migrate into new jobs, in the service industries, for example. Many, if they cannot live on social assistance, return to subsistence agriculture. Romania is the only European transition economy where the share of employment in agriculture has actually increased since the beginning of transition (from 28 to 36% of total employment).

Given limited new investment and very limited rural opportunities, educated and working age people will inevitably be lost to the poorer areas in the longer term, leading to a spiral of decline and loss of confidence in the future, unless new activities begin to provide incentives for re-investment and improved local competitiveness. As the current experience in Romania shows, investment and development processes are often very localized, by-passing disadvantaged areas and operating as enclaves rather than being integrated into a newly revitalized regional economy.

The economic aim has scarcely been a factor at all in regionalization in other countries:

- In **Italy** economics is virtually absent from the responsibilities of the ordinary regions.
- In **Spain** economics had very little to do with the creation of the Spanish autonomous communities.

On the other hand, the role of regional institutions in developing infrastructure and organizing regional networks reinforces the administrative boundaries and maintains the economic dynamics that support the institutions themselves.

Accentuating economic disparities or competition may threaten national unity by reviving forms of regionalism which were considered extinct—potentially giving wealthier regions the idea they would be more successful if they did not have to show solidarity with poorer regions.

Lastly, regionalization is often aimed at rationalizing and modernizing administrative structures; however, only reforms which are geared to encouraging regional expression, not just the action of the central authorities, can be seen as instances of regionalization, in this case administrative regionalization.

**French** regions reflect this trend, even to the extent of disregarding historic regional boundaries. Even though departments co-exist with regions, the creation of the latter went hand-in-hand with the modernization of the state.

In **Sweden** the main reason for the debate on new county boundaries was the realization that existing boundaries had become meaningless; national administrative agencies (particularly those in charge of road networks and education) often base their action on regional divisions rather than on boundaries between counties.

The adoption of special regionalization schemes can be seen from another angle: above and beyond cultural differences, not all of which are asserted to the same extent, distance and isolation justify special institutions and increased autonomy. This fact emerges from study of Spanish and Portuguese island regions, Sicily and Sardinia in Italy and the French overseas regions.

In most Central and Eastern European countries, regional disparities have increased and new economic tensions have emerged with the onset of transition. On the other hand, EU accession presents new possibilities that require important institutional and operational changes for these countries. As a result, the issue of regional development becomes crucial in every economic and political discussion in CEECs. While economic development is stressed in proposed reforms, the general aim is rather to secure a territorial structure enabling certain responsibilities to be devolved to units capable of coping with them in administrative terms.

Despite large regional policy expenditures, regional inequalities in Europe have not narrowed substantially over the last two decades and by some measures have even widened. Income differences across EU states have fallen, but inequalities between regions within each state have risen. European states have developed increasingly different production structures, and European regions have also become increasingly polarized in terms of unemployment.

Traditionally, international and regional economics have explained income disparities on the basis of differences between regions in their endowments of natural resources, factors of production, infrastructure or technology. In this context, the removal of obstacles to the movement of goods and/or factors would alone cause the convergence of factor returns and living standards. The main argument arises from the observation that firms produce more efficiently, and workers enjoy higher welfare, by being close to large markets, and large markets are in turn those where

more firms and workers locate. This creates a cumulative causation process that tends to open regional differences.

The main contribution of what has been called the “new economic geography” is to bring together, in a common analytical framework, both convergence and divergence forces. The advantage of analyzing such forces in a common framework is that we can relate their relative strength to microeconomic conditions and explicitly study the trade-off between the economic advantages of the clustering of activity and the inequalities that it may bring. Recent location theories can thus help us understand the evolution of regional inequalities during a process of economic integration and think about the role of regional policy in such an environment.

## Forms of Regionalization

### *Regional Decentralization*

Regional decentralization is the creation or replacement of a new local authority at the regional level. This type of regionalization therefore has a specific institutional expression characterized by the application to the region of the general regulations governing local authorities. The region therefore neither has a higher legal status than, nor differs from, existing local authorities, but it has a broader geographic framework and its duties are mainly economic in nature. It fits in with the constitutional system of a unitary state.

**France** currently corresponds to this type, but the reforms under consideration in other western and eastern European countries show that some of them may well follow suit.

The current boundaries of the French regions were a response to the needs of state spatial planning policy; they are purely functional in nature. In fact they have been criticized for this very reason. Since the nation was constituted very early on, closely followed by the formation of the state, federalist and regionalist ideas have never had much influence in France. It is significant that the first modern regional institution was the office of the regional prefect.

From the legal point of view, regions are now territorial authorities like municipalities and departments, though they do not have a constitutional guarantee on their existence. French regionalization respects the principles of the unitary state, which have their constitutional guarantee in the principle of the indivisibility of the Republic.

Unless otherwise expressly stipulated by legislation, the principle of free administration for territorial authorities cannot be used as the basis for statutory powers. In practice, regions’ law-making powers are much more limited than those of municipalities and departments, particularly those of the mayor. Regions cannot exercise or assume the right to supervision of local authorities on their territory.

Territorial authorities' institutions, powers and finances are established by law. Regions are administered by a regional council elected by direct universal suffrage under a proportional vote taken in the departments.

The chairman of the regional council, who is elected by the latter, exercises executive duties. Regions are covered by the same standard jurisdiction clause as other local authorities. Moreover, legislation has attributed or assigned responsibilities in the following fields: spatial planning, state-region planning contracts, secondary education (educational planning and school premises), local economic development, transport, vocational training and tourism.

The French conception of the unitary Republic does not preclude taking local cultural differences into account. French law has incorporated and retained part of the German legislation introduced in the Upper Rhine, Lower Rhine and Moselle departments before 1919; the 1991 statute for Corsica stipulates that it is a *sui generis* territorial community with different institutions and wider powers than regions. There are also special regulations for overseas regions, the city of Paris and the Ile-de-France.

In **Portugal**, apart from the overseas regions, the regions defined by the 1976 Constitution have not yet been set up. However, the old districts, which were based on the Napoleonic model, have now lost their local authority status, and the 1991 general principles act set forth general provisions on the creation of administrative regions, governed by an assembly made up of both municipal representatives and members directly elected by the citizens. Regions would exercise administrative responsibilities in the economic, cultural and environmental fields, with respect to which they would be attributed statutory powers. However, their boundaries have not yet been established.

Regionalization projects in Poland, the Czech Republic and Slovakia also seem to follow this model.

**Poland** has made further progress regarding its territorial organization. Following the State Administration Reform of 1999, the newly created self-government provincial (*voivodship*) and county (*powiat*) authorities became fully operational and started to carry out important regional policy functions in Poland in the course of the last two years. In addition, the regulation on NUTS classification was adopted in July 2000, forming 2,489 municipalities (*gminas*), 373 *powiats*, 44 groups of *powiats* (corresponding to NUTS III), 16 voivodships (corresponding to NUTS II) and the country as a whole.

Reform on this scale takes some time to become fully effective. However, it appears at this early stage that the impact to date has been positive. The successful implementation of the new administrative structure requires adequate allocation

of financial revenues and revenue-raising powers in a stable framework. Existing legislation, which set up the system for an initial two-year period, has rolled over for another year with some improvements.

Such reforms made particular progress in **Slovakia**, where eight regions were introduced with local authority status and an elected council responsible for exercising a number of powers transferred from the state (secondary schools, hospitals, regional planning and cultural amenities). In all, eight Slovak regions are included at the NUTS II level and 79 at the NUTS IV level.

Some states have created administrative regions without prior decentralization, for the sole purpose of regional or spatial planning.

This is the current situation in Portugal and Greece, as well as in the present administrative regions in England, in which government offices for regions were recently set up. Such administrative regions can lead to regional decentralization where elected, statutorily self-governing institutions are subsequently set up, as in France and perhaps soon in Portugal. However, this is not indispensable. In Hungary, a 1994 law abolished the office of Commissioner of the Republic which had been instituted in eight regions in 1990.

### *Political Regionalization (Institutional Regionalism)*

This form of regionalization covers a wide variety of situations. Spain is the only country which has fully implemented it. It is to some extent based on the Italian Constitution, but in fact institutional regionalism in Italy was a response to a national political project rather than the upsurge of regionalism, as was the case in Spain. Belgium has also taken this approach, even though it became a federal state only in 1993. Political regionalization is partly applied in the regions of certain states such as France and Portugal.

Political regionalization in **Spain**, as organized by the 1978 Constitution, was mainly motivated by the restoration of the rights of the “historic” regions which had been recognized by the Second Republic but abolished under Franco. It reflects the complex relations within Spain—the “common and indivisible country of all Spaniards” with “the right to autonomy of the nationalities and regions of which it is composed” (1978 Constitution, Article 2).

The seventeen autonomous communities are politically self-governing in that their constituent statutes also establish their organization and responsibilities, within the limits set out in the Constitution and subject to approval by the *Cortes Generales*, and they exercise legislative power in fields falling within their competence.

The Constitutional Court has clarified the legal concept of autonomy (or self-government) in many of its decisions. Autonomy is not sovereignty, and the Constitution guarantees the supremacy of the state as the expression of the unity and predominance of the interests of the Spanish nation. However, regional autonomy is not the same as the administrative autonomy enjoyed by local authorities.

The fact that the state comprises entities with political autonomy necessitates a variety of legal systems and makes Spain a composite state. However, solidarity is the corollary of the autonomy principle. The Spanish regional system is not homogeneous.

There are several different overlapping systems corresponding to different groups of autonomous communities. The autonomous communities have large differences according to their heterogeneous historical experiences, cultural identities and aspirations, levels of development and social cohesion. Accordingly they have a different administrative responsibilities and political powers, and they have evolved at varying speeds.

However, heterogeneity persists partly because the transfers of responsibilities have not been completed in all the autonomous communities concerned and partly because of demands from Catalonia and the Basque Country for additional powers in keeping with their special status within the Spanish state.

As in Spain, regional self-government in Italy is considered differently than local self-government. Regions establish their own statutes, which must be approved by parliament, and they exercise legislative powers in fields falling within their competence. There is also a great deal of heterogeneity, because there are regions that hold a special status and exercise broader responsibilities and legislative powers. However, Italian regions are not flavored any regionalist aspirations, apart from the northern regions that contain linguistic minorities. The ordinary regions were set up in accordance with statistical criteria.

### *Regionalization without Creating a Regional Level*

This situation is met in both unitary and federal states, being the most common situation in Europe. This case implies regionalization without introducing a new territorial level but rather tailoring the existing institutions to the aim of implementing regional policies.

The urban regionalization process initiated in the Netherlands is intended to tailor existing local institutions to the needs of economic development. Moreover, French regionalization has always been geared to achieving spatial planning goals, even the regional boundaries were drawn with this in mind. Funding public investment was the main task entrusted to the regions in the aborted 1969 project, in the 1972 and 1982 laws and also in the practices developed under the latter texts.

Some examples:

As provided by **Romania's** Regional Development Law, issued in 1998, structures are organized at both the national and regional level. The National Council for Regional Development (CNDR) sets up a national strategy for regional development, approves national funds for regional development and manages structural funds from the EC. The main objectives of its executive body, the **National Agency for Regional Development (ANDR)** are:

- to set up the national strategy and national program for regional development;
- to suggest that the National Council create the National Fund for Regional Development
- to ensure the financial and technical management of the National Fund for Regional Development;
- to promote cooperation between counties, towns and villages;
- to suggest that the National Council nominate the subsidized areas;
- to serve as the national negotiator with the EC;
- to manage funds distributed for Romania from ERDF and Cohesion Funds;
- to coordinate the actions for implementing the national plan, which is the basis for negotiations with the EC, and finance other community programs.

The ANDR is a specialized agency of the central public administration authority under the direct supervision of the prime minister.

Consistent with the eight regions, there are eight regional development councils that set up the regional plans and their executive bodies—regional development agencies.

In October 2000, the Romanian Government decided to group together the National Agency for SMEs, the Romanian Development Agency and the National Agency for Development and Implementation of the Restructuring Programs for Mining Areas under ANDR.

The main fields of activity of the ANDR are:

- diminishing the existing regional imbalances and stimulating balanced development;
- preventing the appearance of new imbalances;
- stimulating the establishment of new companies and developing small and medium-sized companies;
- promoting foreign investment and privatization;
- stimulating the reconstruction of disadvantaged zones;
- harmonizing the regional development policies with government sectoral development policies;
- stimulating external and interregional cooperation and the development of trans-border regions such as Euro-regions.

The **Slovenian** Balanced Regional Development Act was introduced in 1998, upgrading the Act for Encouraging Demographically Endangered Regions. This act is actually a result of Slovenian legislative adaptation and harmonization under EC law, which at the same time enables Slovenia, legally and otherwise, to be liable for financial contributions and aid, which is to be gained from Cohesion Funds. This law defines the aims, principles and organization for promoting balanced regional development, allocation of development incentives and eligibility criteria for areas with special development problems. Promoting balanced regional development shall be a component of regional structural policy.

According to the act, regions are defined as statistical units, representing a functional geographical unit, upon which regional structural policy is to be administrated. Nevertheless, in order for this new regional policy to be efficient and functional, it is mandatory that all consequent legal acts, state or municipal, are harmonized and in accordance with the above mentioned.

Secondary legislation implementing the Regional Development Act was adopted in May/June 2000.

The main players implementing regional policy in Slovenia are:

- the Structural Policy Council, which will be a coordinating governmental body in the field of structural policy run by the minister in charge of development;
- the Agency of the Republic of Slovenia for Regional Development, a body organized within the Ministry of Economic Relations and Development, which will develop and promote balanced regional development;
- the Fund for Regional Development and Population Maintenance in Rural Areas in Slovenia, the legally defined role of which is to raise and disburse funds for regional and structural policy;
- regional development agencies, which will be capable of going into new directions and making full use of regional policy instruments.

Now that these institutions have been established, further efforts are required in setting up the appropriate structures necessary to improve coordination between national ministries and regional and local partners. With the establishment of these structures, Slovenia has entered a new phase of preparation for Structural Funds, in which Slovenia will have to develop structures for monitoring, evaluation and financial control. In this context Slovenia will have to emphasize the strengthening of human resources.

The roles of the Agency for Regional Development—entrusted with the coordination, steering and promotion of development within regional policy—are:

- Develop, promote and coordinate regional development;
- Prepare the technical foundation for allocation of stimulants within the scope of regional development, provided by international and Slovenian financing;

- Monitor information and data concerning the regional development and the agency itself;
- Monitor information and data concerning allocation of incentives;
- Form procedures for approval and allocation of incentives and subsidies;
- Evaluate the effects of stimulants on regional development;
- Coordinate the execution of policies concerning Structural Funds, PHARE, ISPA and SAPARD funds.

There are over 190 communities in Slovenia; therefore the definition of twelve statistical region-communities appeared to be mandatory to qualify for financial contributions from the funds mentioned above.

Tasks of the twelve Regional Development Agencies:

- Prepare regional and national development programs;
- Monitor and supervise the regional development programs;
- Announce projects contributing to tenders for allocation of regional development policy;
- Organize and coordinate other tasks deriving from regional structural policy.

### *Federal States and Regionalization*

There often is a tendency to contrast the federal state with the nation-state, equating it with the unitary state. Under this approach, federalism is a means of taking regional differences (cultural, linguistic or other) into account by granting extensive political autonomy.

In fact, federalism and regionalism refer to different political realities. Federal states are the result of the union of a number of states, each of which is itself a political entity that is not necessarily homogeneous, as illustrated by the status of Prussia within the German Empire and during the Weimar Republic, many US states and the Canadian provinces.

Although a federal constitution defines the federate entities' responsibilities and their place in institutions and guarantees their political autonomy, an *a posteriori* reconstruction is needed to justify federalism by the autonomy that it grants to the federate entities. Moreover, the history of the more durable federal states shows that their creation was also a means of national integration; these federal states are in fact nation-states, as seen in the examples of Switzerland, the United States of America and Germany.

On the other hand, there is no precedent for a multi-national state which has been protected by federalism from tensions endangering its very existence: the USSR, Yugoslavia and Czechoslovakia did not break up because their federalism was artificial, but rather they had held together because communism had disguised the fact that the state lacked the requisite degree of national integration.

Therefore, federalism and regionalization are two types of institutional arrangement that can be combined in different ways depending on the individual country's specific history and circumstances.

Institutional regionalism can sometimes emerge in a federal state. Self-governing federal entities have developed in Belgium, just as in other European states that have established entities with the autonomy required to express their cultural, linguistic or religious identity or their distinctive social and economic characteristics (e.g., Spain and Switzerland).

In both federal and unitary states, institutional regionalism reflects weaknesses in national integration; political regionalization, then, can result in federalism, as happened in Belgium. However, this is a very different type of federalism from the traditional type, which derived from a desire for union and was a special mode of national integration. In that case, the federal option is the result of a centrifugal force, and it cannot be taken for granted that the federal option, which confers the title of state on an entity which demands political autonomy, will help restore unity.

Institutional regionalism is very different from federalism in institutional terms. First of all it is always asymmetrical, as it stems from the recognition of certain specific features, whereas in the federal state all the subjects of the federation are equal. The examples mentioned above show that the encounter between political regionalization and federalism raises difficulties to which there are only hybrid solutions.

Furthermore, the main feature of the federal state is the fact that the state's attributes are shared between two levels and that the federated states participate in one way or another in the exercising of state responsibilities at the federal level. But, political regions are not state authorities, they have no constituent power and they play no part in exercising state responsibilities at the federal level.

The overall coherency and unity of the structure is ensured by a federal constitution, which lays down the respective powers of the federal state and the member states and provides for procedures to settle conflicts. However, the federal component is the reciprocal independence of the authorities from the federate authorities and from the federal state in the exercise of their respective responsibilities.

That does not preclude the existence of rival fields of jurisdiction or the limitation of the number of fields in which the federate authorities can independently exercise their responsibilities; such independence must at least exist, especially in order to prevent the federate authorities, in exercising their state responsibilities, from being actually or potentially dependent on the central state in all fields.

Thus federalism does not preclude centralization: one might say that the extent of centralization in federations depends on the extent of the exclusive responsibilities of the federated states. On the other hand, the legislative powers of political regions are always actually or potentially subordinate to the national legislator. In Italy, where the special-status regions have exclusive legislative powers in principle, the reservation regarding the national interest which is included in their statutes has been interpreted by the Constitutional Court in such a way as to enable the national legislator to intervene in such matters.

More generally, setting up elected regional institutions is always backed up by the argument that it increases participation by citizens in decision-making, under authorities that are closer to them than the state.

In some cases regionalization is aimed at meeting a regionalist demand for as broad a political autonomy as is possible on the basis of a given region's and/or population group's ethnic, cultural or linguistic specificities. This is a political type of regionalization whose underlying rationale is not integration as in federal states, but differentiation. In extreme cases this can lead to separatism.

In the **United Kingdom**, public opinion (in Scotland and Wales) is again in favor of devolving certain parliamentary powers to Scottish or Welsh regional assemblies, which reflects some degree of exacerbation in regional sentiment and would confirm the specificity of these nations within the United Kingdom; such regionalism contrasts with the total lack of regional sentiment in England itself.

## Obstacles to Regionalization

These obstacles may occur in various, sometimes specific, types of regionalization:

- the fear that regionalization will threaten state unity,
- the fear of depriving the state of the means of implementing its policies (challenging its internal sovereignty) and
- the fear on the part of the local authorities that their autonomy will suffer if such an intermediate level is introduced.

In practice, these three fears have seldom foiled regionalization but they are inspired by provisions aimed at either guaranteeing state unity or protecting the autonomy of existing local authorities.

The fear of a threat to state unity from the creation of excessively powerful regions has generally hindered the establishment of large regions. This is the reason for the occasional allegations of irrationality in the establishment of regional boundaries or the exiguity of certain regions, although the latter is in fact explained by the desire to take local historical idiosyncrasies into account, as is also reflected in the structure of federal states (for instance Navarra or the Asturias—a single-province autonomous community holding ordinary status in Spain, or the city-states and the Saarland in Germany).

Of course it is not only the size of the regions that can threaten state unity; the combination of size with other features is also at issue.

With 17 million inhabitants, North Rhine Westphalia does not pose a threat to **German** unity, but in **Belgium** the combination of linguistic and economic divisions between the French-speaking Walloons and the Dutch-speaking Flemish has shaken the unity of the country, which is now based on a fragile constitutional balance within a federal framework. In the case of Belgium, and possibly in the case of Italy, solidarity between the regions is also being directly or indirectly called into question.

However, there is less risk of separatism when regionalization benefits economically weak rather than wealthier regions.

In the **United Kingdom**, the budgetary system in fact operates in favor of Scotland and Wales, and oil resources in Scotland are no longer sufficient to sustain any advanced separatist plans; these facts suffice to ensure the unity of the United Kingdom under any reform introducing devolution into these two regions.

In countries which have introduced regional institutions, legal safeguards have been laid down for the unity of the state.

The **Spanish** Constitution places regionalization within a unitary framework: it proclaims “the indissoluble unity of the Spanish Nation, the common and indivisible country of all Spaniards,” prohibits the federation of autonomous communities, makes cooperation agreements between these communities conditional upon the authorization of the *Cortes Generales* and provides for control mechanisms aimed at ensuring that the autonomous communities fulfill their obligations within the Kingdom of Spain. The case-law of the Constitutional Court states that autonomy does not include the right to act in a manner prejudicial to the interests of the nation or other general interests separate from the specific interests of the Autonomous Community, and that solidarity is the corollary of the autonomy recognized under the Constitution.

In **Sweden**, where municipalities have very extensive powers and resources, regionalization will probably be carried out on the basis of cooperation among municipalities in the same region.

Because the **French** departments had shown hostility towards the formation of regions, the 1982 reform and subsequent reforms have confirmed the importance of departments in the French administrative system; this approach has limited regional powers, but in fact it has encouraged dynamism in the regions, which have fewer management responsibilities and, despite the importance of secondary schools, still have a great deal of room to maneuver; the state-region planning contracts also make them the prime partners of the state.

In Central and Eastern Europe, the will to guarantee national unity is present in discussions on regionalization, and plans to establish a small number of large regions have little chance of success because the governments of these countries realize that areas with widely diverging levels of development give rise to strong economic forces of attraction.

Policy considerations concerning the implications of EU policies regarding state and regional aid, the related relevant clauses of the *Association Agreements* and the obligation of the association

countries to approximate in detail their domestic competition regulation with respect to EU standards, lie in different fields. Short- and long-term implications must be considered in this regard.

One of the most important concerns is whether EU standards are flexible enough and appropriate for CEECs. The CEECs, notwithstanding their different success during the transition, still exhibit significant economic and political difference from member states. Within associated countries, where the notion of controlling state and regional aid still confuses the traditional administrative approach toward subsidizing particular sectors and regions, it is important to develop criteria for assessing state aid. In the absence of adequate tradition and practice, the *Association Agreement* uses criteria developed by the EU in this field. The issue is whether stringent EU policy is flexible enough to cope with the problems found in CEECs as they make the transition to a market economy, and to what extent EU standards help facilitate this transition. Market failures are almost inevitable when financial institutions in Central and Eastern Europe find it difficult to correctly assess the long-term prospects of credit applicants and when such assessments are subjected to real hazards in political, economic and social life. Public efforts to compensate failure in the market are likely to be heavily influenced by various political pressures.

The possible difficulties arising from the interaction and interdependence of various policy considerations embodied in EU state aid competition policy requirements deserve careful consideration.

Maintaining the coordination and consistency of economic policies at the national, regional and local level and ensuring transparency, flexibility and simplicity are among the major goals of state and regional aid in the CEECs. Though these countries are considered equivalent in clause concerning regions within the transitional five-year period, there is a major difference between the aid budgets of the CEECs and core member states. Thus, the reallocation of existing resources in CEECs seems to be a radically different matter from the perspective of supporting particular industries, or even countries, lagging behind within the European Union, which have the resources, expertise and mechanisms to do so.

For example:

In **Romania**, a regional approach to economic development and to administrative organization is very new. The role of regional level agencies and policies is still being developed, and the mechanisms for the management of EU Structural Funds, when Romania joins the EU, are not prepared. At the same time, at county and municipal levels, the need to be proactive in articulating and designing interventions to address local needs is equally new. The analysis of local needs and opportunities and the marshalling of resources to help stimulate and attract development is an unfamiliar process in a country in which central dictate was dominant for so long. Cooperation and coordination between the regional, county and local levels of authority is fundamental to achieving success in revitalizing the economic and social conditions of regions.

The political lexicon of EU aid has lost its meaning; hollow policy without the promised effectiveness should be curtailed. The immediate implementation of standards to better determine the size, location and likelihood of improving the actual situation would, in turn, maximize policy effectiveness. In the future, associated countries as a whole are to be considered areas equivalent to the regions of the initial period of the *Association Agreements* (Article 93[3]a). Particular regional aid arrangements should be seen not only in light of recent, often chaotic efforts to revive national economies, but also in their capacity to cause serious problems after the accession of the CEECs. The problems currently experienced in the CEECs will certainly be enhanced through prospective membership in the EU, where the burden and dispersal of EU funds is uneven and benefits peripheral states as they make the necessary structural and economic improvements. The regional development of CEECs still very much depends on state aid arrangements and the reallocation of public money.

Accession indeed means adjustment. In the particular field of regional policy, such adjustment for the EU implies the need to carefully formulate and apply criteria while assessing state aid. It remains highly unlikely that the EU would adopt an unconditional additional principle towards CEECs. Experience with Greece, Portugal and, more recently, East Germany, suggests that one of the conditions for accession for CEECs will be the establishment of a ceiling of output in most industries. Further criteria as to potential authorization of a general regional aid program envisage, for example, the capacity in the relevant market, aid for capital intensive plants and aid exceeding a certain threshold. For reasons of legal certainty the procedures should be clear and decisions should be made within a given time.

The shift in regional aid policy, required by future accession, demands deep changes in the system of public administration and finance reform. Regional aid policies as an integral part or subsystem of the public (government) finance system cannot be viewed outside the public finance system and the ideas on its change or improvement are interrelated and interdependent with the whole system of public finance. The current pattern, where most decisions are taken by a central government that subsequently transfers funds to local budgets, implies a considerable degree of dependence on local authorities and leaves open the possibility for subjective partisan judgments. A new system of coordination is needed to replace the traditional socialist model of taking decisions on the governmental level and implementing them on the local level. Only after adopting new laws concerning local public administration, local public finance and local public assets and implementing a comprehensive program that makes steps toward greater local autonomy and the decentralization of local governance can real reform in the system of state aid begin.

Investigating concrete needs and interests on the local level should be connected with reviewing interests on the regional level, which, in turn, has to be coordinated with interests on the national level. The reform will only succeed when the needs, capacities and prospects for viability are taken into consideration at the same time at each level.

To create a more efficient state aid administration, especially during the transition to market economies and democratic states, it is essential to strictly establish the responsibilities of public

authorities in each country and to properly allocate fiscal functions and effectively assign revenue responsibilities and specific tax instruments among the different levels of government.

The process of fiscal decentralization is inevitably connected to the transfer of political power to local authorities. The main objective is to minimize the level of subjectivity as much as possible and to provide regions with further incentives to compete. The decision should be based on factors such as regional and local financial capacity, spending needs, available sources, development potential or any combination of the above. Spending can be made more efficient by making a more comprehensive analysis of existing needs compared to potential sources of funding and development prospects.

Transparency is essential to enable the public dissemination of information and announce administrative decisions that involve the spending of public money. There should be a dialogue between authorities and citizens through public meetings, surveys and other forms of participation.

A different area of concern relates to whether the system of administrative supervision and control of state and regional aid designed by the EU is indeed the framework best suited to assessing regional policies in the CEECs. The *White Paper* requires associated countries to design forms of control that parallel those found in member states and to introduce a national agency authorized to decide on aid after notification. Furthermore, commentators emphasize the “implicit expectation” of the EU that national authorities will refer to the Community to ensure that no aid is further contested. What seems problematic here is that such control over the CEEC trading partners appears much more far-reaching than the discretion of the European Union vis-à-vis other GATT/WTO partners. Given the asymmetrical disposition of the obligations under the *Association Agreements*, the EU could easily challenge aid that has been given within a CEE state on grounds that it discriminates against EU-based firms. Within the EU, such policy has the clear purpose of counteracting inefficiencies that have been created by intervening in the market and providing different treatment to economic agents. In the context of CEECs, however, applying EU standards to a system of limited resources, investment choices, capital feedback, etc., could be problematic. Given the economic framework of limited actors, resources, potential investors, the often unbalanced political influence on the development of particular industries and other subjective factors, the very idea of EU supervision over CEE national agencies could seem unrealistic.

Commentators argue that such national surveillance authorities, which assume control of state and regional aid, need years of experience to be efficiently incorporated into the existing state apparatus and the system of public administration in CEECs (including local government decision-making bodies). Moreover, the state in most CEE countries is still a major shareholder, notwithstanding the facts that privatization is in process and capital markets are being developed. The whole unique set of diverse political and economic interests makes it highly unlikely that the CEE states would allow far-reaching external control of national policies that provide preferential treatment to particular industries or economic actors of strategic importance.

## The Consequences of Regionalization: Intergovernmental Relations

The consequences of regionalization can be analyzed by looking at relations between regions and states, between regions themselves and between local authorities and regions.

### I. Relations between States and Regions and Interregional Relations

#### A. *Coordination and Cooperation*

In practice, the distinction between coordination and cooperation is not so clear.

- Cooperation presupposes shared objectives between the cooperating parties; it includes and transcends mere coordination.
- Coordination, on the other hand, presupposes a minimum level of cooperation.

In fact, in all modern administrative systems, coordination and cooperation are only two of the expressions of the general development of intergovernmental relations.

Although it is generally considered desirable to establish a clear allocation of responsibilities, as this provides the best guarantee for both the autonomy of the territorial authorities and the accountability of the public authorities in relation to the citizen, the complexity of the main fields of public policy often has the opposite effect, as the exercise of a legal responsibility frequently involves other public authorities or institutions. Regionalization leads to an expansion of intergovernmental relations either because it prompts the introduction of an additional governmental level or because it intensifies cooperation between public authorities within the same geographical area. The reasons for the trend towards regionalization include the need for improved coordination of the various public interventions and for improved cooperation between the institutions.

The structure of intergovernmental relations varies considerably from sector to sector, depending not only on the distribution of responsibilities between the different government levels but also on their relations with the interests in question. However, it is possible to identify different types of intergovernmental relations, whereby some of them are encountered more often in some countries than others and these differences apparently stem from the nature of the state and its constitutional organization.

With specific regard to decision-making procedures, the relations between states and regions and between regions may be broken down into three main categories:

- institutional cooperation,
- contractual cooperation,
- integration.

Of course informal networks play a role in all these relations, though this role is difficult to isolate.

Institutional cooperation may include recourse to specific types of agreements, but it is distinguished from contractual cooperation by the fact that it establishes permanent, stable forms of cooperation.

In **Germany**, while the Bundesrat, which is made up of representatives of the Länder governments, guarantees the participation of the Länder in federal legislation, the operation of the German administrative system overcomes the duality of federal and Länder administration through a large number of intergovernmental bodies responsible for coordinating, harmonizing and even formulating the policies to be implemented by the competent ministers of the Federation and the Länder: the conference of Länder and thirteen specialized ministerial conferences (set up under specific agreements). These conferences draw on the work of innumerable commissions, committees and working groups made up of civil servants from the Federation and the Länder, responsible for preparing their decisions and organizing their enforcement.

One special form of cooperation between the Federation and the Länder is the *Gemeinschafts-aufgaben* (joint responsibilities), which are shared by the Federation and the Länder, give rise to joint funding and planning in specified fields and are organized under a federal act or an agreement between the Federation and the Länder. The fields covered by such joint responsibilities fall under the competence of the Länder, but the Federation provides funding (generally 50%), contributes to planning, and therefore exerts an influence on the exercise of these responsibilities:

- building institutions of higher education,
- improving agricultural structure,
- preserving coasts,
- improving regional economic structures.

As a form of contractual cooperation, agreements between the Federation and Länder have become a common decision-making procedure.

Furthermore, the Länder often conclude mutual treaties regarding the exercise of specific responsibilities which involve several Länder; there are treaties in the fields of spatial planning, the development of areas which straddle Länder boundaries but in which an overall project has to be implemented (e.g., the Rhine-Neckar area or the outskirts of the city-states) and the operation of television networks, as the audio-visual field is one of the Länder's cultural responsibilities.

The **Swiss** federal system is in fact very different from the German arrangement. The cantons participate in federal legislation through an assembly, the Council of States, whose members are now elected by direct suffrage on the basis of two per canton (or one per half-canton). Federal legislation is constantly extending its scope, and Swiss federalism is now commonly described as "enforcement-oriented federalism," meaning that most of the legislation is concentrated at federal level but the enforcement of laws is generally a matter for the cantons.

The distribution of legislative powers is more complex in Switzerland than in Germany, and on the legislative front the cantons still exercise greater powers than

the German Länder. Yet the cantons also indirectly participate in the executive because the seven members of the Federal Council, the Swiss collegial executive, come from different cantons, and also because consultations are held with a view to formulating federal policies or legislation in a particularly compromise-oriented system.

Moreover, the Swiss cantons have developed the practice of inter-cantonal agreements (“*concordats*”), as expressly laid down in the Federal Constitution, “concerning matters of legislation, administration and justice.” However, whereas the German practice is to conclude treaties between two or more Länder on matters of common interest, the Swiss cantons draw up agreements that are negotiated and signed by all 26 cantons and half-cantons. These *concordats* therefore represent an alternative to federal centralization in certain fields, providing the cantons manage to reach agreement.

In an agreement on October 8, 1993 they even established a conference of cantonal governments aimed at improving inter-cantonal cooperation, particularly in connection with the further development of federalism, the apportionment of responsibilities between the Federation and the cantons, the preparation of federal decisions, the implementation of federal tasks by the cantons and foreign and integration policies.

In **Belgium** the amended Special Law on Institutional Reform (1980) provides that cooperation between the state, communities and regions, which is especially important because of the complexity and fragmentation of the apportionment of powers, should be conducted by means of agreements, a number of which are mandatory. These agreements reestablish the physical unity of specific powers and facilitate the coordination of the various competent authorities. The cooperation agreements have been retained in the federal system which has since been introduced.

In **Poland**, regional development tasks are to be subject to so-called “regional agreements,” contracted between the central government and regional authorities. Following this pattern, EU Structural Funds will be transferred to, and managed by, regional governments. While retaining the unitary character of the state and the uniformity of its foreign policy, Polish regions are also able to enter into bilateral and multilateral cooperation with foreign partners.

In May 2000 Poland adopted the Law on Regional Development. This new law has laid down a number of principles for support towards regional development in Poland, notably regarding programming, management and institutional structures, and it also introduces the concept of the regional contract (*voivodship* contract) as the fundamental basis for funding of regional development programs throughout the country.

Regarding **programming**, the Preliminary National Development Plan (PNDP) 2000–2002 was approved by the government in December 1999. This is an intermediate step towards the development of a comprehensive and detailed National Development Plan for 2000–2006 (NDP). A rural development plan is in the process of being approved by the Commission in view of funding from SAPARD. Poland and Germany have made progress with a joint programming document for interregional and cross-border cooperation.

In June 2000 a council of ministers ordinance created a Ministry of Regional Development in Poland, but cross-border cooperation remains a responsibility of the Ministry of the Interior. This new ministry should play a leading role in regional development programming. The Law on Regional Development has laid down the rules of administrative coordination between central and regional government regarding the government's policy for regional development, inter-ministerial coordination, distribution of competencies and application of the partnership principle, including the advisory role to be played by a council on state regional policy. This entire organization is subject to practical administrative arrangements still to be implemented.

**Spain** to some extent followed the model of “German cooperative federalism” in this respect. In 1983 sectoral conferences (*conferencias sectoriales*) were established by law to ensure cooperation between the state and the autonomous communities; they can adopt agreements that become binding upon the parties as soon as they are signed.

The central government and the autonomous communities also formulate bilateral agreements for investments in certain fields, either because the government wants to make specific investments within the territory of the Autonomous Community, or because the extent of the planned investment and the fact that it cannot be covered solely by the Autonomous Community mean that the state has to step in.

**Portugal** has several modes of institutional cooperation for the island regions, in the form of participation in various national bodies; the constitution also provides that in such regions the “organs of supreme authority” must consult the organs of regional government on matters within their powers which concern the region. There is no equivalent of these provisions for the administrative regions which are provided for in the constitution but which have not yet been created, which explains the different legal status of these two categories of regions.

**Italy** draws a distinction between special-status and ordinary-status regions. Whereas over 85% of the budget for ordinary regions comes from the state budget, the special regions have more extensive powers and are largely self-financing (over 55%

of all their resources are independent), enabling them to engage in more balanced cooperation with the state. However, the development of cooperation between the state and the regions is essentially based on agreements, and even the special-status regions have no form of institutional cooperation with the state. The legal framework empowers all government departments and authorities to conclude agreements to regulate cooperation in the development of activities of common interest and regions can accede to such agreements as well.

However, **France** is the country with the most systematic contractual cooperation between state and regions. The existence of territorial authorities which have general jurisdiction above and beyond their attributions under the law and which are prohibited by law from exercising supervision over each other, has created the need in the French administrative system for new instruments of coordination and cooperation.

In countries which have no regional institutions or else have only devolved government departments at the regional level, the problem of relations between the region and the state obviously does not arise, but relations at the local level between local authorities and devolved government departments become more important (Sweden, England, Portugal, Hungary, Romania, where regional coordinating committees are concerned).

The **Swedish** counties are undergoing twofold vertical and horizontal integration. On the one hand, the elected county councilors now dominate the county's state administrative council and can therefore influence the action of the administrative departments, most of which have been placed under the county's State Administrative Department. On the other hand, there are formal and informal central controls: the national administrative agencies have issued a whole series of directives on the implementation of national legislation governing the mandatory powers of counties or municipalities, but party links also have a role to play in the integration of the different levels.

In **Hungary** the Regional Development Act has recently been amended, creating a regional level and associated institutions of regional development. Regional development councils have already been established in the seven designated planning and statistical regions. The government will evaluate, in the light of operating experience, whether there is a need for the establishment of regional governments. This would be required for large regions, comprising of two or three counties each, and would also be justified by the fact that in the system of development operating in the European Union the region is the dominant venue of territorial coordination for economic development.

The Ministry of Economic Affairs links together sectoral and regional planning and development, creating special development programs and cooperation on the basis of the Comprehensive Development Plan.

Comparison with states that have introduced institutional regionalism highlights the distinguishing features of intergovernmental relations in such countries. First of all, regions do not participate in any way in the national legislature or executive; to some extent, legislative initiatives can be promoted to the national legislative body.

### *B. Regional Finances, Solidarity and Equalization*

General and political aspects:

1. Regions generally have greater financial autonomy vis-à-vis their expenditure than their resources.

In the European Union, this proposition applies equally to regions and federate states, with the notable exceptions of the Swiss cantons and the French regions—though obviously on a different scale—as well as the Swedish counties if equated with regions, but this is a hypothesis which must be treated with all due caution. Only these three types of authority are genuinely financially autonomous in terms of resources, because their independent resources constitute a large percentage of their total resources and they can levy taxes, set income tax rates; and therefore deciding on the amount of tax revenue, under the conditions set out in law.

**Swiss** cantons and **Swedish** counties levy and set income tax rates; taxation provides 49% of the cantons' total budgetary resources, and income tax revenue represents almost two thirds of the Swedish counties' total resources. The French regions have much smaller budgets because they have relatively few administrative attributions, but their tax revenue represents almost 50% of their total resources.

The **Italian** regions and the **Spanish** autonomous communities, however, derive most of their resources from shares in national tax revenue, over which they have no influence, and direct budget transfers from the state. In Spain independent resources represent only 10% of the autonomous communities' budgets, and tax revenue only 1%. In Italy this percentage has increased to 15%, but independent and transferred tax revenue represents little more than 10%, although this average embraces wide disparities since special-status regions have more extensive tax-levying powers. The situation in the **German** Länder is fairly similar: over 85% of their tax revenue comes from their shares in national tax revenue; the Länder have a very low level of independent tax revenue.

2. The regions with large budgets are also those with the lowest independent tax revenue.

Here again **Switzerland** is the exception. This situation can be explained by the concern to avoid economic distortions caused by regional variations in the tax burden. This was an explicit consideration in the formulation of the financial system for the **German** Federation and Länder.

Moreover, when authorities wish to ensure some degree of equality in the level of public services they tend to place the emphasis on transfers from or shares in national tax revenue rather than independent taxation, because the former type of revenue is easier to adjust to the level of the needs. However, these aims are somewhat at variance with the financial autonomy objective.

3. Financial solidarity and equalization mechanisms are not peculiar to regionalization or federalism; they occur in most public finance systems. But, the modalities of their implementation and their intensity depend on institutional factors and explicit or implicit choices between political values.

The most vigorous equalization systems are to be found in the United Kingdom and Sweden, though they concern local rather than regional budgets.

In the **United Kingdom** equalization is based on the principle of bringing resources into line with the estimated cost of the needs to be met: in a word, revenue support grants are calculated by comparing the standard spending assessment with the total average expected revenue from independent or transferred local taxation; in this system the assessment of needs is the most difficult, sometimes controversial operation.

**Sweden** has a system of tax revenue equalization which is applied to income tax. Where the municipalities are concerned, the main mechanism consists of defining a guaranteed level of income tax bases, whereby the government sets a tax rate which is applied to the difference between a given municipality's real tax bases and the guaranteed level; this gives the amount of the equalization grant paid to the municipality by the state.

**Germany** has a complex equalization system based on the apportionment of VAT revenue. Since 1995, 56% of VAT revenue has gone to the Federation and 44% has been divided out between the Länder according to three main procedures: 75% of this volume is apportioned in accordance with the size of the population, which is already a form of equalization in view of the uneven distribution of economic activities; the other 25% is used for attributing tax supplements to Länder whose tax revenue from all sources is below the average for the Länder; lastly, on the basis of

variations in tax revenue noted among the Länder, taking 50% of tax revenue totals from the Länders' municipalities as the basis this time, a horizontal equalization funded by the wealthier Länder is conducted on behalf of those Länder which lie below the equalization index.

In **Switzerland**, the cantons' share in some types of federal revenue and their contribution to some types of federal social expenditure are adjusted in accordance with a financial capacity index.

However, neither the Swiss nor the German equalization system is sufficient on their own; they are both complemented with subsidies which are also attributed on the basis of equity criteria. Even so, the results do not always correspond to the aims and sometimes have a fairly limited impact as compared with the budgetary volumes in question. Equalization in Switzerland concerns less than 3% of cantonal budgets; in Germany, before the integration of the eastern Länder, the percentage was the same, but in 1995 it can be estimated at approximately 12% of the Länder budgets. In fact this leap explains the increase in the proportion of VAT attributed to the Länder from 1995 onwards, preventing imbalances in the western Länder budgets, which have virtually all become net contributors.

4. Regionalization can also be accompanied by pressures towards regionalizing resources rather than promoting interregional financial solidarity. In this case it can help maintain inequalities rather than create favorable conditions for endogenous development.

Selfish regional interests may emerge in many different forms and at many levels, but they may be able to establish themselves through institutions and the self-government system. In more tragic circumstances, they have fuelled separatism on the part of certain republics in the former Yugoslav and Soviet federations. This risk is particularly high when political regionalization benefits wealthy regions.

5. Not only the creation of regions but also progress in decentralization seem to push public expenditure up, even when regions have little or no control over the changes in their resources.

In **Spain** the autonomous communities' share in overall public expenditure increased from 6.1% in 1982 to 22.6% in 1992 and has since remained static; their staffing increased from 3.9% to 39.1% of the total Spanish civil service between 1982 and 1994, whereas over more or less the same period (1981–1991) the latter increased by 50%.

The expenditure of the **Italian** regions is proportionally similar to that in Spain, and the consensus is that regionalization was made possible by economic growth, particularly because the ordinary-status regions' most important powers are in the

social field, and that gave politicians direct control over a certain proportion of public expenditure; the result is that the region's role is especially important, because the economic situation gives them more resources to manage.

In **France**, where the regional councils establish the rates for taxes which they levy on the same bases as municipalities and departments, regions' share in local direct tax revenue increased from 5% to 8% between 1988 and 1994 and their overall expenditure in real terms increased by over 20% per annum or thereabouts between 1984 and 1988; despite a slowdown from 1987 onwards, which was also when the transfers of power were completed, the growth rate stayed above 12% until 1991. The development of regional investment expenditure is even more significant, because it has grown much faster than investment expenditure in departments and municipalities.

In **Poland**, since 1999, the regions' (*voivodships*) shares in taxes constituting the state budget are as follows: 1.5 % of PIT revenues collected from voivodship inhabitants, 0.5 % CIT collected from legal entities and other organizational units that have offices in the voivodship. Incomes from voivodship budgetary entities and money paid by budgetary agencies and subsidiarity entities of voivodship budgetary entities, as well as different interest on voivodship funds and incomes from pecuniary penalties are kept by the voivodship.

However, this evolution is apparently not entirely attributable to the creation of regions; it is a phenomenon that occurs in all decentralization processes. Public expenditure is also to some extent a mode of legitimization; the elected members of the new institutions must meet the needs they are confronted with.

The current transition countries' strategy of devolving expenditures to the sub-national level while holding back on transfers is unlikely to be successful. Indeed, net expenditure reductions at the sub-national level may prove difficult to achieve. The sub-national sector has significant expenditure responsibilities in many transition economies. In addition, state enterprises still undertake a wide range of social sector outlays that may have to be taken over by sub-national governments. Sub-national governments are also shouldering much of the burden of replacing and refurbishing obsolete and poorly maintained physical infrastructure. In relative and perhaps even absolute terms, sub-national spending thus seems more likely to grow than to shrink in most transition economies.

In **Hungary** local government expenditure covers approximately 27.7% of total current public expenditure in 1993. The sub-national share of general government expenditures decreased to 26.9% in 1997 with an increasing point in 1994 (28.5%). The same situation is found in the **Czech Republic**, where local government

expenditures' share in general government expenditures slowly decreased from 23.3% in 1995 to 22% in 1998. In **Poland**, sub-national governments expenditures of total government expenditures increase from 12.3% in 1993 to 19.5% in 1997. In the same period, **Romania** faced a more reduced increase, from 10.4% in 1993 to 13.3% in 1997 (data from different studies quoting countries' Ministries of Finance).

## II. Local Government and Regions

Regionalization obviously has different effects on local authorities' self-governing powers, depending on whether or not it entails a new governmental level in addition to the existing local authorities. Clearly, when regionalization involves transforming the functions of intermediate-level institutions or inter-municipal cooperation, it does not curb these local authorities' autonomy; on the contrary, it may reinforce it.

However, the positive or negative consequences for local authorities are just one of the elements to be considered in assessing the merits of regionalization, or to be more exact, the form it takes in a given country. Here again, comparison between regionalization and federalism is relevant to the appraisal of the specific institutional expressions of regionalization.

One will therefore consider the situation of intra-regional local authorities vis-à-vis the regionalization process in a unitary state, then in situations of political regionalization and lastly in federal states. Three variables are relevant for analyzing the consequences of regionalization for local government: the statutory, functional and financial dependence of local authorities.

The most typical example for intra-regional local authorities and regionalization in the unitary state is France. The situation in Portugal is comparable, even though regionalization is still hypothetical in this country's mainland European territory. In both cases regionalization has been influenced by the concern to avoid affecting the autonomy of the other local authorities. The same situation is present in CEE countries where local authorities' autonomy—very often obtained through a difficult process—is protected with priority.

The **French** and **Portuguese** regions are in fact “local authorities” within the constitutional meaning of the term, in that they have the same legal nature as municipalities or other local authorities. In France regions were established by law, as permitted by the constitution, but unlike departments and municipalities, they do not have constitutional status. In Portugal, administrative regions are provided for by the constitution, although their establishment is subject to the wishes of the legislature and the decision of a majority of municipalities in the region. Local government (the principle of free administration by the local authorities) is recognized and protected by the constitution.

In this model the intra-regional authorities are in no way statutorily dependent on the region because both the institutions and the responsibilities of such authorities are established by national law, including territorial changes and the conditions for

such changes. Clearly, neither the French regions nor the Portuguese administrative regions exercise statutory responsibilities vis-à-vis other local authorities, namely departments and municipalities in France and the *municípios* and *freguesias* in Portugal. Furthermore, the state exercises legal and financial control over local authorities, not regions: they involve state institutions, namely the prefect in France and the civil or district governor in Portugal, as well as the competent courts and in certain cases a minister or the government itself.

These two countries have adopted different approaches to protecting the autonomy of intra-regional local authorities. In Portugal, some (less than half) of the members of the regional assembly will be elected by the college or municipal councilors from the *municípios* in the region, while its other members will be elected by direct suffrage.

The Portuguese Constitution confers regulatory power on the local authorities, but they are also required to observe the regulations issued by higher-level local authorities, which means that the administrative regions will be able to issue regulations binding upon municipalities. However, the Constitution provides that the administrative regions, which will be responsible for coordinating and supporting municipalities, must respect the latter's autonomy and refrain from limiting their powers.

French local authorities have no regulatory power except where the latter is expressly provided for by law as part of the exercise of a responsibility; this explains the importance of negotiations, incentives and contracts in interregional relations and relations between the regions and the departments or municipalities. Furthermore, the apportionment of responsibilities between municipalities, departments and regions must not enable any of these authorities to exercise any form of supervision over any of the others and a decision whether or not to grant financial aid to another local authority cannot have the effect of establishing or exercising supervision. On the other hand, the plan set out in the 1969 draft to include representatives of local authorities in regional councils—applied during the establishment of regional public structures provided for under the 1972 law—has been abandoned.

In **Poland**, municipal authorities were granted the right to self-government in 1990. Recently, the country has returned to the traditional three-level administrative system. Two new levels of public authorities were created, besides the already existing democratic and independent municipalities. In this way, a three-tier system was established composed of the existing 2,489 municipalities, 308 districts and 16 regions. The sixty-four largest cities function as both municipalities and districts. All entities are self-governing. Each entity has a council whose members are elected and who supervise administration. Each entity has a legal status and its own financial resources.

## *Key Points*

### 1. Models of Regionalization

Each individual European state has its own history and geography, its own cultural and linguistic characteristics, its own economic and social situation, and its own political tendencies and tensions, all of which generate and explain the differences existing in the territorial organization of these states. These disparities also make it difficult to arrive at a common notion of the term region or to derive a single unambiguous definition for the term regionalization.

The term regionalization may be used to cover a wide variety of situations, including certain forms of cooperation between local authorities and even decentralization of the administrative departments of central government. In fact, regionalization may also occur—and often does—irrespective of whether a recognized regional authority already exists or is to be formally created.

The decentralization of the administration departments of central government is clearly distinguished from other forms of regionalization in that it is almost entirely consummated by reorganizing central government administration and its operation. True, decentralization of the central government's administrative departments is usually attended by a new conception of central-local government relations. Greater proximity of the central administration to the local authorities naturally entails the discovery of new forms (and procedures) for coordinating and supervising the action of the latter, and it may also aid the devolution of certain functions to local government.

Development of inter-municipal cooperation assumes major importance in a number of European states. It is a response to the challenges that certain communities, not of sufficient size for the complete discharge of all their responsibilities, are unable to meet if they remain isolated. On a different plane, it also provides a response to the problems faced by Europe's large towns and the communities on their outskirts. Significantly, these areas are referred to under the designation of urban or metropolitan "regions."

The above forms of regionalization admittedly have a substantial impact on local authorities engaged in reorganization and establishment of institutional structures aimed at improving the management of affairs which pertain to their level and catering more satisfactorily for the needs of their residents. Moreover, the stimulus to integrate that they create frequently proves itself a powerful instrument of rationalization and efficiency, and as a result the process can make for the conferment of new functions on the structures thereby established.

The trend towards greater regionalization, even in this narrower sense which describes the development of an intermediate tier of government, does not necessarily lead to the creation of a new territorial entity but may rather entail the adaptation of existing institutions: it may occur within states where an intermediate authority already exists on which it is intended to confer new responsibilities and duties; at least in theory, regionalization might in some cases lead to the abolition of a lower-intermediate tier of government.

In other words, understood in this way, the process of regionalization may take one of two paths: the creation of an intermediate authority or the strengthening of one that already exists by allocating to it certain powers and the management of certain public services.

## 2. The Purpose of Regionalization

Whatever the chosen model, regionalization reflects a particular view of the nation-state and translates a specific policy:

- Firstly, an economic aim exists, whatever the form of regionalization, even where it does not involve the creation of an additional tier of administration. Indeed, with the growing importance of regional economic systems in the present European and worldwide context, regionalization can become a mandatory choice for adapting established local institutions to the dictates of sustainable economic development or founding new institutions capable of fulfilling them effectively.
- The second aim of regionalization corresponds to the need to structure the territory in such a way as to allocate public responsibilities to different levels of government according to the principles of efficiency and economy. In this context, it is necessary to note that territorial organization is an extremely complex and highly sensitive task; the individual features of each country may justify the adoption of different solutions. In this sense, establishing a regional self-governing authority is advisable whenever it enables powers to be shared more rationally, available resources to be used more efficiently and economically, and public services to be better managed for the benefit of the public.
- There are undoubtedly political motives underlying the establishment of a regional level of government when it is a case of responding to demands for self-government. More generally, the creation of autonomous regional authorities—or their reinforcement—can be justified by the desire to bring the exercise of public responsibilities as close as possible to the citizen and represents a method of implementing the principle of subsidiarity, which thus constitutes the basis and justification of the process.

Other forms of regionalization linked with the enhancement of inter-municipal cooperation may also be contemplated in response to the political demand for more pronounced decentralization.

## 3. Factors Affecting Regionalization

In all events, whether to regionalize or not remains an eminently political decision, which depends on the concept of state organization adopted. This concept has changed—and is still changing—particularly in light of the role taken by the state and its component authorities and of the extent of their involvement in ordinary people's day-to-day lives.

It is up to policy-makers in each state to assess their country's specific situation and to decide whether one of the regionalization models is an appropriate response to citizens' problems, expectations and aspirations. Several factors should be taken into account for this purpose: socio-economic, historical, ethnic and/or cultural, geographic and demographic. All deserve consideration with a view to determining whether regionalization is desirable, or even necessary, and which form it should take. These factors also shape the course of the regionalization process, influencing both the division into regions and the nature and scope of regional government, if that is a result of the process.

Nor is it possible to present a single regionalization model or even a standardized regional model, be it in terms of size (geographical or population) or competencies. Such uniformity would not seem feasible given the differences between states. On the contrary it is possible and worthwhile to indicate the criteria which may guide policy-makers. In particular, the adoption and implementation of these criteria in a given situation should comply with three principles:

- Given the highly competitive European and world situation, the territorial organization of the state—and the accompanying administrative institutions—should act as a catalyst for stimulating the economy, avoiding unnecessarily bulky or complex structures which would hamper or handicap the private sector.
- In a rapidly changing environment, the regionalization process should lead to solutions well-suited to current problems and also adaptable to future changes.
- The solutions adopted should conform to the necessity of safeguarding the territorial unity of the state while preserving solidarity between its various components.

### 3. PLANNING FOR EFFECTIVE DEVELOPMENT

As shown in the previous chapters, systems of governance are adapting to the intensified economic competition and new technologies that make cooperation between countries and regions necessary. The regional impact of globalization and urbanization has raised the danger of enhanced disparities between regions and between urban and rural areas. Budget deficits and economic constraints must be managed consistent with these threats and with citizens' demands to deal with emerging social and environmental issues. As a result, governments are under pressure to perform. Public administrators must learn to do more with less, to work differently and at a higher level. Governments must find effective ways to make responsive policy decisions and to identify the right mix of instruments and incentives to implement them.

The processes of distributing economic power through regional development and eliminating regional disparities have a certain momentum in common, as one can see in the examples previously presented. Though integration processes have shifted responsibility for social cohesion and uneven development across European areas, subsidiarity and endogenous development still lead to increased decentralization. On closer inspection, however, this is only an apparent contradiction. EU assistance concentrates on support policy, which is in essence a redistribution policy from richer countries to poorer regions through designated funds. This mechanism of assistance engages regions in the creation of programs and projects as well as in the processes of co-financing. In this way, centralization of regional policy becomes significantly more relative and narrows to a single instrument, subsidizing policy, through redistribution.

One would expect that decentralization of government enhances the prospects for higher growth, as tends to be assumed that decentralized provision of public services:

- increases efficiency because local governments are better positioned than the national government to deliver public services as a result of better information.
- population mobility and competition among local governments for delivery of public services ensure the matching of preferences of local communities and local governments.

Much has been learned in recent years about the individual components of development. Certainly, enough is known to be able to create, given the appropriate resources and powers, the ability to tackle most local situations on a reactive basis. The difficulty is often to know how to correlate the available ingredients so that there will be an ongoing, sustainable response that is in the interests of the affected community.

Most communities are powerless to prevent external influences that arise on the global level. Positive external trends are normally not a problem, but it is important for the community to position itself effectively to take advantage of changes. When faced with negative trends, at best, communities can seek to minimize damaging consequences. Ideally, communities should have the capacity to adjust the local impact of external forces in ways that will lead to a desired adaptive response and support further development as the environment continues to change. Communities need to avoid the pitfall of becoming tied to a programmatic package that, while successful in the past, on being repeated fails to develop new responses in line with the current thinking, experience and conditions.

Economic development is dependent on what a community does. Components that can help enhance economic development opportunities include establishing effective national and local institutional relations, creating an attractive (profitable) investment environment and capitalizing on community resources, in accordance with the following principles of local economic development:

- Local economic development programs should be elaborated and executed in partnership with regional, national and international policies and programs.
- The private sector creates wealth—access to employment opportunities, income for citizens, revenues for public expenditures, capital for investments; local, regional and national governments just support the appropriate environment for economic development.
- Efficient and effective public institutions reduce the cost of production for the private sector.
- The human and physical environment (infrastructure) contributes to a community's competitive advantage.

## General Methodological Approaches for Development Strategies

In today's world, local economic development policies and programs must respond to policies and programs at the international, national and regional levels.

The actual imperatives require an initial commitment to “do something.” Others must then transform this commitment into a program for action. Such a program can take a long time to reach the launching stage. This results in constant pressure, not only to commit funds but also to push for quick solutions and immediate delivery, too often without consideration of good projects, best practice or effective results. There is pressure to target scarce resources at immediate and obvious actions or political priorities that may not be effective in the end. As shown in the first chapter, actions focused on short-term perspective tends to be concentrated on physical

capital—which for CEECs apparently is the most needed—and not enough focused on long term capital building.

Agreeing on a “solution” that is broadly acceptable both to those affected and to those providing the funds can be difficult. The legal and financial powers of the government, a donor organization or a charitable donor, are best structured to enable usage in different communities and for differing purposes. The final empowering document, once approved by the lawyers, bureaucrats and legislators, is rarely able to provide the flexibility for progressive local needs assessment and future project adjustments. In addition, there is often a lack of relevant local agencies with adequate powers, staff, finance and experience to provide effective delivery. Frequently there are no existing legal powers or designated funds intended for specific problems or new and emerging community needs. The practitioners’ role has become the search for niches in existing powers that will allow action and funding. As mentioned before, in some countries, delegated authority and flexibility at the local and regional level allow people to interpret powers and guidelines and ultimately allot resources. It is common to find development specialists in existing institutions reshaping their desired projects to match their available legal competencies or existing programs and still be relevant to new needs. Unfortunately, the measure of achievement in such projects is, too often, the level and timing of spending rather than program effectiveness and efficiency.

In deciding on action, drawing up powers and budgets and identifying delivery mechanisms there are also social factors that can cause rigidities. The conflict of past experienced methods with the need for innovative responses creates another form of rigidity. The governments and communities under pressure to respond to change may be reluctant or unable to look ahead in ways that are not simply a continuation of the present or recent past.

Some examples:

CEECs communities that have grown up around industries over generations will find it difficult to give up their traditional way of life and work when that industrial sector goes into decline.

For example, in coal mine closure areas it is common to find that the local community and labor organizations will concentrate their lobbying effort on keeping a coal mine open and will ignore the fact that market and/or technological conditions may preclude future profitability. Eventual closure is likely to be inevitable and attention should be focused not on deferring change, but on replacing the role of the mine as the life support of the community. Unfortunately, many of the mistakes made in the coalfields of the EU are being repeated in the countries of Central and Eastern Europe.

In addition, there are always deep-rooted interests in management, trade unions, local government and elsewhere that will be threatened by actions that jeopardize the status quo and current benefits. Meeting change with more change is a difficult and traumatic step for the community and its decision-makers. It would be made easier if institutions in the community were already in place and prepared to anticipate and manage the necessary changes.

There is a mismatch between economic boundaries and the political boundaries of local government units. People and commerce flow across arbitrarily established political boundaries, respecting the imaginary geographic boundaries defined by the opportunity cost of supply and demand. Corporate success and regional success, jobs and prosperity are all intertwined. Many countries have economic development organizations that are able to address the complexity of local, regional and national economic systems and industrial complexes.

Managing these emerging changes is about *anticipating* what is *likely* to or *could* happen and putting into place actions to counter the negative effects and to exploit the opportunities that change creates for the benefit of the affected communities.

### *Strategic Participatory Planning*

The difficulty of putting together qualitative development priorities through a sound based budget has its mirror image on the expenditure side, where one observes diminishing financial support for development strategies. This is so because current political habits reduce the budgeting exercise to a battlefield where regions and special interests wage a continuous war to maximize their piece of the pie. Paradoxically, in many countries, governments are abandoning planning and thus relinquishing the crucial function of democratically building scenarios for the future with a view to elaborating, negotiating and choosing appropriate priorities and strategies. In sum, political and party patrimonial interests and corporatism are eroding democratic institutions while governments waive the function of planning just when it is most needed.

Definitions of planning:

- “A process concerned with the conscious evaluation of interrelated decisions and policies prior to undertaking action” (Brown 1998).
- “A process by which scientific and technical knowledge is joined to organized action” (Friedmann 1973).
- “The enterprise of facilitating decisions and making them more realistic and rational” (Kaplan 1964).

The term “planning” when used alone seems almost meaningless. Actually, it is very meaningful. But few recognize planning for what it is—decision-making. When plans are made, although they may not be implemented, decisions are made as well. Moreover, the act of planning usually has to do with the allocation of resources.

The term “planning” becomes much more specific when it has a qualifier attached, such as participatory, comprehensive, strategic, action, five-year or development, to name those most in keeping with our experience. Only when we add the qualifying term does the word planning have clarity of purpose.

For many, the term planning is synonymous with government-sponsored and controlled five-year development plans. These plans, born from the bowels of a distant bureaucracy charged with producing such documents, were largely mechanisms for allocating scarce resources to long-term physical and social investments. These periodic *grand plans* were typically formalistic, even

ritualistic, statements of global intent that, more often than not, had little to do with day-to-day operations or current reality. They were based largely on predictions and forecasts. This approach to planning will sound familiar to those working and living in transition countries.

Countries outside the boundaries of those in transition are engaged in similar activities. But, more often, planning was conducted at sub-national levels of governance. The planning outputs were called master or comprehensive plans. These plans often were pre-conditions for gaining access to national funding allocated for specific kinds of projects and programs. These allocative planning processes were largely top-down decision-making processes dominated by elected officials, urban managers and planners.

National multiyear plans and their counterpart master plans, depending on the part of the world from which they emanated, did not work very well for a number of reasons. They reflected the thinking of a few select individuals who had access to formalized power and decision-making or who possessed the knowledge and skills associated with the planning profession. Their “plans” were, more often than not, static statements of future intent. As a result, these plans often became barriers to the process of managing public decision-making in dynamic and rapidly changing economic, social, political and physical environments.

Moreover, the creation of these long-term plans rarely involved the participation of those who would be most affected by their implementation. Citizens remained for all practical purposes outside the circle of public planners and decision-makers. This exclusivity denied to planners and decision-makers the potential power of wider understanding and ownership of the plans by those who would be affected, the citizens.

John Friedman, an important urban planner, has said, “the process of societal guidance—a fancy term for planning—is too important to be left entirely to experts.” He says the planning process must reach down into the schools, farms, factories, offices and neighborhoods to draw an increasing number of people into a direct engagement with their society. In other words, those who profess to plan must engage an ever-expanding circle of others in the planning or decision-making process.

There is another distinctive aspect to the kind of participatory planning process we are talking about. It is the pro-active notion that planning is a management tool designed to address issues, problems and opportunities in an on-going process of community-building. Participatory planning is a fluid, organic process that redefines its boundaries quickly and easily based on the needs of the environment it is serving. More importantly, planning involves putting together action plans that are realistic and can be quickly implemented. In other words, plans are not made in a vacuum. Moreover, there is an underlying belief that planning is decision-making and that decisions reached through a process of participatory planning are “owned” by those who help make them. In other words, participatory processes enhance the chance of implementation.

### *Planning a Chaordic System*

Organizational systems, like communities, contain elements of both extremes: rigid structure (order) and undue flexibility (chaos). The interface between chaos and order is fully explored

by Dee Hock, who proposes it as beneficial response to the present context, under the name of “chaord” (Hock 1999). The same author defines the “chaordic” term as “the behavior of any self-governing organism, organization or system which harmoniously blends the characteristics of order and chaos.” He shows that there is a clear need to reconceive long-held notions of institutional organization and delineates a path to organizations and systems that are based on chaordic principles—organizations he believes can harmoniously blend chaos and order, competition and cooperation.

In the same respect, operating chaordic principles means balancing a system between the two extremes to achieve the benefits of each dynamic, knowing that it is not efficient to create a single, standard, institutional response that will ensure the same response to any conditions and changes.

The experience of central planning, national prescriptive policies and large, national implementation agencies has not been positive. On the other hand, encouraging the creation of a “free market” for development actors and agencies would lead them to an inappropriate competition for investment and incentives.

Much of the current thinking and policy work in regional development seeks to reconcile these two extremes. One of the key methods for doing this is to empower decentralized and/or quasi-state regional actors to coordinate local and national strategy. Such a framework can form networks with multiple levels of action from local to international.

A major objective of regional development agencies could be to promote the formation of other actors. It might be argued that this would cause bureaucracy to proliferate and raise administrative costs. Certainly, care would need to be taken to ensure efficiency and public acceptance.

The debate between the free market and central planning continues. Regulations on economic activity are increased and decreased. The vocabulary of development changes, the “national plan” is replaced with “integrated action,” and so on.

Both extremes have failed to demonstrate convincing success and compromise too often is simply that—a political position without validity on the ground level. Neither view fully recognizes the constantly shifting nature of community and economic reality, the need for strong direction tempered with freedom to adapt to circumstances in a changing world, or the requirements for accountability and flexibility. Neither has been able to focus the always-limited resources at targets that are prioritized at the local and regional community levels, which can achieve a solid sense of community ownership and yet fit within national strategies.

Development realities need to be handled with a sense of direction but with constant adjustment to unpredictable directions. In dealing with such a moving target, managers often have to commit resources, then redirect them before reaching the intended objectives.

At a simple level, planning on chaordic principles comes down to having a long-term strategy, based at national, regional and local levels, on how to approach constant change. A regional development policy or institution that operates “chaordically” will have a flexible, coherent, strategic direction that allows for local variations while avoiding fixed institutional structures, exaggeratedly detailed legal restrictions and rigid long-term implementation programs.

Such a strategic view has to:

- cope with unpredictability;
- be uncontrolled, but not shoot off in all directions;
- accept that it is likely, within normal definitions, to appear to be inefficient;
- be proactive;
- be a continuous process;
- be “self-organizing” and capable of adaptation.

A clearer understanding of some of the characteristics of complexity and chaordic operation is arising, and it is becoming apparent that several characteristics are relevant to formulating economic and community development initiatives. It is desirable to create structures that are responsive to change, demonstrating a high degree of order and also showing adaptability and self-organizing ability. Such planning methods challenge policy makers to determine not only what to structure but also, and essentially, what not to structure.

The theory for evaluating scenarios works on a similar “chaordic” picture, in which the locus of decision-making lies between the known past and some unpredictable future. Dominated by past events, political policy-makers are forced not to become overly dependent on experience. On the other hand, planners may often become too committed to one future direction that may need to change as time passes, even if it is not wrong altogether. As Brown and Eisenhardt indicate, “the critical challenge is to balance on the edge without falling off either side.” If too much attention is paid to the past then policies, strategies and institutions become locked into dated models. If too much attention is given to the future then strategies, institutions and initiatives can get too far ahead of what the community sees as the necessary actions to address today’s immediate priorities.

The policy-maker, therefore, whether politician, civil servant or consultant, should always think in a chaordic manner, neither dominated by the past nor filled with false confidence in a future certainty. Planners need to manage plans with multiple possible futures while using the experience and knowledge of the past and not ignoring today.

### *Testing the Strategy*

Diversity of response is recognized by experts to be a key element in regional economic and community development. Unfortunately, the institutional, legal and cultural frameworks that have shaped responses of CEE countries to local development in the past are in danger of protecting structures that are losing relevance to the reality of current community experiences. The reductionist, analytical approach of the process “policy – strategy – actions” can be quite different than reality.

Practice and experience create a dynamic feedback spiral that can be effectively used to guide and (re)target development initiatives. Experience gained in practice in turn influences other practices, and other practices and experience may influence the original practice. The new

experiences could influence the formulation of strategy and could bring new characteristics of identified problems or even new problems. It is difficult, if not impossible, to assess accurately the quality of given initiatives before trying them out. There must be experimentation if techniques are to advance. To experiment, however, implies that the end result is not known in advance. This uncertainty can be an extremely difficult issue for politicians and the administrative controllers of the public goods.

The work of the complexity theorists suggests that frequent inputs, with correspondingly quicker feedback, are more effective than fewer large changes. A positive feedback circle occurs when an input is made—for example, a policy concept in a position paper—and then reinforced by further citation or practical usage.

Positive feedback is very common in economic development. For example, when a development agency has begun to invest in a run-down inner-city area, the resulting public discussion of future development often in itself leads to a rise in property values, increased private sector development and the growth of economic activity in the area. As activity increases, investment opportunities increase, and so on. One strategy for using this kind of feedback loop is to attract one or two firms in a sector to a location. These pioneer firms can then serve to bring a greater concentration of similar and complementary firms. This process is called “reinforcement.” As it gathers momentum, it can lead to “clustering.” Such strategies to encourage high-tech development locations are now commonplace. This strategy can revive the overall economy of a whole region and also help to develop new skills on the local labor market.

### *Anticipation and Flexibility*

Development professionals and policy-makers are forced to deal with a whole other set of problems related to the uncertainty of outcomes and future trends. Experience and community feedback should be connected to form proactive responses to anticipate future events.

To examine a situation and consider scenarios to predict future trends is common practice. But these scenarios have to be evaluated to allocate public funds with total confidence that the programs are on the correct path. Lack of flexibility can be a major constraint to developing a useful response to local crisis. Interpretation opens up the risk that what is done will be contrary to the original intentions or will be deemed “unwise” in retrospect. Even with good forecasts, a decision could turn out to be wrong or could lead to an unpopular outcome.

Changing views as to what constitutes the needs and social norms of communities are just as important as economic growth. The need for anticipatory approaches to product design, market trends and so forth is accepted in the industrial and commercial world. Similar approaches should be used to anticipate the future capacity of communities to generate the wealth that today is a prerequisite for healthy survival.

To plan ahead, to spend scarce resources on anticipating trends and likely developments and to draw up strategies in advance of immediate need is a very difficult task. On a personal level, it is quite normal to plan for change and take action to anticipate possibilities by way of

education, retraining, insurance, relocating and planned pensions. Such anticipatory action at community or regional levels, however, is a new concept and has a long way to go.

Spending scarce resources today on anticipating what might happen in the future seems to be common sense, but, when resources are scarce, it is rarely supported. Yet it is essential for communities to prepare and plan ahead to minimize the negative impacts of adjustment to change. That is extremely important because public sector resources are normally provided within a politically determined policy framework that, because of its need to meet national criteria and national political realities, does not always fit well with local/regional circumstances. A consequence is that the reason that funds are given is often different from the reason they are needed. Often funds will be utilized in a way which, as much as possible, is in line with local needs but presented as though in line with political imperatives.

As managing change means anticipating trends, countering negative effects and exploiting positive opportunities for the benefit of the community, many possible alternatives leading forward into the future have to be analyzed. Choosing the right direction is the crucial issue. An effective planned response to the unpredictability of change has to include more forward-looking institutional, legal and financial frameworks. Because of the inherent uncertainty of the future, the freedom to change plans, to adapt as circumstances change, is the measure of a successful strategy as opposed to a sign of failure. It is important to remember that one of the few certainties or near certainties in the development field is that the original plan will be wrong. Experience shows there is a danger in remaining too committed to the initial plan. A plan can become just another rigidity.

## Maintaining Adaptability to Change

It was indicated earlier that development and change might be considered an “emergent phenomenon” arising from the interaction of a wide range of actors in a complex adaptive system. This proposition gives rise to a question: could the direction of those properties be guided in a way that meets and responds to community needs?

The implication of a “chaordic” strategy is that outcomes are unpredictable, innovative and sometimes even inefficient. Strategies based on this concept are, however, very relevant for circumstances in which there is a need for constant readjustment to a shifting landscape and it is not possible to identify accurately the “winners and losers” from a wide range of constantly appearing and disappearing elements and actors. From a base of knowing a great deal about past events, something about the present and little or nothing about the future, it offers a link between what might happen and how one might react.

Anyone who has worked in the field of community and regional economic development—with its multiplicity of agencies and institutions, local political actors and activists forming or influencing policy, usually uncontrollable external market, technological and social trends and constant tendency for change in the overall political direction—will recognize the validity of the assertion that economic development can be considered a complex adaptive system. What

is less clear, perhaps, is the self-organizing aspect of systems of economic development and how ideas about complex adaptive systems can be applied. A better understanding of this approach could enable more effective advice to be given to the policy makers, strategists and practitioners involved in this kind of activity.

It has been argued that innovation, a prime requirement in a constantly changing landscape, is stronger in more chaotic systems. But in the policy arena there are constant forces of attraction pulling toward systematic, institutional, bureaucratic or political rigidities. In an economic development context, the tendency toward extremes is illustrated by the difference between the rigid dogma attached to supporting old established industries—long-term protection and subsidy for industries such as steel and coal in the face of clearly discernible trends against the sectors and established enterprises—and the “free market” freedoms and lack of coordinated action that enabled the migration of economic activity out of cities and rural communities.

The challenge of maintaining the adaptability to change, of staying in that area where improvisation and innovation are more likely, is clearly a matter of some importance for people involved in community and economic development. For local and regional development the implications point to encouraging and promoting institutional networks that give the widest possible scope for new initiatives, for trying out new ideas without becoming locked into unwelcome rigidities and long-term, inflexible programs. This is to be within a loose arrangement that allows for coherent guidance and decision-making mechanisms but can respond quickly as changed circumstances demand and allow.

Coherence needs to be encouraged by means of guidelines rather than hard and fast rules and procedures. The guidelines that avoid central planning and prevent the “chaos trap” of too little structure have to create a flexible structure.

A structure of small, flexible parts in a network can promote improvisation and innovation by giving support to a wide range of technical and community interests. By building capacity among diverse community actors the overall network can hedge its chances of being able to deal with unpredictable future events. A team-based project management approach within or among agencies can offer greater flexibility and encourage creativity. It generally supports improvisation and yet provides a coherent reporting structure to manage effective implementation.

In some cases, it may even be advantageous to separate “implementation” from “improvisation and project design.” The skills and operating environment needed to draw up policy and strategy can be very different from those needed for efficient implementation. Equally different are the conditions to promote improvisation and innovation.

There are more questions than answers in the development world. The above issues beg a number of questions that need to be addressed by individual policy-makers and managers on their own:

- Would institutions made up of a small number of core staff, whose role is to put together short-term project teams that can be established and closed down as conditions change, be a realistic and flexible alternative to current practices?
- Would it be better that responsibility for decisions be widely distributed or closely targeted?

- Would it be better for the government to act as an “enabler,” providing a framework of powers and resources but not getting involved in program formulation and implementation?
- Is the principle of subsidiarity, extending decision-making as far as possible toward the end-user, effective?
- Would the tendency that this confers to permit individual organizations to deviate from the intended use of public funds be acceptable?
- Could the monitoring of resource use be sufficiently flexible to allow “point of use” validation in ways that do not stifle creativity?

Obviously, creativity cannot be mandated. Rather, it is a consequence of random actions or events within complex structures that result in changes. It can, however, be promoted by encouraging more interactions among diverse elements in the community.

After all, delegated authority to spend against locally-determined plans and budgets with after-the-event justification is a well-entrenched practice in private sector operations. A test for economic development practitioners would be to see whether an approach that is possible in the management hierarchy of a large corporation, no matter how lightly structured, is valid or can offer lessons for the much looser and less hierarchical world of economic and community development. Consider here the experience of the European Community’s support for the countries of Central and Eastern Europe. As the support increase and experience was gained, rules and procedures proliferated within the Commission with a resulting loss of flexibility. Larger programs sacrificed quality of output in favor of fast disbursement. Decentralization took decision-making closer to the point of use, but with even more rules and procedures designed—but failing miserably—to cover all eventualities in widely differing countries, sectors and communities, it resulted in inefficient use of scarce resources.

## Implications for Policy Development

As the East-West Institute’s study “Regional Policy Goes East” presents, the future focus for local and regional development thinkers should not be on the search for new techniques. While there is room for more research and ideas on tools such as innovation centers, science parks, training programs, certification of practitioners, flexible financing schemes for SMEs, etc., the next stage of work lies in examining and understanding the social, political and economic dynamics of the processes that guide community and regional development.

Research and experimentation should be concentrated on the practical lessons that will enable communities to anticipate changing circumstances and be prepared to respond. With increased understanding, practitioners can seek ways of developing the institutional and policy frameworks that will better equip communities to look and plan ahead.

A “chaordic” strategy for economic development can be formulated based on one of the most important lessons drawn from the experience of recent years: designing a regional or local strategy for regeneration based solely upon analysis followed by a series of planned initiatives or

projects does not work. Communities contain many more ideas for projects, a greater and wider level of expertise and more motivation awaiting release than the institutions that are expected to initiate action. Strategy needs to be a process of growth—a process that builds upon existing strengths, existing people, businesses—and organizations and which, while flexible and, to a degree formless, provides input and feedback and guides the move forward.

Progressive present-day thinking promotes the idea of the widest community consultation and local accountability rather more than has been traditional, where as many local actors as there are special interests are to be supported. The frequent reference to and stated desirability of a “bottom-up” approach is a marked feature of this kind of thinking. If policy, whether through national initiatives or by the operation of regional development agencies, promotes a multiplicity of local actors and agencies, democratic participation is not necessarily enhanced, but the reactive capacity of the community is likely to be.

It could also be expected, however, that there would be failures as well as successes. An analytical tool, using criteria determined by local evaluators, can help organizations observe and manage change, promoting successful projects and weeding out the less successful over time. The demise as well as the birth of projects, agencies and other organizations needs to be a routine feature of the development process. One way to alleviate the pain of cutting less successful programs has been to give fixed-term support so that there is a regular period when a new decision to give support must be taken. This way change becomes a less threatening occurrence.

There is a great challenge for politicians, policy makers, administrators, managers and others to “let go” of control and to allow flexibility, delegated authority and risk-taking at the middle and junior management and professional staff levels in community development organizations. Such a course carries obvious risks for senior decision-makers, in that events could transpire in a way that they do not like or that could invite criticism from others.

Recognizing that development is an emerging property in a complex adaptive system can show the way to new directions that will permit the wise allocation of scarce resources and improve the chances for effective use yet avoid control, rigidity and waste.

### *Key Points*

- Local economic development programs should be elaborated and executed in partnership with regional, national and international policies and programs.
- Local, regional and national governments have to support the appropriate environment for economic development for the private sector—the real wealth creator—to reduce the cost of production for the private sector by creating efficient and effective public institutions and to enrich the human, environmental and physical capital (infrastructure) which contributes to a community’s competitive advantage.
- Managing emerging changes is about anticipating what is likely to happen and putting into place actions to counter negative effects and exploit opportunities that change creates for the benefit of the affected communities.

- At a simple level, planning on “chaordic” principles comes down to having a long-term approach to strategy based on responding to constant change at national, regional and local levels. A regional development policy or organization that operates “chaordically” will have an adaptive, flexible, coherent, strategic direction that allows for local variations while avoiding fixed institutional structures, exaggeratedly detailed legal restrictions and rigid long-term implementation programs.
- The challenge of maintaining the adaptability to change, improvisation and innovation, is of high importance. For local and regional development the implications point to encouraging and promoting institutional networks that give the widest possible scope for new initiatives, for trying out new ideas without becoming locked into unwelcome rigidities and long-term, inflexible programs.

#### 4. FUNCTIONS AND ROLES IN ECONOMIC DEVELOPMENT

A broader analysis of decentralization is provided by Bailey (1993) in relation to the economic functions of local governments:

- To produce a more efficient *allocation* of resources when the market fails;
- To ensure a more equitable *distribution* of income and wealth than would be produced by market forces alone;
- To ensure appropriate quality and quantity of *regulation* to support and channel the market forces;
- To *promote stability* and a reasonable rate of growth in the overall level of economic activity.

It is usually argued that stabilization and income distribution are properly the concern of central government or—if we refer to intra-regional distribution—of the regional structure, while resource allocation is primarily the concern of local governments. The regulatory function is better to be divided between local and central governments reflecting the division of service responsibilities.

##### *Regulatory Function*

Although there is no accepted international definition of regulation, the term “regulation” is used broadly in this document to include the full range of legal instruments by which governing institutions, at all levels of government, impose obligations or constraints on private sector behavior. Constitutions, parliamentary laws, subordinate legislation, decrees, orders, norms, licenses, plans, codes and even some forms of administrative guidance can all be considered “regulation.”

Regulation in its many forms—from parliamentary law to ministerial orders to municipal bylaw—is among the most important tools of government. Quality regulation is crucial for government effectiveness. Concerns about regulatory quality have emerged at national and sub-

national levels of government, and also at international levels, as international bodies increasingly set rules or coordinate national regulations to address problems that cross national borders.

The maturing and expansion of regulatory systems has given rise to concerns about:

- The growing quantity and costs of regulation: complaints are voiced throughout the European area about “regulatory inflation,” rising compliance costs and the burden of administrative formalities. Economic costs stemming from rigidities and anti-competitive effects are often noted. Many of these costs are justified by the benefits of regulation, but often the costs—in terms of slowed economic growth, sluggish job creation and barriers to structural adjustment—appear to be larger than necessary. In very few countries are the costs of regulation assessed, suggesting that a more careful and informed approach to the use of regulatory powers is needed.
- The quality of individual regulations: many governments may not wish to regulate less (indeed, in many areas such as environmental quality they wish to regulate more), but the desire to regulate better is universal. New rules should be as well designed as possible. Governments are emphasizing a variety of quality standards: user standards such as clarity, simplicity and accessibility; design standards such as flexibility and consistency among rules and in application; legal standards for structure and drafting; and analytical standards such as benefit-cost and cost-effectiveness tests. The quality of existing rules is receiving more attention as governments screen out out-dated or unduly onerous regulations. To expand the range of available policy instruments, governments are looking more closely at alternative approaches such as economic instruments, voluntary agreements and information disclosure.
- The legitimacy and openness of regulatory decision processes. Throughout the CEEC area, administrative openness and responsiveness have become more important. There are pressures for more accessible processes of regulatory decision-making in which affected parties and the larger public can be involved and can understand how decisions are made.

Countries are also focusing on regulatory quality because the governing environment is changing. Economic conditions are becoming more difficult and are highlighting direct and indirect costs of government actions. Businesses facing tougher competition are asking their governments to reduce regulatory burdens to the greatest extent possible. Impacts on small and medium-sized enterprises are being given more attention within economic policies on job creation. The quality of national regulatory systems is more important than ever to international competitiveness. New global markets and technologies have rendered some older forms of government regulation counter-productive, as was recognized in the deregulation trend across the EU area in the 1980s and 1990s.

The internationalization of rule-making is also forcing governments to question long-standing regulatory traditions and to seek innovative forms of regulatory cooperation. Internationalization is heightening pressure for improvement: the quality of regulatory decisions in one government becomes a matter of concern to other countries that are linked by cross-border effects, or by agreements for regulatory harmonization, mutual recognition or coordination. Improving

regulatory quality at the level of national governments is an important condition for sustaining and expanding an open world trading system.

Finally, regulatory quality is receiving more attention because countries are learning from each other how to improve regulations. An international flow of information on innovations and experiences is supporting and stimulating new reform movements.

The quality of government regulations concerns all who are working to establish the conditions for sustainable global economic growth. As the OECD's Public Management Committee has noted, regulatory quality is crucial for economic performance and government effectiveness in improving the quality of life of citizens. The quality of regulations is becoming even more important as rules are internationalized, and national regulations affect the world trading system.

The OECD recommends that member countries take effective measures to ensure the quality and transparency of government regulations by steps such as:

- examining the quality and performance of administrative and political processes for developing, implementing, evaluating and revising regulations
- developing—as far as is practical and in conformity with legal principles and governing traditions—administrative and management systems through which principles of good decision-making will be reflected in regulatory decisions
- integrating decision-making principles for efficient, flexible and transparent regulation into regulatory policy processes at all levels of government
- paying particular attention to regulatory quality and transparency with respect to regulations that may have impacts on other countries, or affect international trade, investment or other aspects of international relations

Regulatory principles necessarily differ from country to country, since issues of concern will arise from specific economic, social and political environments and values. When properly framed, the values inherent in a regulatory checklist—such as the balance between individual and collective rights, or the role of government in society—should reflect the values of a government and the society it serves. For that reason, the regulatory checklists of some governments emphasize economic analysis and cost reduction, others stress civic principles such as due process for citizens and the legal basis for government action, while others focus on quality issues such as simplicity, clarity and minimization of formalities.

Adoption of good decision principles is not, in itself, a sufficient condition for improvement. If such principles are to produce genuine benefits in the quality of regulations, governments must develop systematically organized procedures, with sustained political support at the highest levels, for the implementation of such principles. That is to say, checklists should be one element of a broader regulatory management system.

It is a necessary condition for success that regulatory officials at all levels of administration be familiar with quality principles established for regulatory decisions, which places special emphasis on training and incentive programs within the civil service.

The *OECD Reference Checklist for Regulatory Decision-making* responds to the need to develop and implement better regulations. It contains ten questions about regulatory decisions that can be applied at all levels of decision- and policy-making. These questions reflect principles of good decision-making that are used in OECD countries to improve the effectiveness and efficiency of government regulation by upgrading the legal and factual basis for regulations, clarifying options, assisting officials in reaching better decisions, establishing more orderly and predictable decision processes, identifying existing regulations that are outdated or unnecessary and making government actions more transparent. The *Checklist*, however, cannot stand alone—it must be applied within a broader regulatory management system that includes elements such as information collection and analysis, consultation processes and systematic evaluation of existing regulations.

**1. *Is the problem correctly defined?***

The problem to be solved should be precisely stated, giving clear evidence of its nature and magnitude and explaining why it has arisen (identifying the incentives of affected entities).

**2. *Is government action justified?***

Government intervention should be based on clear evidence that government action is justified, given the nature of the problem, the likely benefits and costs of action (based on a realistic assessment of government effectiveness) and alternative mechanisms for addressing the problem.

**3. *Is regulation the best form of government action?***

Regulators should carry out, early in the regulatory process, an informed comparison of a variety of regulatory and non-regulatory policy instruments, considering relevant issues such as costs, benefits, distributional effects and administrative requirements.

**4. *Is there a legal basis for regulation?***

Regulatory processes should be structured so that all regulatory decisions rigorously respect the “rule of law.” That is, responsibility should be explicit for ensuring that all regulations are authorized by higher-level regulations and consistent with treaty obligations and comply with relevant legal principles such as certainty, proportionality and applicable procedural requirements.

**5. *What is the appropriate level (or levels) of government for this action?***

Regulators should choose the most appropriate level of government to take action, or, if multiple levels are involved, should design effective systems of coordination between levels of government.

**6. *Do the benefits of regulation justify the costs?***

Regulators should estimate the total expected costs and benefits of each regulatory proposal and of feasible alternatives and should make the estimates available in accessible format to decision-makers. The costs of government action should be justified by its benefits before action is taken.

*7. Is the distribution of effects across society transparent?*

To the extent that distributive and equity values are affected by government intervention, regulators should make transparent the distribution of regulatory costs and benefits across social groups.

*8. Is the regulation clear, consistent, comprehensible and accessible to users?*

Regulators should assess whether rules will be understood by likely users and, to that end, should take steps to ensure that the text and structure of rules are as clear as possible.

*9. Have all interested parties had the opportunity to present their views?*

Regulations should be developed in an open and transparent fashion, with appropriate procedures for effective and timely input from interested parties such as affected businesses and trade unions, other interest groups or other levels of government.

*10. How will compliance be achieved?*

Regulators should assess the incentives and institutions through which the regulation will take effect and should design responsive implementation strategies that make the best use of them.

A closer look at question five gives us further opportunity to approach decentralization. This question is both legal and pragmatic in nature. In some cases, competencies are designated by higher-level regulations, and regulators have no discretion. But in many cases, governments can choose who should act. In these cases, the question is, given the nature of the problem, what level or system of cooperation between levels of government can regulate most efficiently? This issue is raised under many policies, including decentralization, federalism, subsidiarity and internationalization. As they distribute regulatory competences, governments are choosing more carefully today between sub-national, national and international levels of government.

The answer to this question will rest on several criteria: does the problem cross legal and political boundaries? Are there negative or positive externalities? Does it involve issues of a primarily regional or local character? Are there economies of scale in regulating across a larger territory? What are the institutional capacities of various levels of administration? In many cases, the need for national (or international) uniformity of regulatory standards must be balanced by sensitivity to local differences. Harmonization can achieve efficiency gains by removing regulatory barriers to trade, but over-harmonization can be as inefficient as under-harmonization.

Multiple levels of government are often involved in regulatory development or implementation. In these cases, the regulator should ask: How can consultation and coordination be best carried out between levels of government? Problem solving, whether regulatory or not, will often involve cooperative action between levels of government. Cooperation, in turn, may require the building of new forms of administrative partnerships and relationships. So that regulations can be implemented successfully, regulators should ensure that administrative capacities to accomplish tasks and duties are fully in place and should carry out necessary consultation and training programs to achieve this.

### *The Stabilization Function*

The role of decentralization as a means to foster growth and development has been questioned as leading to an unprotected stabilization policy. Faced with this potential for instability, central governments of developing and transition economies believe that they must retain control over fiscal activities in order to implement stabilization policy, on the pretense that inflation control and deficit reduction programs cannot be implemented when a significant portion of national spending and taxation is in the hands of local governments who do not have a consistent interest in pursuing stabilization policy.

Arguments in favor of centralizing monetary and fiscal policies to secure the macro-economy have recently been restated based on the following reasoning:

- The use of a national currency implies centralized monetary policy. Since monetary and fiscal policies are intertwined, centralized monetary policy equally seems to entail the case for centralizing fiscal policy.
- The monetization of public debt at local levels is likely to interfere with monetary policy. This may diminish the central bank's ability to pursue its national policy objectives.
- The impact of regional stabilization initiatives is usually negligible at the national level—because of its relative small size compared to the national budget.
- Furthermore, the openness of regional economies limits the effectiveness of local fiscal policy because any fiscal stimulus is exported to a high degree.
- Given regional spillovers of fiscal stimuli, local authorities will never provide enough stabilization because the costs are too high compared to the internal benefits of the policy.

European Union countries widely accept the notion that monetary policy be centralized as long as sovereignty for this type of policy is vested in an institution which is independent from government. On the other hand, the idea to centralize fiscal policy in the European Union is generally rejected.

The European Commission presented recently (in May 2001) a communication on the EU's future strategy regarding taxation policy, based on the Commission's desire for more tax coordination and to move away from plans for more tax harmonization. The main objective of the new proposals is to make tax policies contribute to achieving the goals established by the Lisbon Summit of making the Union the most "competitive and dynamic knowledge-based economy in the world by 2010." In order to make sure that individuals and businesses can benefit fully from the internal market, inefficiencies due to the co-existence of fifteen different tax systems within the EU should be eliminated. Several proposals to harmonize certain elements of the tax regimes failed because of strong opposition from member states not willing to give up any sovereignty over taxation policy (mainly the UK and Luxembourg). Any changes in tax legislation in the Union need to be approved by all member states ("unanimity rule").

The political reasons for this are self-evident: in the EU, this thesis would lead to a strengthening of the supranational tiers, in particular through the widening of the European Commission's budget at the expense of member states. This would heavily inflict upon national sovereignty and contradict the "subsidiarity principle"—formally adopted as a quasi-constitutional rule through Article 3b of the Maastricht Treaty—which stipulates that the powers of EU institutions be limited to those functions that cannot be adequately performed by member states. This is an *a priori* conjecture in favor of national sovereignty.

### *The Distribution Function*

It is generally argued that local governments should not undertake the redistribution of income. A local government adopting a program with substantial redistribution objectives would have to tax high-income groups in order to pay subsidies to low-income groups. Such a program will attract low-income groups into the area, but will lead high-income groups to migrate elsewhere. If local government does not tax high-income groups beyond a certain ceiling in order to avoid high-income migration, then the funds available to subsidize low-income groups will decrease per capita as they move into the area. Only programs that are mildly redistributive between original incomes and post-tax disposable incomes would be feasible at the local level.

There is another variety of arguments that appear to lend support to the view that local governments may not be well equipped to exercise distribution:

- Sub-national governments may spend excessively on the "wrong" expenditures even if the assignment of outlay functions is optimal; in particular, local governments tend to spend on public consumption rather than public investment so that the formation of infrastructure capital is sub-optimal.
- Another argument, especially for developing countries, is that the efficiency gained from fiscal decentralization may not materialize since revenue collection and expenditure decisions by local governments may be constrained by the central government.
- The administrative capacity of local governments may be too weak. Therefore they may not be able to exploit their local tax capacity appropriately and will be inefficient in providing public services.
- The system of intergovernmental grants may be unhealthily designed. This is the case whenever transfers encourage inefficient local government spending or reward the indulgence of sub-national governments through implicit bail-out guarantees. In particular the intensity of interregional fiscal redistribution (equalization) may have detrimental effects on national growth.
- In practice local governments may not be as responsive to citizens' preferences and needs. This is particularly true where local officials are not directly elected, where there is corruption, a lack of freedom to express one's views and a low level of education. Poverty, economic and social dependence may also restrict the mobility of citizens, so that the "voting with one's feet" argument does not hold in developing countries.

Some of these arguments are of a technical nature and do not weaken the case for decentralizing government as such. It is obvious that the assignment of taxes and expenditure responsibilities, for instance, has to be effected in a way so that the benefits of decentralization can in fact materialize. Another strong argument is the weakness of local government administrations in many developing countries. This should not be underestimated and it will call for specific solutions where this problem exists. Other arguments are of a political nature and call, for instance, for democratic institutions, freedom of speech, free elections and a regulatory and legal framework that is favorable for political and economic initiatives both in the private economy and in the local government sector. In many developing countries, the political and legal environment for economic activities is still very weak, and political and legal processes are often unpredictable—which must lead to negative consequences for private and public investment and hence diminish economic growth.

Economic growth and intergovernmental fiscal relations are, however, intimately linked where resources originating from high-income jurisdiction are transferred to poorer regions either through equalization grants or revenue assignment and sharing arrangements. Negative effects on national growth may result from such equalization payments where the revenue capacity of faster-growing regions is diminished so as to jeopardize its potential to keep up with the needs for public infrastructure. The question is how much high-income regions have to “earn” to deliver a net outflow of resources to poorer regions and still sustain and strengthen the basis for further high levels of economic activity. This question is crucial for effective growth policies, but it does not necessarily relate to the issue of decentralization; it also applies to regional policy in a unitary government setting.

## The Main Roles of Economic Development Actors

### *National Governments*

In the context of the globalization of information and the economy, the role of the state will grow in importance. Its removal from productive activities, at which the private sector and the market have shown themselves to be superior, should not mean that the state should abdicate its role as “regulator” or its primary function of democratically determining public policies of national interest. New systems, mechanisms and specialized public agencies should be set up for this purpose.

National governments can create macroeconomic conditions that facilitate local and regional economic development. They can create stable currencies with low levels of inflation; remove trade barriers from export and import markets; implement sound and transparent legal, economic, financial, tax and regulatory systems; encourage open and transparent financial and labor markets; and build reliable political systems.

In its new role, the state will act as a strategic planner, regulator, rights guarantor and facilitator of partnerships in creating an enabling environment for investors to participate in a local economy. Its responsibilities are to:

- *Ensure the stability of fiscal and regulatory policies.* Volatility and instability in these policy environments inhibit investor activity. If investors are uncertain of the climate in which they are undertaking business, they will be less willing to take the inherent risk of new investment.
- *Ensure macroeconomic stability.* Fiscal policies should encourage low inflation and stable exchange rates. This may require a reduction in public spending.
- *Fix the legal framework.* Investors need a stable and reliable legal framework that guarantees property rights and allows for the development and enforcement of contracts.
- *Streamline processes and controls.* Governments need to reduce the red tape involved in administrative and regulatory controls. All processes should be transparent and consistent.

The risks and opportunities that the state must be aware of in developing a policy for globalization could be managed as pointed out by Sachs (1993):

- Do not rely on artificial competition based on very low wages and setting too low a value on natural resources and energy; use the dynamic competitive advantages obtained through knowledge as a base instead.
- Do not put too much emphasis on the competitiveness of companies to the detriment of systemic competitiveness, which rely on efficient infrastructure, banking and insurance systems, telecommunications, etc.
- During the process of sustained export growth, do not forget the internal market, whose importance is fundamental, especially in large countries; the greater the present degree of social exclusion and asymmetry in the distribution of income, the better the perspectives for expanding the internal market by applying the instruments for re-distributing income and growth. The internal market is an asset, not a liability.
- Do not cause the collapse of the industrial structure of the country by total deregulation; adopt selected processes of liberalization instead.
- Be selective when applying policies with regard to technology. Such policies always demand a balance between the importation of black boxes, adaptation and adequate support for local research efforts.

### *Local Governments*

As “centers of investment,” cities, not nations, are the engines of economic growth. They house the physical evidence of outcomes of international, national, regional and local government policies.

Local government plays a critical role in establishing an investment-friendly environment in which private investors can expect a reasonable return on their investment and citizens can acquire

a better quality of life through improved employment opportunities. To create this environment, local government officials focus on human resources (labor), physical and financial resources. Their goal is to improve the productive use of space, the productivity of labor and effective use of financial resources ultimately creating a more inviting investment climate. In many ways, local economic development is a hybrid field that relies on the principles of economics, finance, planning, public administration, local government management and spatial geography to achieve the ultimate goal of increased wealth for the community.

The local government's role is to build market-driven, public-private partnerships that will create long-term jobs, income and wealth. In the end, the town or region must restructure itself. Economic restructuring is successful only if it is a long-term process with commitment, driven by an innate understanding of local comparative advantages which are continually adapted and adjusted as needs and opportunities change.

Local governments can also play an important role in influencing the local investment environment. For example, they can provide services designed to help investors navigate both local and national tax and regulatory systems, creating a "one-stop shop" for investors that could serve as a central point of contact for businesses working with various government departments or agencies. The local government also should keep local taxes and regulations investor-friendly by considering their effect on businesses and the overall investment environment.

Local governments can play an equally important role in influencing the broader investment environment by working independently and through municipal associations to encourage appropriate national reforms.

Ultimately, successful private-sector participation in land and property development will take place when:

- The title to all parcels of land is soundly based in law.
- Transactions are recorded in a way in which the legal title and other significant legal interests can be proven with reasonable speed and cost.
- Access to capital financing based upon an effective mortgage system is available through a commercial banking system.
- Statutes and laws do not impose undue statutory or fiscal constraints on transactions (such as sales and leases).
- Expertise is available to advise on legal, valuation and other issues affecting the land.
- The local government builds public-private partnerships for land development.
- The local government uses its zoning powers to steer development.

Impediments to public-private partnerships and access to credit for private development are numerous in the CEE region. Without a developed banking system, a title system for private property, fiscal cadastres and mortgage laws, local governments must find creative ways to assist investors in securing access to property and buildings. Local governments in the region have addressed these issues in a number of ways, including:

- Constructing new commercial building space for a business (as in Poland and Romania).
- Assisting and delivering training programs to new business (as in Poland).

- Conducting an inventory of the condition of vacant or underused enterprise buildings and negotiating affordable rents for the investor (Romania).
- Assembling land for capital projects that will increase the value of land for business development (Hungary).

For example:

The creation of the Enterprise Center in Szczecin, Poland, was intended to offer diverse facilities to the small companies newly created—offices, small production spaces, phones, faxes, computers, internet access, etc., as well as legal and accountant consultancy offered by the small enterprises also hosted by the center. At the end of 2000, seventeen companies operated in the Enterprise Center with 300 employees in Szczecin and in the surrounding region (120 employees in Szczecin).

This first objective was enlarged by renovating old industrial buildings to transform them into enterprise “incubators” including training and marketing spaces. The impact of the renovation initiative was bigger than initially foreseen—many other investors were attracted in the area, the value of the land in the surrounding area increased after five years and many other workplaces were created.

Until the last local elections, the Enterprise Center—functioning as an NGO—received external grants and direct support from the local government for building rehabilitation as well as operation and maintenance. The previous local government also offered small grants—under USD 5,000—as support to unemployed people willing to create new enterprises. The newly elected councilors recently cut down all the support offered both to small enterprises and the center. Moreover, the local government started to charge the center for rent and utilities.

Excellence in service delivery—providing the infrastructure and services needed by businesses to succeed—is also an important element in attracting new business and maintaining existing business, as well as in encouraging business growth.

### *Economic Development Organizations*

Regional development agencies and equivalent agencies at local levels have been, and continue to be, promoted as a major tool in economic and community development. The limited resources made available through a typical small development agency can generate useful initiatives but the effects are too often marginal in their impact. Their role is often as much to give hope that things can change for the better as it is to have a direct impact on unemployment figures. Essentially, they must demonstrate that the rules of the game can be altered. It is often up to the private sector as much as national governments to then take over and invest in a new idea.

Economic development organizations provide institutional structure—support and coordination—for the implementation of economic development plans and structures. There are many

types of organizations, and each organization may offer a menu of functions or activities. The primary purpose of economic development organizations, however, is to ensure that government support, capital, and a legislative framework conducive to successful business activities are provided in an efficient and coordinated fashion.

The objectives of a local economic development program dictate the various functions that are appropriate. Depending on the resources available within a single community, it may be necessary or more efficient to partner with higher-level organizations to provide a larger menu of activities. First, it is important to gain an understanding of the various functions, then explore, through examples, at what level—local, regional, national or supranational—these functions are best addressed.

The function of economic development organizations is primarily to support business through:

- Business inventory, in order to form the basis for the types of marketing, business incentives and training programs that will strengthen the related firms.
- Product and resource marketing programs to develop a focused marketing program (trade shows, brochures, employment of a marketing representative), in order to find firms that are interested in investing in the types of products offered or are interested in locating in the region.
- Institutional resource inventory, in order to match private business demands with other institutions in the community.

They could have also important financial functions, such as:

- Generating capital for business development through reducing the cost of capital resources such as land, buildings and equipment and lowering interest rates.
- Attracting international capital, through initiating venture capital and replicating an investment success of a firm that already is part of a joint venture or has foreign investors, in order to serve as a model for developing training programs in business investment strategies for companies willing to restructure or retool so that they can attract foreign investment.
- Reducing capital costs through capital resource identification and negotiate lease programs.
- Training human capital (labor), thereby adding value to the product in the most efficient way.

Whether a government is members of an economic development organization or not, the organization is performing intergovernmental functions. It is important to ensure that the public services required by business, the land and access to transportation and the regulatory permit process are all available at the right time. Regarding higher levels of government, an economic development policy agenda should be developed based on input from businesses in the area. Economic development staff should work with central government legislatures to pass favorable tax legislation, property rights, tariffs for utilities, labor laws, etc.

To be consistent with the “chaordic” approach and promote activity at the interface, a regional development agency needs both to encourage the formation of a network of independent

initiatives and yet be just a player in that landscape without seeking to impose order upon it. Most regional development agencies today fall somewhere in between these two categories. This raises the question of whether a clearer policy and practice could be formulated that would assist in forming the preferred network management, whether development agencies, by stimulating external pressures, could be the vehicle for the promotion of diversity and yet avoid fragmentation.

## Levels of Economic Development Organizations

### 1. *Local Organizations*

Community-based organizations most effectively deliver services to and communicate with the private sector. These organizations typically bring financial and training institutions, utility companies, landowners and local government together. They also provide a vehicle to develop and implement the strategic plan that defines the local economic development program.

For example:

The Economic Development Plan of Sibiu County, **Romania**, provides an overview of how a community alliance can be built and sustained. The main goal and strategic objectives of the plan were identified following numerous discussions and in the light of conclusions reached by analysis of the county's and area's competitive potential. Changes in its geopolitical, social and economic situation forced Sibiu County to confront its need to develop new means of existence.

The mission of the plan describes Sibiu County as a multifunctional area integrated into the Romanian and world economy that provides a favorable environment for life and economic activity. The plan is a consensual public contract under which authorities, businesses and public organizations take upon themselves certain obligations. Sibiu has a local development board that involves community representatives in implementing the plan.

The primary functions or activities provided by the Sibiu Economic Development Agency include:

- Identify, conceive and promote development programs;
- Support public authorities and the private sector;
- Provide specialized consulting services;
- Administer development programs;
- Represent Sibiu county's interests in relation to the Regional Development Agency.

### 2. *Sub-national or Regional Organizations*

Strategic alliances seek to capitalize on the comparative advantages of sub-national units of government. Clustering occurs for a variety of reasons. For example, some regional clusters reflect a relationship based on a physical attribute such as the Rhine river basin region in

Germany, or agricultural characteristics such as the Tokaj wine-producing region in Hungary. Together, such regions collectively address issues related to education, infrastructure and civic leadership and jointly market the region's comparative advantages.

### 3. *National Organizations*

National organizations are often the most effective at lobbying the government for the adoption of more favorable development legislation and programs. In most post Soviet Union and Eastern Bloc countries, national economic development organizations such as the Romania National Chamber of Commerce and Industry are mandated and funded by the central government, eliminating their effectiveness as lobbyists. They can, however, be a source of information for regional and local organizations to learn about available funding sources for capital improvements and international firms interested in investing in a country.

In developed countries, national organizations such as the Council for Urban Economic Development in the United States provide support and training for economic development officers, while others such as the U.S. Chamber of Commerce lobby for favorable business legislation.

### 4. *Supranational Organizations*

Supranational regions are being formed to allow for more freedom in trade. They reduce trade barriers by creating a supranational organization or by executing multinational trade agreements. In the European region the most influential organization is the EU. The EU's objective is to create a collective voice for the region, forcing the restructuring of each country's industrial complex. The EU has four structural instruments (funds) that are designed as incentives for states to develop programs and policies that comply with the EU's objective. The coordination of structural instruments seeks to concentrate resources, develop compatible programs, create partnerships and generally add value to available resources through coordination. The structural instruments are:

- The European Regional Fund,
- The European Social Fund,
- The Agriculture Guidance and Guarantee Fund,
- The Cohesion Fund.

This coordination is accomplished by the creation of National Development Plans (NDPs). Countries seeking accession to the EU must demonstrate actions that bring corporate governance structures into being (i.e., efficient government bureaucracies and regulatory systems), reform financial institutions and privatize industry. NDPs address industrial sector and sub-regional development issues, relying on input from regional and local economic development agencies.

National Development Plans are to be a reflection of sub-regional and local development plans. Ideally, the sub-regional and local input should define the NDP. For this to occur it is

necessary that alliances be developed between communities and regions so that the national government and the EU can hear a common voice.

## Partnership Networks

In several countries and at several levels, the state is already calling for “participation,” looking for partners to share responsibility in the performance of tasks and their costs. But the institutions and the legislation that shape the state as it is today are neither keeping pace with the rhetoric nor with the experimentation that is already widespread, notwithstanding very positive results. The current legal framework prevents progress in the direction of more flexible arrangements and at the same time protects the forces of conservatism.

The pattern that governs the relationship of the subsystem components of the overall system arises from the network or from a larger context of multiple linked networks. As individual organizational components of the system grow, they are likely to reach a point of stress or instability where they will either fragment or adapt. As components or subsystems develop, grow and change they cause consequent change to the networks that constitute the environment. The awareness of these interconnections can be described as a “sense of community”—a dynamic representation of the likes and dislikes, checks and balances, and internal and external pressures to be found in a community. Operating in a feedback loop, changing subsystems alter the operation of the overall system and, as a consequence, the attitudes prevalent within a community. The challenge for development professionals and policy-makers is to understand these processes and find ways of guiding them.

Regional diffusion and technology transfer have assumed an increasing significance in recent years, especially from the standpoint of regional development policy. Support policy primarily targets technology transfer through research parks, transfer centers and other advisory consulting institutions. The growing role of *networks* in this process is evident: networks facilitate relatively stable relations with selected partners.

Networks thus occupy a middle position between the market and the hierarchy. They have more flexibility than an internal organization, they shorten the innovation process, and they are successful in the current period of dramatic technological change. The development of new technologies (e.g., microelectronics or biotechnology) in other sectors strongly stimulates the networking process.

Consulted studies distinguish global networks (connecting international partners for the benefit of access to new markets, complementary technologies or acquisition of a highly sophisticated knowledge base) from regional networks. These latter are, to a larger extent than global networks, based on informal relations and spatial proximity.

Often, joint efforts by top managers, the inter-company mobility of managers and employees, long-time mutual acquaintance and trust play a role. Universities, research institutes and technology transfer centers are important actors. Many works have shown that technological innovation must be organized on territorial bases and requires careful coordination between

regional qualification, community development, education, research, fiscal and regulatory policy on the local and regional levels.

The existence of networks and clusters is a decisive element in the competitiveness of regions and countries (as opposed to cheap labor, land, energy, etc.). Innovations are increasingly becoming a matter between firms, a product of the environment of the firm itself (spatial relations to research, development, transfer institutions, clients, cooperation partners, production services, public institutions, etc.).

Experts believe that participatory methodologies can assist in this process of producing desired change. Experience has shown that the living systems of communities react better to change when community actors are involved in the process and able to interact with it. It is therefore important that methodologies be transparent and incorporate effective mechanisms for communication and access to information.

It is unrealistic to assume that private sector enterprises could accept a role as development planners; their obligation is to maximize the interests of their shareholders. Only the public sector can take the lead role in looking forward from the perspective of its “shareholders,” the communities it represents. The public sector needs to take the lead but not exclude or ignore the other players. As experience in the EU over the past ten to fifteen years has demonstrated, there is a major role for the private sector in local and regional development. The EU position advocating partnership and cooperation among the public, private and social partners in communities has gained clear acceptance across much of the political, social and professional spectrum.

When the three potential partners (the government, the private sector and civil society) belong to different hierarchical categories, the natural and traditional form of partnership for the government is to contract the services of the other two. However, since the public sector is often prevented from doing this because of lack of funds, a way of getting around the difficulty is to network. Setting up a network can be proposed by any one of the three partners, but since the state is responsible for establishing public policies and regulations, as well as proposing development goals so that they can be democratically endorsed, it is very likely that it will be the initiator of a network when crucial issues are at stake.

In such a network, the partners draw up a protocol wherein the procedures and the obligations of each are clearly defined. Most important in this process is the establishment of a consensus with regard to the “goals” and “products” to be attained, on the basis of which the partners devise strategies and a work program, including timetables and the assignment of tasks. Because the hierarchical principle does not apply in a network, leadership is divested of the power to command. Any member of the network may exercise *ad-hoc* leadership for the sake of efficiency, if all are in agreement. Guidance is achieved by constant discussion and even by negotiation.

Communication between the partners, which strengthens mutual confidence, must be constant and proceed both ways, in contrast to a hierarchical structure where it is usually top-down. The continuous flow of communications makes for strengthening mutual confidence.

The new work paradigms that emerge from the patterns of these partnerships will, in time, bring about substantial changes in institutions. On the side of the government, they will facilitate its engagement in such arrangements. For the private sector, it will entail a change of roles, from

one of subordination as in a contractual relationship, to one of equal status within the framework of the partnership. Furthermore, instead of receiving money for work performed, the private sector will foot part of the bill. A promising future may also be seen in the development of the third side in the partnership triangle, represented by nongovernmental organizations. Their inclusion will add efficiency to the exercise, especially when important social issues are at stake.

### *Key Points*

- The central government should not abdicate its role as “regulator” or its primary function of democratically determining public policies of national interest, in the context of recent changes; the state should act as a strategic planner, regulator, rights guarantor and facilitator of partnerships in creating an enabling environment for investors to participate in a local economy.
- Local governments play a critical role in establishing an investment-friendly environment in which private investors can expect a reasonable return on their investment and citizens can acquire a better quality of life through improved employment opportunities. To create this environment, local government officials focus on human resources (labor), physical and financial resources.
- The objectives of a local economic development program dictate the various functions that are appropriate for supporting organizations such as economic development agencies.
- Regional diffusion and technology transfer have assumed an increasing significance in recent years, especially from the standpoint of regional development policy. Support policy primarily targets technology transfer through research parks, transfer centers and other advisory or consulting institutions. The growing role of networks in this process is evident: networks facilitate relatively stable relations with selected partners.
- Private sector enterprises cannot become development planners; their obligation is to maximize the interests of their shareholders. Only the public sector can take the lead role in looking forward from the perspective of its “shareholders,” the communities it represents. The public sector needs to take the lead but not exclude or ignore the other players. Partnership and cooperation among the public, private and social partners in communities has gained clear acceptance across much of the political, social and professional spectrum.

## 5. INTERGOVERNMENTAL RELATIONS' IMPACT ON DEVELOPMENT POLICY

Seeking to discern a community's willingness to mobilize local revenue by testing local needs is assumed to be the most efficient way to allocate the spending of public finance. By setting the ratio between tax and service, local governments directly and transparently confront their constituencies on the allocation of public finances.

As mentioned, the sub-national administrative capacity and sub-national governments' accountability vis-à-vis their constituencies are two main prerequisites for the positive outcome of the devolution of spending responsibilities and revenue sources to sub-national levels, evaluated by the following issues:

- Measures taken to ensure the appropriate administrative structures and capacities;
- Measures for fiscal transparency: public information on governments' fiscal decisions and activities and public budget processes;
- External, independent control: auditing and similar procedures;
- Systematic measures for public participation in the delivery of services, including client surveys;
- Measures from the central government to encourage the receptiveness of services (self-regulatory mechanisms and market testing of services).

Seen from the national perspective central governments can re-address demands for additional public services to sub-national governments. Under the proper arrangements, the devolution of expenditures can take away local pressure on the national budget and stabilize public finances in general. On the condition of an efficient local tax administration the devolution of revenues to sub-national governments might further enhance the likelihood of successful results in the macroeconomic fields, due to the fact that the sub-national levels have had their "basis of accountability" enhanced.

Recent years have seen a rediscovery of the role of small and medium-sized businesses in regional development, as part of a whole complex of processes denoted as "bottom-up development"—which is the complete antithesis of earlier concepts of development as managed and initiated from the top down. As development in different European regions shows, the linkage of small and medium-size businesses in the regional network becomes a factor of growing significance. Small businesses provide many advantages in regional development: they are capable of creating a relatively high number of job opportunities, improve industrial environment and industrial relations, create a diversified and flexible industrial base, stimulate both competitiveness and cooperation with small and big businesses, stimulate innovation, etc.

Several studies cite the experience of local institutions, emphasizing the roles of enthusiastic local actors in creating and sustaining development. Different organizations from the outside can provide technical or financial assistance but the revitalization itself of the economy definitely originates from within.

This is because revitalization of the economy is only successful when:

- It is approached as a long-term process with a certain measure of enthusiasm that can be sustained only when the actors in the process are directly involved in it, giving and receiving feedback.
- It stems from internal understanding of local comparative advantages.
- Its strategies are constantly adapted and adjusted along with the changes in needs and possibilities within the local economy.
- It combines strict structures/rules of implementation with flexible ones, responsive to permanent changes.

## Centralized Control and Its Regional Impact

The arguments for centralization revolve around the possibility of deploying centralized measures for depressed regions (either through regional policy or expenditure control, with an increasing role for regions or legislative expenditure control in prosperous regions—for example, the competitive policy of the EU). The way central government implements regional policy and how and whether macroeconomic policy can be used (not only fiscal, monetary and trade policy, but also sectoral policies, such as industrial, agrarian, transport, etc.) to solve problems in areas that are lagging behind is shaping the entire process.

Another set of problems—using macroeconomic policy to promote depressed regions—is not as rare as would seem to be the case. For example, general support of investments in the national economy within an industrial policy often can be connected to additional support for underdeveloped regions.

It is argued that central government has a legitimate interest in searching for solutions to regional and local problems and that its engagement in effective coordination of regional policy is necessary.

As it was presented in the previous chapter, economic power—as an instrument to achieve quality growth—is crucially influenced by social, environmental and anti-corruption policies. The decentralization of the responsibilities to implement these policies is important as well, but most important is the correlation between the decentralization of two sets of policies, whether they support each other or not.

The main elements of economic power—fiscal, monetary and trade policy—vary widely across countries, ranging from totally centralized (e.g., Great Britain) to significantly decentralized (e.g., the United States and Canada, where economic power is vested in individual states and provinces). Most decentralization traditionally occurs in federal states.

The implementation of *monetary policy* is limited, mainly because the assistance provided to regions through increasing aggregate demand can strike against the borderline of inflation and balance of payments.

At the regional level, easier access to credit by households and businesses can be implemented. A general problem of the resultant increased demand is that the demand is “implemented” through import from other regions or from abroad (e.g., from increased investment activity in a depressed region, firms from a developed region can profit—which is not rare). Because of the highly integrated nature of monetary policy, its regional employment is limited.

The *trade policy*, especially through the use of tariffs and quotas to control imports, always puts some regions at an advantage at the expense of others, as a result of regional specialization (regardless of the fact that these measures are not regionally compounded). The reverse also takes place: state policies favoring high-tech industry will probably concern prosperous regions. Trade policy limits are determined by cost and international agreements (e.g., the General Agreement on Trade and Tariffs—GATT).

## Decentralization of Fiscal Policy

The question is whether decentralized fiscal policy helps or hinders regional policy. First, passing powers over expenditures to regional officials allows individual regions to implement their own development policy. This can have the advantage of increased knowledge of local conditions and employment of local initiative. Second, the existence of regional councils can give regions a stronger voice in the process of national decision-making. Third, the existence of regional councils enables improved coordination of development initiatives at the level of local elements.

Passing fiscal power on to regional councils allows them to generate revenues to cover additional expenses and have clarity and transparency in them, administrative management, efficient selection and flexibility. These taxes should not affect the remainder of the country's fiscal system. Taxes on income and sales best meet the above criteria.

There is, however, a danger in central government losing control over fiscal policy, which would affect macroeconomic policy. Increased power over fiscal policy creates two problems in underdeveloped regions:

- Their weak financial position does not allow regional governments to increase the tax burden (it could cause decreased outlays on consumption and migration).
- With regard to the openness of regions, increased outlays may largely be shifted to other regions (either through consumption or investments).

Underdeveloped regions would struggle constantly with a budgetary deficit. This problem could be—and usually is—resolved by subsidies from the national/federal to regional governments.

In conclusion, feasible types of decentralization fluctuate between total centralization and economic separatism. The example of federal states shows, however, that significant power over taxes and expenditures can be passed on to regional bodies without the central state losing control over macroeconomic stability.

The design of fiscal decentralization is a process that is almost permanently on the political agenda—not only in states with in transition but in OECD states as well.

Setting up local fiscal systems and intergovernmental financial relations involves multiple and often conflicting economic and political objectives. It is one of the most complex reform processes of public finance.

A double set of conditions has to be met by the national government. As part of the fiscal objectives, targets are set on public expenditures and general government finance. The national government must—as the first condition—implement measures on fiscal discipline and constraints for the sub-national governments, just as the relevant mix of revenue sources must be reserved for the national government, for national purposes.

Depriving central government of broad and powerful revenue sources and/or expenditure responsibilities structurally diminishes the scope for political maneuver of the government, especially in the context of regional groupings where the supranational authority constrains fiscal sovereignty.

On the other hand national government must provide sub-national governments with the proper background for the local political and economic processes to get into operation. Schemes for equalization of differences in tax bases and expenditure needs are examples. This obligation of the national government also includes the establishment of institutional arrangements for ensuring allocative efficiency at the sub-national level, such as incentives for expenditure competition between jurisdictions and measures for improving transparency and responsiveness of local operations.

Finally, administrative aspects must be considered. A process of capacity-building is needed at the sub-national level, because a lack of professionalism and capacity might highly moderate—or even contravene—the effects of fiscal decentralization. As an example, collection of devolved revenue might be later than scheduled, endangering both the preconditions for sub-national governments and the targets for the public finances. For the CEECs in transition this must be seen in connection with the fact that revenue collection in its present form is in the initial phase of implementation.

For example:

A survey conducted by the author in 2000 revealed important aspects concerning the implementation of new fiscal decentralization procedures in **Romania**.

Concerning local autonomy, progress was made by increasing local governments' autonomy in assigning, billing, collecting and controlling revenues and by abolishing former restrictions on local budget rectification, credits transfer and capital investment decisions. But, obstacles such as an unstable legal framework, difficulties in forecasting shared revenues, the absence of legislation regarding the assignment of surcharges and limited autonomy regarding income tax, make many local governments appreciate that local autonomy should be increased to a greater extent.

No great progress was made in terms of the municipal credit market, with direct impact on local and regional economic development. Because of low capacity and inability to work with commercial banks, local governments were rarely able to successfully borrow.

Another sign of the low capacity of local government professionals and decision-makers was revealed by the survey referring to the methods used to reduce expenditure. Postponing payments for assets or services already accomplished was the procedure used by 90% of local governments and the majority of the respondents mentioned reduction of capital expenditures. This reveals important financial management difficulties, leading local governments to use inadequate measures. One can observe that capital investments are the expenditures with the highest elasticity, expenditures that can be most easily cut out from the budget. Postponing payments is totally inappropriate, as it freezes finances and increases future investment costs.

More specifically, fiscal decentralization as a reform process involves a comprehensive list of considerations:

- Seek to match locally-managed expenditures with corresponding revenues, and keep to an acceptable level of vertical imbalance, ensuring both local accountability and fulfillment of national fiscal policy objectives.
- Devise proper institutional arrangements for ensuring fiscal discipline and budgetary constraints.
- When arranging intergovernmental fiscal relations, balance the need for local autonomy with national targets for equity and policy standards for locally-provided services.
- Find the proper composition of local revenues—revenue base and taxation vs. user charges.
- Look for the best design of expenditures—local vs. national public services and complex vs. simple services.
- Optimize revenue collection and cost-efficiency of provided services.
- Respond to the need—from national and sub-national levels—for transparency and predictability of the fiscal processes.

There is no single or standard solution to these issues. The design of local finance and intergovernmental fiscal relations varies from country to country, reflecting actual decision-making processes and distributions of political power. The country's physical and political geography, historical and cultural traditions, not to mention the configuration of the political system, structurally determine the actual design of sub-national government responsibilities and competencies.

Factors arguing for assigning fiscal responsibilities to sub-national government:

- The proportion of local expenditures that are financed by own-revenue capacity should be maximized; by reducing the vertical imbalance local needs are financed locally, and local problems are solved by collective decision-making.
- Borrowing for current expenditures should be minimized.
- Shared financing should be minimized; with small own-revenue sources the possibilities for budget pressures are limited, avoiding the demands for greater transfers and increased tax shares which put pressure on the national governments budget.
- The necessary external financing—the arrangements of transfers—should avoid distorting local decision-making processes; priorities can be made freely among different policy objectives and expenditure items by general state grants.
- Transparent and objective criteria for the amount and allocation of the transfer, in order to ensure the proper conditions for sub-national decisions of services vs. financial capacity.
- The base of taxation should be relatively broad, leaving sub-national governments with real opportunities to compose a profile based on own-revenue; revenue instruments, in support of the concept of decentralized decision-making, should be given priority, as user-charges and property taxes.
- Clearly delineated responsibilities to other levels of government are preferable (as the ability

to set amount and price of the services) in order to assure the optimal expenditures profile; the provision of local services should be financed locally; national or regional services, provided by sub-national governments, should be financed through such intergovernmental arrangements as to minimize the distortion of the local financial decision-processes.

Factors which support a degree of fiscal centralization:

- Targets for macroeconomic stability and sustained growth imply fiscal consolidation, including disciplined public finance, for all levels of government, objectives which might come into conflict with decentralization of expenditures and revenues; this circumstance is often intensified by the economic fluctuations which characterize economies in transition.
- Central governments may need a degree of discretion in setting the amount of transfers.
- Sufficient tax instruments should be reserved for central governments in order to support redistribution objectives, tax efficiency (optimal exploitation of revenue sources) and to finance state policy objectives.
- Design of transfers should permanently encourage revenue mobilization and cost-efficiency of spending activities at the sub-national levels. As an example, special and conditional grants with the primary objective of promoting programs with national interests may take into account measures of expenditure competition and indicators on performance.

## Intergovernmental Relations Regarding Revenues

Indicators on transfer arrangements must reflect the fact that a transfer system generally addresses a range of objectives. Attempting to maximize the efficiency of transfers, these objectives are generally the following:

- Horizontal fiscal imbalance due to differences in expenditure needs and/or fiscal capacity of sub-national governments; schemes of equalization must be formulated as part of general grants or tax sharing arrangements.
- Vertical fiscal imbalance toward sub-national governments, ideally to be covered by general grants, thus providing sub-national governments with the financial basis for making their own expenditure priorities.
- Setting national standards, due to redistributive or equalization objectives; the national objective is to influence the level and standard of the services that are provided sub-nationally—a specified system of grants will typically be appropriate.

For example:

In **Slovenia**, the Financing of Municipalities Act follows the principle that a municipality should be financed through its own revenue. Municipalities which cover the cost of appropriate expenditure with their own revenue are not entitled to financial equalization. The act differentiates between two kinds of municipal revenues:

Revenues under Article 21 and Article 23:

- 35% of personal income tax (amounting to an average of 77% of the entire revenue of a municipality);
- inheritance and gift taxes;
- taxes on profits from lotteries and gaming;
- taxes on real estate business transactions;
- administrative fees and duties;
- a special tax on the use of slot machines outside casinos.

Municipalities do not set tax rates; they are determined by law and are assigned to municipalities by the state.

Revenue under Article 22 consists of:

- property tax;
- compensation for use of building land;
- local tourist taxes;
- municipal communal rates;
- various fees;
- indemnities for use of agricultural land or forests;
- compensation and indemnity for the degradation and pollution of the environment;
- administrative revenue;
- revenue defined by other acts.

The most important of the stated revenue sources is compensation for the use of building land, which amounts to 56% of all revenue under Article 22 of the act.

## Intergovernmental Relations Regarding Expenditures

Evaluation of local autonomy and intergovernmental relations regarding expenditures involves a range of different perspectives:

- The purpose of the expenditure: activities solely reflecting local needs should be controlled and financed locally, as expressed in the principle that expenditure responsibilities should be assigned with a spatial distribution of benefits (refuse collection, primary education, local libraries ); a degree of shared control and finance is to be expected for activities reflecting “extra-local” or national needs and/or reflecting redistributive aspects (hospitals, special education and regulation of environment).
- The complexity of expenditure: health services, regulation and inspection are among the complex services where dual financing arrangements and centralized provision will typically prevail. For such services, control by sub-national and national levels can be identified in relation to:

- control of policy formulation for services,
- control of the provision of services,
- control of the financing of services.

*Table 1*  
Control over Sub-national Expenditures

	Sub-national control	National control
<b>Policy formulation of the service</b>	<ul style="list-style-type: none"> <li>• Setting level and composition of services</li> <li>• Discretion in contracting goods and services</li> </ul>	
<b>Provision of services</b>	<ul style="list-style-type: none"> <li>• Clearly delineated responsibilities in relation to other tiers of government</li> <li>• Ownership of enterprises</li> <li>• Discretion in recruitment and pay of personnel</li> <li>• Negotiation of agreements and settlements on wages and employment conditions.</li> </ul>	<ul style="list-style-type: none"> <li>• Control through performance or input indicators</li> <li>• Design of expenditure completion (mechanisms for outsourcing)</li> <li>• Rules for economic management (standardization of budget and accounting system)</li> </ul>
<b>Finance of services</b>	<ul style="list-style-type: none"> <li>• Charges for activities</li> <li>• Profile of financing: for each main field of activity—grants are specified in proportion to total sub-national expenditures.</li> </ul>	<ul style="list-style-type: none"> <li>• Specific design of the transfer in question</li> </ul>

SOURCE: *Fiscal Decentralization Benchmarking*, FDI draft study, 1999.

## Intergovernmental Transfers

Revenue and expenditure assignments give rise to vertical and horizontal imbalances within a nation's intergovernmental finances. In fact, every intergovernmental transfer system has two dimensions:

- *the vertical dimension*, concerned with the distribution of revenues between central and local governments;
- *the horizontal dimension*, concerned with the allocation of financial resources among recipient units.

A vertical imbalance occurs when the expenditure responsibilities of sub-national governments do not match their power to raise revenue; the issue of vertical imbalance is widespread in all

regions. At least 30% of sub-national governments' revenues come from intergovernmental transfers in all regions. A horizontal imbalance occurs when the fiscal capacities to carry out the same functions differs across sub-national governments. In all countries, these imbalances are handled through a variety of transfer mechanism in order to allow sub-national governments to perform their assigned functions.

There are different forms of transfer mechanisms: sharing revenues and tax bases and establishing conditional or unconditional grant systems. Central government and sub-national governments can share revenues based on a formula or share a tax base by applying a surcharge on other's tax. In the case of establishing a grant system, conditional grants require matching elements by recipient government, but unconditional grants are given to recipient government with full discretion to spend.

The choice of transfer mechanism depends on the objectives of the intergovernmental policies. If the only concern of the intergovernmental system is to address the vertical fiscal gap, this could be achieved either by revenue sharing or by "gap-filling" unconditional grants. The horizontal imbalances can be alleviated with equalization transfers from the central government to sub-national government. However, in practice, measuring the horizontal imbalance and relative fiscal capacities of sub-national governments is a very difficult task and only very few countries review them. The countries that undertake a comprehensive review of horizontal balances are Australia, Canada and Germany (Ahmad and Craig, 1997).

The intergovernmental transfer system of a country usually has diverse objectives to meet and in most cases, these objectives may need to be met through a combination of policy tools. According to Ahmad and Craig (1997), there are three different policy responses to establishing the link between vertical and horizontal balances:

1. Correct each imbalance by separate policy measures: the vertical imbalance at each level is resolved by tax-sharing or grant arrangements. Horizontal imbalances are then resolved by payments from regions with higher fiscal capacity to poorer regions. This is the approach used in Germany.
2. Implement an integrated system of equalization grants: vertical and horizontal imbalances are dealt with simultaneously through a system of grants, including equalization payments and special purpose grants, as used in Australia and Canada.
3. Correct only the vertical imbalance and ignore horizontal balance: as under the first option, vertical balances are resolved by tax sharing and grants, but no action is taken to correct horizontal imbalances. Capital and labor migration then respond not only to earned-income differentials but also to regional net fiscal benefits (net benefit received from government expenditure and taxes paid). There may be, however, special purpose grants servicing central government objectives which may also reduce horizontal imbalances, at least in some functional areas. This is the approach in the United States.

There are three key factors in the design of intergovernmental fiscal transfers:

- the size of distributable pool;
- the basis for distributing transfers;
- the conditionality.

Determining the distributable pool has an important impact on the stability of the intergovernmental fiscal relations system. Sharing a fixed percentage of all central taxes is a better way of establishing transfer system than sharing on an *ad-hoc* basis. Sharing must be based on the basis of a formula. Discretionary or negotiated transfers are unstable and unpredictable in nature. The formula for revenue sharing should take needs and capacity into consideration. Once the first two factors have been sorted out, the last question is whether the transfer should be made conditional on a measure. Expenditure conditionality ensures that the transfer amount is spent on a specified service. On the other hand, performance conditionality links transfers to a performance criteria.

For example:

The **Slovenian** Amendment to the Financing of Municipalities Act abolished the system of expenditure financing, which was based on criteria for allocating expenditures predetermined by ministries, in cooperation with municipalities, and which had a major impact on the so-called financial equalization of municipalities or additional resources from the state budget. Only municipalities that are unable to provide their own resources for the implementation of the functions related to their local matters of public interest, as set by the constitution and by the law, are entitled to such financial equalization.

A system of appropriate expenditure, i.e. an appropriate amount of resources, was introduced in order to allow a municipality to carry out its constitutional and legal responsibilities. The appropriate expenditure per inhabitant is defined by the Slovenian National Assembly when the state budget is passed for a set fiscal year. This expenditure is determined as an average amount of resources per inhabitant of Slovenia.

Local interest tasks can be grouped in the following way:

- the work of municipal administration and bodies;
- matters of local public interest in the area of elementary education, culture, sports, social care, primary health care and other social services;
- public commercial services of local interest financed through a municipal budget (public utilities, road works, housing construction, physical planning, environmental protection and other similar activities);
- fire safety matters and protection against natural and other disasters;
- other matters of local public interest (mortuary services, tourism, agriculture, business—particularly small businesses).

Appropriate expenditures do not include funds for urgent investments in public utilities and other public infrastructure.

The appropriate scope of resources (appropriate expenditure) for the financing of previously stated tasks is determined on the basis of a mathematical equation in which the appropriate scope of resources per capita, defined by the National

Assembly, amounts to 70% of resources, while correction factors amount to a total of 30%.

The correction factors taken into consideration are:

- the ratio between the per capita length of local roads in an individual municipality and the per capita length of local roads in Slovenia;
- the ratio between the per capita surface area of an individual municipality and the per capita surface area of Slovenia;
- the ratio between the share of population under the age of fifteen of an individual municipality and the average share for municipalities in Slovenia;
- the ratio between the share of persons under the age of 65 in the entire population of an individual municipality and the average share for municipalities in Slovenia.

The equation mentioned above is used by each municipality to calculate its appropriate expenditure. Those municipalities that cannot ensure their own resources to finance appropriate expenditure are entitled to financial equalization by allotment of funds from the state budget. In 1999, 172 municipalities out of 192 made use of this possibility. Those municipalities whose own resources exceed the calculated appropriate expenditure and are not entitled to financial equalization may freely dispose of such surplus resources and may not have these surpluses removed from them.

Slovenian municipalities are also entitled to state co-financing of municipal investments (elementary schools, kindergartens, road construction and infrastructure for public utilities) in the amount of 10–70% of the value of investment. The state share of co-financing depends on the economic standing of a municipality, so those municipalities with smaller revenue receive a greater share of funds for investments. The law defines the scale for such co-investments, while the decision on co-financing is made by the government of the Republic of Slovenia.

Article 26 of the act sets the rules for co-financing investments in municipalities. The volume of co-financing funds depends on the per capita share of personal income tax in a municipality in comparison with the average of such shares of municipalities in Slovenia. This means that municipalities with a smaller per capita share of personal income tax are entitled to higher co-financing resources for investments. Those municipalities where the share of personal income tax reaches up to 50% of the average of such shares on the national level are entitled to 70% share of state co-investment. This scale drops in steps of 10% in relation to the volume of personal income tax down to a 10% share of state co-financing of investments. In this way municipalities with a low per capita personal income tax can be allocated larger investment resources for assistance.

## Sub-national Borrowing

There are three primary reasons why sub-national borrowing can be considered an appropriate tool for sub-national public finance:

- *Economic Development:* Delaying infrastructure investments might have a negative impact on sub-national economic performance. Such a negative impact will have a direct effect on residents' lives in terms of employment opportunities and earning levels. Therefore, borrowing is an appropriate tool for sub-national governments in investing infrastructure projects to stimulate the regional economy.
- *Inter-generational equity:* The benefits of certain investment projects, such as infrastructure and education, are spread over time, which means that not only present residents of a locality, but also future residents will consume the services provided by the projects. Therefore, the benefit principle of taxation suggests that future residents should also contribute to the cost of investment. For this purpose borrowing is an appropriate tool that offers a means through which payments for capital projects can be spread over the life of the project so as to coincide more closely with the stream of future benefits.
- *Synchronization of expenditure and revenue flows:* Access to financial tools offers an opportunity to sub-national governments to synchronize expenditures incurred and revenue collection. For a variety of reasons expenditure incurred and tax intake may not be fully synchronized for a particular year. In such a situation, borrowing provides sub-national governments to smooth out the mismatch and provide services without disruption.

Sub-national borrowing is an important component of the devolution of fiscal powers to local authorities. However, a well-designed regulatory framework for sub-national borrowing is necessary to ensure that sub-national borrowing does not provide perverse incentives to lending institutions and sub-national governments for excessive lending and borrowing. Such a framework includes standardized accounting procedures for sub-national governments and disclosure of sub-national governments' liabilities and repayment capacity. However, these measures by themselves will not be sufficient to curb the moral hazard. The macro concern of the moral hazard occurs when the central government provides guarantees for borrowing by sub-national governments. In these circumstances, the incentive structure is set for excessive borrowing by sub-national governments, which would ultimately lead sub-national governments to default on loans.

A common proposal to deal with sub-national governments' that default on loans is to institute limits on the borrowing ability of sub-national governments, for the following reasons:

- If there is no constraint on sub-national governments borrowing, the propensity for fiscal irresponsibility is very high. In the absence of the checks and balances of the sub-national debt issuance mechanism, sub-national governments may increase their current expenditures well above their capacity to finance them and close the gap through borrowing, especially in countries where a general inability of central governments to impose hard-budget constraints exists.
- *Macroeconomic stabilization:* since the central government has the responsibility for stabilization policies, it is important that it has full control over public debt.

Some examples:

**Slovenian** municipalities can incur debts only for those investments that are approved by the municipal council.

Municipalities may not incur debts exceeding 10% of the realized revenue of municipalities in the year prior to the year of borrowing, while the repayment of principal and interest in a particular year must not exceed 5% of the realized revenue.

Exceptionally, a municipality may incur a larger debt, but only for financing housing construction, water supply, sewage or waste disposal.

Reformers in **Poland**, in their efforts to control public borrowing and rapidly enter the European Union, have imposed stricter limitations than those required by Maastricht. Having written the Maastricht guidelines into national law, the Ministry of Finance felt both justified and compelled to introduce mechanisms that would allow the direct control of local government debt by the national government should the consolidated public debt begin to approach 60% of the GDP. Thus the recent legislation introduces a set of distinct and mechanical limitations on sub-sovereign borrowing that go into effect if the consolidated public debt exceeds 50% of the GDP. In essence the legal provisions state that once the 50% threshold has been crossed, the maximum borrowing of each and every local government cannot exceed the relationship between the states planned revenues and its planned deficit for the year. In other words, if the 50% threshold is crossed and the state limits its borrowing to 10% of its current revenues, no local government can borrow more than 10% of its planned revenues. Similarly, and by extension, if the 50% threshold is crossed and the state decides to balance its budget, then no local government would be able to borrow anything at all.

The consequence of these mechanical limitations on sub-sovereign debt is to place local government borrowing in direct competition with national government borrowing. Or put another way, these limitations put local government borrowing for investment purposes in direct competition with national government borrowing for current operating expenses. This is unwise for both practical and theoretical reasons. In practical terms, the national government's debt is equal to about 48% of the GDP, while local government borrowing is equal to no more than 0.7% of the GDP. As such, it seems that if reformers want to control the consolidated public debt they should do so first by reducing the states overwhelming share of this debt, especially when in most Western European countries local government borrowing amounts to between 3 and 5% of the GDP (Levitas 1999).

## Impact on Regional Financing

Since regional economic policy is concerned mainly with eliminating disparities between regions, attention is primarily given to direct cash flow aimed at regional assistance. In reality, however, the volume of resources flowing into regions through redistribution of public finances is several times higher than direct regional support. Two instrument forms are encountered to resist this: automatic stabilizers and targeted action.

Many taxes and transfer payments are so constructed as to automatically stabilize employment and pensions. The wage tax, for example, leads to an automatic increase in tax revenues when salaries rise. Unemployment benefits play a similar role on the side of spending in budgetary policy. These benefits grow in recession, thus helping to keep expenditures down at a time when it is necessary.

Very often, progressive taxes tend to reduce regional disparities, whereas regressive taxes enhance these disparities. The government can affect the level of employment through state orders from particular industries, or it can subsidize some sectors (e.g., mining) localized in depressed areas. Moreover, the government itself is a major employer and can directly create job opportunities in supported areas. Many authors claim that all taxes and outlays have a regional impact (e.g., “non-regional” outlays on defense are regionally determined and, in turn, disarmament cuts in outlays also have a regional impact).

A large EU comparative study on the territorial redistribution effect achieved through public expenditures and taxes notes that many fiscal mechanisms of redistribution (primarily aimed at social protection and increased equity) have, at the same time, an important regulatory effect on the economy. And although they are not, as a rule, established specifically for this purpose, they can reduce regional inequalities.

The effect of public expenditure through redistribution of personal income (through income taxes) is quite considerable in EU member countries. The effect of transfers between populations has a general tendency to redistribute in favor of poorer territorial units, thus contributing to a more balanced redistribution of income.

Functional redistribution mechanisms in EU member states are numerous and complex. It is very important not to confuse the scale of redistribution—either through revenues or expenditures—with the effect on the development of territorial units, which depends more on the way redistributed resources are used. Citizens and organizations that receive transfers use them in different ways. Some of these can help reduce territorial disparities in degree of development; others cannot. Expenditures can:

- directly contribute to increasing productive potential (investments in infrastructure or education and training of the local workforce);
- help maintain local economic activity (expenditures on locally produced goods and services);
- help maintain economic activity in other areas (sales of imported goods and services);
- facilitate transfer of revenues or investments from the region directly.

Obviously, the scale of redistribution does not directly determine its efficiency or the quality of development.

For example:

In **Hungary**, the social and economic transformation of the last decade created a highly devolved local government structure. At present there are more than 3,000 local authorities, which are responsible for the provision of all local services. Unfortunately, there are only a few local governments with sufficient sources of funding: most require significant financial aid from the central government budget for specific purposes.

Progress is required in two areas. Certain responsibilities and funds should be delegated at an intermediate level whereby spatial or small regional cooperation will develop, allowing more efficient use of resources and offering the opportunity for reducing a number of overlapping local administrations. At the same time, major internal funds should be made available to local governments.

The government is considering substantial changes in the scope of its responsibility and powers:

- It will establish a level of self-governance at the sub-county level (i.e., district, city) or, alternatively, oblige local governments in sub-regions to form associations. The tasks of small communities requiring substantial technical, professional, or financial expertise should be concentrated at this level.
- The range of service provision and related responsibility in county governments should be defined more clearly and if necessary concentrate resources on regional level.
- A simpler and less differentiated system of funding regulation, based on an increase in the number and volume of local sources, should be implemented.
- Local sources could be enhanced by the introduction of certain local taxes, e.g. in the longer term, the general introduction of a value-based real estate tax, and in the shorter term, the introduction of an obligation to impose local enterprise tax. This will result in bank loans and the issuance of bonds playing an increased role in the financing of local governments.
- A supplementary aid mechanism is in operation to reduce income differences between local authorities. This mechanism should be further developed parallel with the increase of own revenues. In addition, it is necessary to reduce the large number of earmarked subsidies and to simplify the system.
- The institutional set up of regional development aid should be improved. A solution will need to be found to strengthen the regional concentration of targeted subsidies and their adjustment to programs. This is also necessary for the co-financing of the expected EU subsidies.

The Regional Development Act has recently been amended, creating a regional level and associated institutions of regional development. Regional development councils have already been established in the seven designated planning and statistical regions. The government will evaluate, in the light of operating experience, whether there is a need for the establishment of regional governments. This would be required for “large” regions, comprising of two or three counties each, and would also be justified by the fact that in the system of development operating in the European Union the region is the dominant venue of territorial coordination of economic development.

Alleviation of regional inequalities is the key strategic task of regional development. Differences between Budapest and the rest of Hungary, between the eastern and western halves of the country, between towns and villages, and advanced and backward regions and municipalities, need to be reduced with regard to economic development, employment, living conditions, education, access to cultural activities, health and social and infrastructure facilities and resources. To this end, it will be necessary to concentrate an increasing proportion of the available central resources on regional development for disadvantaged regions. The Ministry of Economic Affairs will link sectoral and regional planning and development, creating special development programs and cooperation on the basis of the draft comprehensive development plan.

## Redistribution Effects on Individual Economic Segments

### *Redistribution Effect of Social Security*

The largest items of social security are expenditures on health care, retirement pensions and expenditures on unemployment.

Retirement pensions comprise the largest part of social security, and an aging population increases the significance of this item. The impact of pensions on the general redistribution effects of social security across different areas depends on a country's individual conditions. There is a general tendency for young people to gravitate to development centers, primarily to large and medium-sized towns that continue to expand and whose development potential is being enhanced. Older people, on the other hand, increasingly settle in rural areas. From this, we may derive a general truism that drawing old-age pensions serves more or less to reduce rather than increase territorial disparities.

Expenditures on health care vary considerably depending on the proportion of the elderly population—specifically the very old citizens in a population, since the expenditures per person over 75 years of age are ten times higher than for young people—expenditures on health care reveal regional tendencies similar to those for pensions.

In most of the countries studied, expenditures on unemployment and employment training comprised as much as one-third of total social security. This expenditure item has a relatively significant redistribution effect, since the rate of unemployment is, as a rule, higher in less developed areas than in developed territorial units.

On the revenue side, social security expenditures are partly financed through contributions of employers and employees in proportion to wages and partly from general taxes. The volume of financial resources transferred is substantially changing and depends on the level of original disparities in revenues.

### *Redistribution Effect of Taxation*

It is very difficult to compare all taxes, but it is generally believed that taxes function outside the compensatory mechanism and transfers and contribute very little to equalization. Efforts by local governments to intervene in the distribution of income and wealth are very likely to be self-defeating. An effort by the government of one area to offer especially generous welfare benefits is likely to attract poor people from other areas. Less developed territorial units most often install higher taxes with regard to their lower revenue potential. At the same time, the higher taxes necessary to support those benefits are likely to impel rich people to move to areas with lower taxes.

The main characteristic of personal income tax is its progressive nature. People and regions with higher incomes thus pay generally higher tax rates. Notwithstanding any additional factors, these taxes have a redistribution effect on territorial units.

Indirect taxes, such as the value-added tax, are generally very similar in EU countries. Although poor individuals and regions pay a smaller volume everywhere, part of the expenditures going to indirect taxes is usually greater than in more developed regions and for richer individuals. In other words, the redistribution effect of these taxes is more regressive.

Territorial units in many countries are financed partly on the basis of taxes that they have themselves accumulated, which it means that poorer regions have lower per capita revenue. That is the reason these countries have developed an explicit mechanism of fiscal equalization.

### *Interregional Mechanism of Fiscal Equalization*

All federal countries have an automatic and explicit mechanism for equalizing the financial resources of the state and the territorial units. This mechanism is the central element of a functioning federal state and is the subject of much discussion.

The **Belgian** fiscal equalization mechanism is undoubtedly the simplest: an indexed sum of 468 BF per capita annually is redistributed in every region for every percentage point by which the region's fiscal revenues from personal income is lower than the national average. Under this system, Walloon gets a transfer equivalent of around 1% of its GDP from the remaining two regions (Flanders and Brussels).

The **German** *Finanzausgleich* has undoubtedly become the most famous system of fiscal equalization. It was established in 1990 as part of German reunification and

is subsidized as a transitional solution through the German Unity Fund. It is the largest redistribution mechanism of recent years.

Nonfederal countries also practice equalization.

In **Spain** autonomous communities obtain resources through transfers from the Interregional Compensation Fund, which finances 25% of total public investments and guarantees additional resources to regions for which the first objective of the EU Structural Fund applies; these receive assistance in eliminating deficits in economic and social infrastructure.

Until 1992 **Italy** had a special system of transfer into *Mezzogiorno*, which represented a sum of around 3.5 billion ECU annually. Since then, responsibility for regional development has been significantly shifted to the regional budget.

In 1993 **France** introduced a fund for correcting regional disparities by which regions with an above-average fiscal capacity provide resources to areas with a below-average capacity. The total amount transferred is relatively small—around 100 million ECU—and legislation recommends higher volumes of redistribution.

In **Great Britain**, there is no administrative authority lower than the government; there is only direct local administration. Revenue support grants allocate resources to local units on the basis of a very complex scheme that takes account of needs and revenues. Since revenues from local taxes are very low in Great Britain and cover only about 15% of local body expenditures (which, on the other hand, comprise about 25% of total public expenditures), redistribution of resources from the center is very high.

The revenue support grant is but one element of redistribution, through which about 40% of the total sum is channeled; it only partially serves to equalize revenues that are available for moderate expenses.

### *Redistribution Effect of Public Investments*

The redistribution effect of public investments (together with regional assistance, which is discussed below) acts not only through the transfer of relevant resources but also through expenditures, which can strengthen the economic base of weaker regions and contribute to enhancing their development. From this perspective, investments can have a multiplier effect:

- stimulating economic activity;
- initiating growth;
- supporting investments in the private sector.

Investments in economic and social infrastructure play a particularly strategic role in regional development by creating conditions for an expansion of economic activities. A substantial

component of investments of this type—e.g., investments in education—are only rarely included in public investments, even though their potential contribution to strengthening the economic base of a region by upgrading labor force qualifications can be at least as important as investments in physical infrastructure.

In all EU member states, there is generally a conflict between the long-term development needs which involve weaker regions and short-term needs to quickly expand development capacities based on growth in demand; the latter involve stronger, more developed areas. This conflict becomes particularly significant when financial resources are limited. Such resources are often aimed at short-term needs, thus flow to more developed regions rather than less.

#### *Redistribution Effect of Regional Assistance*

Strictly speaking, the regional assistance (investment subsidies, contributions for employment, etc.) introduced by EU member states to address their regional problems represents only a very small part of the state budget. Recently, expenditures in this area have dropped still further.

The actual effect of this regional assistance, however, cannot be judged solely on the basis of these aggregations, since in reality this assistance has always concentrated on particular areas and sectors to elicit a multiplier effect. Regional assistance is essentially always an element of development.

Regional assistance is very sensitive to cyclic fluctuations in the economy, primarily at a time of change toward growth; when economic conditions are favorable, assistance can influence the location of investments that companies have already decided to make.

Slovak regions, regarded through the prism of current EU support criteria, reveal that the system and support policy of underdeveloped regions is insufficient. Only the Bratislava region would satisfy the condition of 75% of average EU GDP at the NUTS II level; surprisingly, it would be included among the top third of the most successful NUTS II regions in the EU. Bratislava's dominant position is due to its share of GDP generation (accounting for more than one-third of the country's total GDP and three times the Slovak average per capita GDP); its low unemployment (three times below the Slovak average); and its "hard" and "soft" infrastructure (accounting for 51% of the country's university faculty, more than 60% of its research and development workers, 92% of its banking and insurance workers, etc.). Also, more than 60% of the country's foreign capital is concentrated in Bratislava, as well as 32.2% of its entrepreneurs.

Other NUTS II areas and regions in the Slovak Republic generate only 28 to 30% of the EU average per capita GDP. Thus, roughly 88.5% of the Slovak population and 96% of its area would be subject to regional support of approximately eight billion SK and would move to the borderline of capacity of our own co-financing and preparation and implementation of regional development projects.

### *Key Points*

- Sub-national administrative capacity and sub-national governments' accountability vis-à-vis their constituencies are fundamental prerequisites for a positive outcome of the devolution of spending responsibilities and revenue sources to sub-national levels.
- Setting up of local fiscal systems and intergovernmental financial relations involves multiple and often conflicting economic and political objectives. This system has to be consistent with the desired and appropriate (also flexible enough) roles designated to economic development stakeholders.
- The redistribution effect of public expenditures and taxes among territorial units is important, but—to a large extent—often invisible and difficult to measure. Although measures of fiscal equity, public investment and regional assistance are most frequently transparent, they do represent a smaller part of redistribution, invisible flows.
- The scale of redistribution does not depend as much on the volume of gross flows between revenues and expenditures as on the net balance between them.
- The fewer territorial units that are subjects of transfers, the greater the redistribution effect. It is also an advantage when the number of regions from which resources are transferred is larger; thus, the transfer volume is lower and, consequently, more acceptable.
- New trends affecting regional development and connected with globalization, the diffusion of innovation, the building of regional networks and the new position of external forces in development have a more complex relation to the financial base for regional development than is typically expected.
- Direct and targeted assistance in eliminating regional disparities cannot be undermined; it forms a small element in size, but often a very efficient impulse aimed at inducing and sustaining regional development on the level of individual countries. Transfers through automatic stabilizers and targeted expenditures of public finance deserve attention due both to their scale and effect.

## REFERENCES AND BIBLIOGRAPHY

- Ahmad, Ehtisham and Jon Craig, "Intergovernmental Transfers" in Teresa Ter-Minassian (eds.), *Fiscal Federalism in Theory and Practice*. Washington D.C.: IMF, 1997.
- Armstrong, H. and J. Taylor, *Regional Economics and Policy*. London: Harvester Wheatsheaf, 1993.
- Bailey, Stephen J., *Local Governments Economics*. New York: Macmillan, 1999.
- Bahl, Roy W., *Intergovernmental Transfers in Developing and Transition Countries: Principles and Practice*, Intergovernmental Fiscal Relations and Local Financial Management Course. Budapest: WB, 2000.
- Benveniste, Guy, *The Politics of Expertise*. London: Heinle & Heinle, 1972, 34.

- Bird, Richard M., Robert D. Ebel and Christine I. Wallich. (eds.), *Decentralization of the Socialist State*. Washington, D.C.: World Bank, 1995.
- Bird, Richard, M., Robert D. Ebel and Christine Wallich (eds.), *Decentralization of the Socialist State. Intergovernmental Finance in Transition Economies*. Washington, D.C.: World Bank, Regional and Sectoral Studies, 1995.
- Brown, Shona L. and Eisenhardt, Kathleen M., *Strategic Planning, Organizational Change, Competition*. Boston: Harvard Business School Press, 1998.
- Bucek, Milan, *New Trends in Regional Development and Their Financial Base*. Bratislava: Economic University, 2000.
- Canova, Fabio and Albert Marcet, *The Poor Stay Poor: Non-convergence across Countries and Regions*, Discussion Paper 1265, Centre for Economic Policy Research, <http://www.cepr.org/>, 1995.
- Central and Eastern Europe Democratizations and Reform*, <http://www.gv.at/politik/#pos1>.
- Cohesion Forum Proposes Reform of EU Regional Policy*, <http://www.euractiv.com/cgi-bin/eurb>.
- Conway, Francis, *Local Government Revenues and Budgets: Concepts and Issues*. Washington, D.C.: The Urban Institute, 2000.
- Coricelli, Fabrizio, Dabrowski, Marek and Urszula Kosterna, *Fiscal Policy in Transition—Forum Report of the Economic Policy Initiative, No. 3*, Institute for East-West Studies, 1997.
- Council of Europe, *European Charter of Local Self-government: Explanatory Report*, Strasbourg: Council of Europe, 1985.
- Dhareshwar, Ashok, *et al*, *The Quality of Growth*. Oxford: Oxford University Press, 2000.
- Dunn, Jonathan and Deborah Wetzel, *Fiscal Decentralization in Former Socialist Economies: Progress and Prospects*. Washington, D. C.: World Bank, 2000.
- Ebel, R., István Varfalavi and Sándor Varga, *Sorting Out Government Roles and Responsibilities in the Hungarian Transition*, World Bank Institute working paper, 2000.
- European Commission, *Regular Report on Poland's Progress towards Accession*, EC, 2000.
- European Commission, *Regular Report on Romania's Progress towards Accession*, EC, 2000.
- European Commission, *Regular Report on Slovenia's Progress towards Accession*, EC, 2000.
- European Commission, *Work Program for 2000*, European Commission Directorate-General for Regional Policy, 2000.
- Freire, Mila and Richard Stern (eds.), *The Challenge of Urban Government—Policies and Practices*. Washington D.C.: World Bank Development Studies, 2001.
- Friedmann, John, *Retracking America: A Theory of Transactive Planning*. New York: Anchor Press/Doubleday, 1973.
- Hock, Dee, *Birth of the Chaordic Age*. San Francisco: Berrett-Koehler Publishers, Inc., 1999.
- Horváth, Tamás, *Decentralization: Experiments and Reforms*. Budapest: OSI/LGI, 2000.

- Hudak V., Huitfeldt H. and Meegan E. (eds.), *Regional Policy Goes East*. Prague: The East West Institute, 1999.
- Kaplan, Abraham, *The Conduct of Inquiry*. New York: Harper Collins, 1998.
- Levitas, Tony, *The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland 1989–99*. Intergovernmental Fiscal Relations and Local Financial Management Course. Budapest: WB, 2000.
- Lulfesmann, Christoph, *Central Governments or Subsidiarity: A Property Rights Approach to Federalism*, Bonn Economic Discussion Papers, 2000.
- Maier, G. and F. Toedtling, *Regional and Urban Economics*, FDI readings, 1996.
- Marks, Christopher, *A Note on Intergovernmental Transfers to Intermediate-Level Governments in Europe*. Washington D.C.: USAID, 1998.
- Martinez-Vazquez, Jorge and Robert McNab. “Fiscal Decentralization, Economic Growth, and Democratic Governance,” paper prepared for USAID Conference on Economic Growth and Democratic Governance, Washington, D.C., October 9–10, 1997.
- McLure, Charles E, Vazquez and Jorge Martinez, *The Assignment of Revenues and Expenditures in Intergovernmental Fiscal Relations*, Intergovernmental Fiscal Relations and Local Financial Management Course. Budapest: WB, 2000.
- Nemec, Juraj and Glen Wright (eds.), *Public Finance – Theory and Practice in Central European Transition*, NISPAcee, 1997.
- OECD, *Recommendation of the OECD on Improving the Quality of Government Regulation*, Paris, adopted March 9, 1995.
- OECD, *The OECD 1999 Survey on Fiscal Design across Levels of Government*. Paris: Directorate for Financial, Fiscal and Enterprise Affairs, 1999.
- Open Society Institute, *European Union Enlargement and the Open Society Agenda: Local Government and Public Administration*. Budapest: OSI/LGI, 2000
- Puga, Diego, *European Regional Policies in Light of Recent Location Theories*, University of Toronto, CEPR Discussion Paper 2767, prepared for the conference Globalization and the Location of Economic Activities, Sitges (Barcelona), October 2000.
- Romanik, C. with P. Coman, D. Daianu, H. Garzon, *Romania: Winners and Losers – The Impact of the Reform of Intergovernmental Transfers*. Washington, D. C.: The Urban Institute, 1999.
- Sachs, Jeffrey, *Poland’s Jump to the Market Economy*. Cambridge, MA: MIT Press, 1993.
- Seale, Lawrence C., *Proposed Principles for State Financial Support for Local Governments*. Sigma Papers: No. 26, 1998.
- Sigma Papers, *European Principles for Public Administration*, Sigma Papers: No. 27, 1999.
- Sigma Papers, *Sustainable Institutions for European Union Membership*, Sigma Papers: No. 26, 1998.

“Social and Economic Analysis at the Regional Level,” *National Development Plan*, Bucharest, May 2000.

Vintar, Mirko, *Reengineering Administrative Districts in Slovenia*, Discussion Paper No.11. Budapest: OSI/LGI, 1999.

Wilhelm, Jorge, *Overcoming the Trauma of Transition: Trends and Changes on the Threshold of the 21st Century*. Washington, D.C.: Woodrow Wilson International Center for Scholars, 1999.

# Index

- act 25, 28, 32, 41, 44, 87–88, 91–92, 97
- agency/agencies 31–33, 37, 39, 44, 48, 55, 58, 60–62, 64, 72, 74–78, 81
- anti–corruption 17–18, 22, 83
- assistance 11, 25, 53, 82–83, 92, 95, 99, 100–101
- Association Agreements 36, 38–39
- Australia 90,
- authority 10, 23, 27–29, 31, 37, 43, 45, 50–52, 55, 63–64, 84, 99,
- borrowing 86, 93–94
- boundaries 24–28, 30, 35, 41, 56–57, 69
- Budapest 24, 97
- budget 11, 20, 36–38, 43–48, 53, 55–56, 63, 70–71, 82, 84–86, 89, 91–96, 99–100
- business 12, 64, 66, 69–70, 73–78, 82–83, 88, 91
- Canada 83, 90
- capacity 17–18, 20, 22, 38–39, 47, 54, 60, 62, 64, 69, 71–72, 82, 85–87, 90–91, 93, 99–101
- capital 10–17, 18–19, 20–22, 38–39, 54–55, 64, 71, 74–78, 85, 90, 93, 100
- central government 12, 23, 38, 42–43, 51, 65, 70–71, 76, 78, 81–84, 87, 90, 93, 96
- centralization 34, 42, 53, 83, 87
- chaord(ic) 57–59, 61, 63, 65, 76
- co–financing 53, 92, 96, 100
- compatibility 78
- concordats 42
- constitution 24, 27–30, 33–36, 40, 42–43, 49–50, 65, 71, 91
- cooperation 19, 31, 36–37, 40–45, 49, 51–53, 58, 66, 69, 80–82, 91, 96–97
- coordination 23–24, 32, 37–38, 40, 42–44, 66, 68–70, 75, 78–79, 83–84, 97
- corruption 16–18, 20–22, 71, 83
- Cortes Generales 29, 36
- council 25, 28–29, 31–32, 41–44, 48, 50, 75, 78, 84, 94, 97
- councilor 44, 50, 75
- debt 70, 93–94
- decentralization 5, 11, 27–29, 38–39, 47–48, 51–53, 63, 65, 69–72, 83, 84–87, 89
- decision–maker 55, 57, 64, 68, 85
- decision–making 34, 39–41, 56–57, 59, 62–63, 66–68, 84, 86
- decline 12–15, 25, 55
- delivery 53–55, 75, 82
- donor 55
- EC (European Community) 24, 31–32, 63
- environment 9, 11–13, 14–19, 21–22, 27–28, 53–54, 57, 62, 64, 66–67, 72–74, 77, 79–83, 88, 91
- EU (European Union) 5, 11, 24, 26, 36–39, 42, 44–45, 53, 55, 66, 70–71, 78–80, 83, 94–100
- expenditure 11, 19–21, 26, 45, 47–49, 54, 56, 71–72, 82–87, 88–93, 95, 97–101
- federal 27, 29–30, 33–35, 41–43, 46–47, 49, 69, 83, 84, 98
- federation 34, 36, 41–42, 46–47
- feedback 39, 59–60, 64, 79, 82
- France (French) 24, 26–30, 35–36, 44–45, 48–50, 99
- funds 10–11, 24, 31–33, 37–38, 42, 48, 53–55, 60–61, 63, 71, 78, 80, 91–92, 96
- GATT (General Agreement on Trade and Tariffs) 39, 83
- GDP (gross domestic product) 11–14, 19, 22, 94, 98, 100
- Germany (German) 24, 28, 33, 35, 38, 41–43, 45–47, 78, 90, 98–99
- globalization 5, 10, 17–18, 19, 53, 72–73, 101
- Gmina 28
- growth 9–22, 47–48, 53, 60, 64–67, 70–73, 75, 83, 87, 99–100

- harmonization 32, 66, 69–70
- horizontal 44, 47, 87, 89–90
- Hungary 5, 15, 24–25, 29, 44, 48, 75, 78, 96–97
- improvisation 62, 65
- income 11–13, 14–15, 17, 20, 26, 45–46, 48, 54, 65, 71–74, 84–85, 88, 90, 92, 95–96, 98
- indicators 12–15, 19, 87, 89
- investment 9–10, 14, 17–22, 25, 30–31, 39, 43, 48, 54, 56, 58, 60, 67, 71–74, 76, 81, 83–85, 91–95, 99–101
- Italy (Italian) 24–26, 29–30, 34–35, 43, 45, 47, 99
- Länder 41–42, 45–47
- law 27–32, 36, 38, 41–45, 49–50, 55, 65, 68, 74, 76, 88, 91–92, 94
- local government 5, 11–12, 39, 48, 49, 51, 53, 55–56, 65, 70–72, 73–75, 77, 81, 85, 89, 94, 96
- Maastricht Treaty 10, 71
- macroeconomic 16, 20–21, 72–73, 82–84, 87, 93
- management 17–18, 24, 31, 36–37, 42, 51, 55, 57, 62–64, 67–68, 74, 77, 84–85, 89
- manager 57–58, 62, 64, 79
- market 9–10, 16, 18–22, 26, 37–39, 55, 58, 60–62, 65, 66, 70, 72–73, 75–76, 78–79, 82, 85
- national government 53–54, 64, 67, 72, 75, 79, 84–86, 94
- nongovernmental organization (NGO) 22–23, 75, 81
- NUTS (Nomenclature of Territorial Units for Statistics) 10–11, 24, 28–29, 100
- OECD (Organization for Economic Cooperation and Development) 10, 15, 67–68, 84
- pension 61, 95, 97
- planning 24–25, 27–30, 36, 41, 44–45, 53, 56, 57–59, 62, 65, 74, 91, 97
- Poland (Polish) 5, 14–15, 28, 42–43, 48–50, 74–75, 94
- policy instrument 32, 66, 68
- policy making 9, 18, 20, 68
- policy tool 90
- policy-maker 18, 52–53, 59–60, 62, 79
- poor 11–12, 14, 17–18, 21–22, 25–26, 48, 53, 72, 90, 95, 98
- Portugal 24, 28–29, 38, 43–44, 49–50
- poverty 9, 12, 14–15, 17–20, 71
- practice 27, 30, 35, 37, 40, 42, 54, 59–60, 62–63, 71, 77, 90, 99
- prefect 27, 50
- quality 9, 12–14, 16–19, 21–22, 60, 63, 65–67, 74, 81, 83, 96
- regulation/regulatory 15–16, 19–22, 27–28, 37, 50, 58, 65–69, 72–74, 76, 78, 80, 82, 88, 93, 95–96
- regulatory inflation 66
- resources 10, 12, 14–16, 19, 21–26, 32, 36–37, 39, 44–48, 50, 52, 54–56, 58, 60–61, 63–65, 72–76, 78, 81, 89, 91–92, 95–101
- Romania 5, 15, 25, 31, 37, 44, 49, 74–75, 77–78, 85
- services 10–11, 13, 17, 21–22, 24, 46, 51–53, 71, 74–77, 80, 82, 85–89, 91, 93, 95–96
- Sibiu 77
- Slovenia 5, 32–33, 87, 91–92, 94
- small and medium-sized enterprises (SMEs) 31, 63, 66, 82
- social security 97–98
- Spain (Spanish) 25–26, 29–30, 34–36, 43, 45, 47, 99
- sub-national government 48–49, 71, 82, 84–87, 89–90, 93, 101
- Sweden (Swedish) 24, 26, 36, 44–46
- Switzerland (Swiss) 33–34, 41–42, 45–47
- tax 21–22, 39, 45–48, 70–72, 74, 76, 81–82, 84–88, 90–93, 95–96, 98–99, 101
- transfer 11, 19–20, 25, 29–30, 38–39, 42, 45–46, 48, 71–72, 79–81, 85–87, 89–91, 95, 98–99
- United Kingdom or Great Britain 24, 35–36, 46, 70, 83, 99
- United States 11, 33, 78, 83, 90
- value added tax (VAT) 46–47, 98
- vertical 44, 86–87, 89–90
- voivodship 28, 42, 48
- wealth 26, 36, 47, 54, 60, 64–65, 74, 98
- World Bank 14–15
- WTO (World Trade Organization) 39

# Biography

## **Claudia Pamfil**

As an experienced trainer and consultant, Claudia Pamfil has managed a number of important capacity-building programs for local governments and their partners in Romania. She conducts and manages training and technical assistance programs for elected and appointed officials, technical staff of local, regional, central governments and non-governmental organizations on topics like participatory strategic planning, community participation in governance decision-making, local governments financial management, fiscal policies, urban management, leadership and organizational management, as well as numerous training-for-trainers programs in all the above mentioned topics. Comments can be addressed to: [claudia.pamfil@consultant.com](mailto:claudia.pamfil@consultant.com)



# LGI Policy Fellowship

## PURPOSE

The purpose of the LGI Policy Fellowship program is to provide experts and professionals from the region the opportunity to work with a multinational team of fellows on comparative research. The fellowship program is aimed at developing policy research and strengthening regional capacity by developing policy networks throughout the region.

The primary goal of the LGI Policy Fellowship program is to launch policy research and to design recommendations on the interaction of development models in various areas of government and public services. Fellows are encouraged to initiate research and to work on policy conclusions with national and local government officials and advisers.

Each year, three or four broad topics are identified for candidates from different country groups. LGI supports joint, or compatible, research and policy development studies. Combining the fellows' efforts on their own countries' problems, our intention is to create long-standing horizontal professional contacts and to improve knowledge on specific Central European and Eastern development models.

## METHODS AND PROCEDURES

LGI awards successful applicants with a stipend for a period of 10 months between October and July of the fellowship year. The grant covers a monthly stipend as well as expenses related to the research and travel costs related to fellowship workshops.

Applicants are generally either civil servants, policy researchers, or policy advisers and must be citizens of CEE, SEE or NIS countries. A graduate degree or equivalent is required. The fellows are based in their home countries and expected to continue activities at their home institution, working on the mutually agreed project for fifty percent or less of their work time.

LGI groups fellows into small teams of three or four according to their topic. Each team of fellows is lead by a mentor—a well-known expert, who advises and supervises fellows in the course of the implementation of their research projects. Mentors also facilitate professional cooperation and communication between members of the team. Fellows are encouraged to support each other's work with their expertise and comments within their teams. LGI encourages teams of fellows to develop joint or comparable research agendas.

## EXPECTED OUTCOMES/PRODUCTS

As a final product, fellows submit a research report that is an informative policy document, based on recent theoretical literature and policy research findings, that includes policy recommendations. Teams are expected to submit a joint report concluding their comparative results. The best reports are then published by LGI.

# Local Government and Public Service Reform Initiative

The Local Government and Public Service Reform Initiative (LGI), a network program of the Open Society Institute (OSI), is an international development and grant-giving organization dedicated to the support of good governance in the countries of Central Eastern Europe (CEE) and the Newly Independent States (NIS). LGI seeks to fulfill its mission through the initiation of research and support of development and operational activities in the fields of decentralization, public policy formation and the reform of public administration.

With projects running in countries covering the region from the Czech Republic to Mongolia, LGI seeks to achieve its objectives through:

- Development of sustainable regional networks of institutions and professionals engaged in policy analysis, reform-oriented training and advocacy
- Support and dissemination of in-depth comparative and regionally applicable policy studies tackling local government issues
- Support of country-specific projects and delivery of technical assistance to implementation agencies
- Assistance to Soros foundations with the development of local government, public administration and/or public policy programs in their countries
- Publication of books, studies and discussion papers dealing with issues of decentralization, public administration, good governance, public policy and lessons learned from the process of transition in these areas
- Development of curricula and organization of training programs dealing with specific local government issues
- Support of policy centers and think tanks in the region

Apart from its own projects, LGI works closely with a number of other international organizations (Council of Europe, The British Department for International Development, USAID, UNDP and World Bank) and cofunds larger regional initiatives aimed at the support of reforms on the subnational level. The Local Government Information Network (LOGIN) and the Fiscal Decentralization Initiative (FDI) are two main examples of this cooperation.

*For additional information or specific publications, please contact:*

LOCAL GOVERNMENT AND PUBLIC SERVICE REFORM INITIATIVE

P.O. Box 519

H-1397 Budapest, Hungary

Phone: (36-1) 327-3104 • Fax: (36-1) 327-3105

E-mail: [lgprog@osi.hu](mailto:lgprog@osi.hu) • Web Site: <http://lgi.osi.hu/>



OPEN SOCIETY INSTITUTE

ISBN 963-9419-56-7



9 789639 419568