



Local Government
and Public Service
Reform Initiative

*Investing in
Regional Development:*

Policies and Practices
in EU Candidate Countries

Edited by

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Foreword

This book was prepared under the “Local Government Policy Partnership” Program, the joint project of two donor organizations. The British Government’s Department for International Development (DFID) and the Local Government and Public Service Initiative (LGI), Open Society Institute, Budapest launched this regional program together. The “Local Government Policy Partnership” (LGPP) projects intend to contribute to policy development and innovation within these countries (<http://lgi.osi.hu/lgpp/>).

The LGPP hopes to develop expertise and support professional cooperation amongst local government specialists throughout Central and Eastern Europe. Parallel to this, the experiences gathered throughout the region should be made available in Central and Eastern Europe as well as in Central Asia. The core partner countries are the Czech Republic, Hungary, Poland and Slovakia. However, other countries have been invited to participate in these regional projects, in order to help facilitate direct information exchange and comparisons of policy efforts.

LGPP publications include policy studies and proposals that have been presented to government officials and experts in the countries involved. Targeted beneficiaries of LGPP projects are national government ministries, local government associations, research and training institutions and individual local authorities throughout the CEE region. LGPP intends to publish three studies a year.

In the first year of operation, the LGPP selected the following three policy areas for analysis: (i) education financing and management; (ii) regulation and competition of local utility services and (iii) public perception of local governments. The policy studies were widely disseminated in our region. They supported the policy dialogue (e.g., on education in Macedonia) and served as training materials (e.g., for regulatory experts).

Topics for the second year of LGPP (2001/2002) were rather different by nature:

- a) decentralization and regional development;
- b) the relationship between local government size, local democracy and local services delivery;
- c) local government and housing.

This publication comprises the findings of the LGPP project, which has studied the local capital investment funding schemes and mechanisms in six candidate countries (Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania). These reports contain an inventory of the major flows of public finance for investment in infrastructure, business and labor market promotion. The studies focus on funding schemes with a regional dimension: European Union funds, transfers from state budget and off-budget funds, local government revenues, including municipal borrowing.

The basic purpose was to analyze how far these investments conform with the EU's regional development model and the related criteria of concentration, programming, subsidiarity, partnership, additionality and transparency. The authors investigated: (i) the relationship between the sectoral and regional allocation of investment resources and (ii) the respective roles of national, regional and local government in the allocation and management of regional development funds.

Kenneth Davey
June 2003

Gábor Péteri

Decentralization and Regional Development: The Rationale

Executive Summaries

Czech Republic

Hungary

Latvia

Lithuania

Poland

Romania

Conclusions: Decentralization and Regional Development in Practice

Decentralization and Regional Development: The Rationale

Kenneth Davey

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Decentralization and Regional Development: The Rationale

Kenneth Davey

1. INTRODUCTION

Negotiation and preparation for accession to the European Union (EU) have focused increasing attention on the interrelation between decentralization and regional development.

In several candidate countries reforms are in progress to complete or revise the process of decentralization commenced at the beginning of the 1990s. These reforms have three dimensions:

- (1) The creation or revision of higher tiers of self-government at regional level;
- (2) The devolution to regional or municipal government of responsibilities previously held by field offices of state administration;
- (3) The enhancement of the fiscal capacities of self-government to strengthen local taxing power, take over operational funding of more local public services and accelerate investment.

Simultaneously, the pre-accession process has focused increased attention on investment in local public services and regional economic development. This is due partly to the prospective availability of pre-accession funding by the European Union and partly to the requirements to meet EU standards, particularly in the field of environmental protection.

2. EU POLICY

These two trends are fuelled by the importance given by the European Union to the roles of regional governments and partnerships, both intergovernmental and public/private, in the design and execution of development programs.

The EU's emphasis on regional development stems from the fear that a single market devoid of protectionist barriers will widen regional disparities. These in turn will threaten political, social and economic stability. Measures are needed to counteract these risks by strengthening the competitive capacity of poorer regions. Investment of "cohesion" funds is needed to "level the playing field."

There appear to be three reasons why the EU promotes the role of regional or local self-governments in allocating and managing these investments. Firstly, it ensures that they will be made in the target regions; it is much more difficult to determine the geographical use of money disbursed through sectoral ministry programs.

Secondly, developing regional capacity depends on integrating a variety of individual interventions; attracting private investment, for example, may require a mixture of infrastructural and environmental improvements as well as business support and labor force development.

Thirdly, regional and local governments are regarded as best placed to build up the intergovernmental and public/private partnerships necessary to development in a plural polity and market economy.

The implication of these concepts is that a major proportion of public investment should be targeted on less developed regions, channeled through integrated regional programs, and allocated and managed in partnership with regional and local governments and “economic and social partners” (i.e., private enterprise and NGOs).

3. NATIONAL RESPONSES: REGIONAL DISPARITIES

The reality of national situations in candidate countries falls short of this vision. In the first place there are tensions between *regional* and *sectoral* approaches to investment.

By regional investment we mean the allocation of resources for coordinated, multi-sectoral use in a given territory. The choice of territories to be covered and the overall distribution of resources between them would be largely determined by the objective of correcting inter-regional disparities in income and employment levels.

By *sectoral* investment we mean funding dedicated to a single sector and distributed by a sectoral ministry (or parallel government agency) at the national level.

The EU approach to regional development is concerned with the reduction in disparities, measured largely by differences in GDP per capita. The first objective is to raise below average incomes and all other objectives are concerned with contributory causes of low incomes, mainly related to changing employment. Interventions may be multi-sectoral, but they need to be integrated to achieve a common aim of generating greater income.

Much government investment, however, using both EU and other funding sources, is sectoral rather than regional by nature. It is concerned more with local disparities in individual public services from schools to sewerage. It lends itself to segmented programs driven by sectoral ministries. This sectoral approach is also encouraged by another dimension of accession, the requirements to meet EU standards and the financial support available from the Union in doing so.

Sectoral and regional allocation are not totally incompatible. Sectoral programs can be distributed to individual regions by competitive bidding. Regional economic and social priorities can be reflected in their allocation or in differential requirements for local contribution. They can be allocated and executed by sectoral ministries but within the context of French style regional planning contracts, involving agreement and complementary investment by regional governments. They can be executed by grants to regional/local governments who would decide on specific locations and uses within broad national specifications.

The financing of local government is also dichotomous in relation to the correction of disparities. State contributions to the operating costs of local government services are largely provided through tax shares or block grants that do not determine their end use. They are governed by normative formulae that also tend to incorporate some element of equalization of local revenues. The basic aim of such equalization is to reduce disparities in local public service standards. Of course, this type of equalization may well favor the less economically developed areas, but there is no exact fit. Territorial fragmentation may be just as responsible as economic differences for disparities in local tax bases and the lack of scale economies in service provision.

State contributions to regional/local government investment tend in contrast to be channeled through grants or direct expenditures that are sectorally dedicated. A normative basis of allocation is rare. Distribution may be based on service deficits, rates of return or outright patronage; it is rarely connected to regional economic disparities or to differences in local fiscal capacity. Some criteria, such as requirements for local matching, may have a dis-equalizing impact.

In practice, regional and local governments in CEE countries have financed much investment from their own resources, i.e., from a combination of operating surplus, borrowing and asset sales. However, their capacity to do so is generally declining for a variety of reasons and is in rough proportion to their economic prosperity, i.e., least in the poorer localities.

4. NATIONAL RESPONSES: DECENTRALIZATION AND PARTNERSHIP

It is by no means clear in practice that self-government is the chosen instrument for achieving regional participation and partnership in the design and management of regional development programs. In Hungary, for example, a set of development councils has been established at regional and county levels, in which self-governments are represented but not dominant players. In the Czech Republic and Slovakia, regional operational programs (ROPs) were compiled with the participation of regional state offices and *ad hoc* "monitoring committees." Other parallel structures are represented by the proliferation of regional development agencies.

These *ad hoc* measures in the Czech Republic and Slovakia were to some extent due to the absence of regional self-governments at the time ROPs had to be compiled. Nevertheless the fact that upper tiers of self-government may not equate with NUTS II regions and that they do not directly represent “social and economic partners” may continue to give governments an excuse for diluting their coordinating and management role in regional development.

Above all the influence of a fiercely competitive political environment has to be recognized. Most CEE governments are coalitions in which sectoral ministries cannot be coerced into surrendering power and resources to regionally determined and managed programs. Governments collectively may also be reluctant to vest discretion in regional governments that may well be controlled by opposition parties.

5. POLICY AND RESEARCH ISSUES

This analysis leads to two major conclusions. In a pluralist political environment constant tension and competition must be expected between:

- (1) Sectoral and regional approaches to investment,
- (2) Central, regional and local government agencies over the control of investment plans and resources.

The research summarized in this volume has looked at the actual funding of capital investment in six candidate countries—Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania—from two related perspectives:

- (1) The balance and relationship between the sectoral and regional allocation of investment resources.
- (2) The respective roles of national, regional and local government, in the allocation and management of regional development funds.

The research is concerned with public investment in projects that are regional or local in terms of their location and impact. The basic purpose is to see how far this investment conforms to the EU’s regional development model and the related criteria of concentration, programming, subsidiarity, partnership, additionality and transparency. The experience is used to assess the real significance of regional policy, regional government and regional development planning in investment. How feasible are the aims outlined in paragraph nine that “a major proportion of public investment should be targeted on less developed regions, channeled through integrated regional programs, and allocated and managed in partnership with regional and local governments and ‘economic and social partners’ (i.e., private enterprise and NGOs).” How might this model evolve in practice?

6. THE COUNTRY REPORTS

The full report from each of the six countries is contained in the attached Compact Disk, and summarized in the following chapters. Each report analyzes current flows of investment finance to regional development and local public services. It describes briefly the public administration system and the divisions of responsibility between national, regional and local levels for functions relevant to regional and local development, outlining any major changes in progress or planned. It also outlines such regional policy as may have been developed and any changes over time, describing any significant disparities between regions and the terms in which they are understood and addressed by regional policy, as well as mentioning any significant changes over the last decade.

The reports then contain an inventory of the major flows of public finance which have, or should have, a regional dimension for investment in:

- Infrastructure,
- Business promotion,
- Human resource development (for labor market promotion only).

These are categorized by the following sources:

- European Union,
- State Budget,
- Off-Budget Funds,
- Local Government Revenues,
- Local Government Borrowing.

The inventories describe the approximate volume of these funds, the criteria and procedures used in distribution.

Each flow of funds described (whether from the EU or other sources) is evaluated in terms of its conformity with the following criteria:

- (1) *Concentration*: i.e., the priority given in its distribution to the correction of inter-regional disparities;
- (2) *Programming*: compatibility with coordinated multi-sectoral development strategies;
- (3) *Partnership*: between levels of government and socio-economic partners in identification, design and implementation, and linked to subsidiarity, the assignment of responsibilities to the lowest efficient level;
- (4) *Additionality*: co-financing between levels of government, socio-economic partners and/or final beneficiaries;
- (5) *Transparency*: of criteria and procedures for allocation.

This evaluation is factual rather than judgmental. It is not assumed, for example, that priority in public investment should always be given to correction of inter-regional disparities or that all investment should require partnership or additionality.

7. CONCLUSIONS

The findings of the research are summarized in the final chapter, which attempts to reach conclusions about the current and potential significance of regional government, regional policy and regional development planning in the overall investment process.

Country Executive Summaries

Czech Republic

Jiří Blažek, Jan Příkryl, Tomáš Nejdrl

Hungary

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Latvia

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Capital Investment Funding in the Czech Republic

Jiří Blažek
Jan Příkryl
Tomáš Nejdrl

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Capital Investment Funding in the Czech Republic

Executive Summary

Jiří Blažek, Jan Příklad, Tomáš Nejd

INTRODUCTION

This executive summary provides the main findings on the current state of regional development and policy in the Czech Republic, including the key issues of local and regional administration and especially conclusions and policy implications based on extensive analysis of existing support programs that are potentially eligible for assistance via the EU.

1. KEY PROBLEMS OF LOCAL DEVELOPMENT

1.1 Horizontal Fragmentation of Local Government

Several features specific to the Czech Republic have affected development at the local level. Prominent among these is a very fragmented settlement system. The communist regime responded to the huge horizontal fragmentation of the settlement system and of local government with a rigid policy of forced amalgamation of municipalities. Under the communist system of central planning, the amalgamation endangered the very existence of small villages for it was almost impossible to obtain any resources (administered centrally) for investment or other projects in small, amalgamated villages. Even the construction of family houses was discouraged by the state in these villages. Consequently, under communism, the process of amalgamation was extremely unpopular; the municipalities concerned tried to delay the whole process as much as possible.

Therefore, in the Czech Republic, the number of municipalities decreased from 11,000 in 1948 to only 4,100 in 1989. In addition, for the reasons described above, when democracy was reintroduced at the local level after 1989, many amalgamated municipalities decided, on the basis of local referenda, to split-up and to re-establish the local government in their villages. This movement, mirroring the revival of

local communities, was quite overwhelming; more than 2,000 municipalities were re-established within the first two to three years of transition, thus increasing the number of municipalities by about 50% to approximately 6,200. The number of municipalities now appears to have stabilized (see Table 2.1).

The 1990 decision to abolish the regional level of administration (consisting of eight regions) also had important implications for local development. This measure was taken mostly for political reasons, especially to destroy the communist hierarchical system. At the same time, it was decided to leave only the functions of the state administration at the district level. Consequently, a significant re-allocation of responsibilities had to take place. Some responsibilities (especially from the regions) were transferred to the bodies of central administration while others were assigned to the districts or even to municipalities.

Table 2.1

Territorial Structure of Public Administration in the Czech Republic

Year	Number of Municipalities	Number of Districts	Number of Regions
1989	4,231	76 ¹	8
1999	6,234	77	0
2001	6,258	77	14 ²

SOURCE: *Czech Statistical Office, The Constitution of the Czech Republic.*

The huge territorial fragmentation of local government and the abolition of regions have many important implications for the relations between the state administration and local government, as well as for the design of the system of local government financing. The large number of small municipalities has caused two principal problems since the beginning of the transition. The first problem was the acute investment needs of re-established municipalities of a small size. This problem was caused by the restricted possibilities for investment under communism, on the one hand, and the very limited size of their budgets, on the other.

The second problem is connected with small municipalities' limited human resources. The shortage of capable personnel was exacerbated by swiftly changing legislation during the period of transition. Many small villages do not even have sufficient personnel to read the new pieces of legislation, let alone implement them properly. This situation significantly limits the capability of many small municipalities to take on additional competencies. To solve some of these problems, a network of about 380 larger municipalities has been formed. These municipalities were delegated various additional tasks that they also perform for other smaller municipalities. Although horizontal fragmentation is causing many day-to-day problems, the flip side of the coin is that citizens have an enhanced interest in the local affairs of their villages.

1.2 Reform of Public Administration at Regional Level

The reform of public administration at the regional level has proved to be the most difficult of all the levels of public administration. The reform started in 1990 by abolishing eight regions and leaving only state administration at the district level. The rationale was to cut the mutual ties of the former nomenclatura cadres and to decrease bureaucracy.

However, the absence of any self-government bodies between the municipal and the state level caused many practical problems, such as the lack of an institution responsible for managing services and dealing with issues above the municipal level. Moreover, the central ministries faced difficulties in executing their tasks and therefore set up a network of regional branches, so called “deconcentrated offices.” The establishment of these regional branches was uncoordinated; consequently, nearly all ministries designed their own network of regional branches.

In addition, neither citizens nor politicians perceived the issue of regional administration as a priority. This situation changed after the 1996 elections when the center-right coalition lost its majority in parliament and had to change its policies and make concessions in order to retain its power as a minority government. In 1997 parliament approved a constitutional law stating that from 2000 the Czech Republic will consist of fourteen self-governing regions. However, the preparation of the whole package of more specific acts defining the competence and financing of new regions has been delayed. Therefore, the creation of regions was postponed by one year to January 2001.

2. RE-ESTABLISHING FISCAL AUTONOMY

2.1 Solving the Dilemma between the Principles of Solidarity and Meritocracy

Two important components of the re-establishment of the democratic system at the local level were restitution of municipal property (the vast majority of which had been owned by the state) and re-establishment of local financial autonomy. The problem of financial autonomy proved to be especially difficult to solve. The design of the new financial system of Czech local governments can be described as a “trial and error” approach. At least four different systems can be identified in the period from 1990 to the present (see Blažek, 1996).

The first period was 1990–1992. Because of a general mistrust of the central redistribution of resources under communism, there was strong pressure from newly elected local representatives to decentralize part of the tax system. However, in the first years of the transition a radical transfer of competences was carried out. The transfer

of competences had to be accompanied by a transfer of financial resources for local authorities to perform these tasks. This was often done in the form of general or special grants. Therefore, until 1992, the main financial resources (about 70% of the total) of local government were received in the form of grants.

Table 2.2
Main Reforms of the System of Local Government Finances

System between 1993–1995	System between 1996–2000	System 2001
100% of revenues from personal income tax paid by employees working in the particular district, of which 45% allocated to particular district office and 55% distributed among municipalities within particular district according to per capita principle	60% of revenues from personal income tax paid by employees working in the particular district, of which 30% allocated to particular district office, 20% distributed among municipalities within particular district according to per capita principle and 10% allocated to municipality according to working place of employees	20.52% share on national revenues of VAT, on business tax, on personal income tax paid by employees and on personal income tax paid by small entrepreneurs distributed according to per capita principle ³
100% of revenues from personal income tax paid by small entrepreneurs allocated to municipality according to permanent living place of the entrepreneur	100% of revenues from personal income tax paid by small entrepreneurs allocated to municipality according to permanent living place of the entrepreneur	30% of revenues from personal income tax paid by small entrepreneurs living in municipal territory
—	20% of revenues from business tax, allocated to all Czech municipalities equally according to per capita principle	Transformed into shared taxes (see above)
100% of property tax	100% of property tax	100% of property tax
other income: local fees, loans, etc.	other income: local fees, loans, etc.	other income: local fees, loans, etc.
territorial equalization grant (general grant)	territorial equalization grant (general grant)	abolished
special grants	special grants	special grants

SOURCE: Acts on State Budget of the Czech Republic in 1995, 1996, 2000.

In 1993 a radical reform of local government financing was executed to increase the percentage of revenues that local government generated from their own sources. The core of the reform was that revenues from personal income tax were allocated to local government. At the same time grants were cut correspondingly. The system was rather complex (see Table 2.2), with a strong equalization mechanism operating among the municipalities within the districts on a per capita principle. On the other hand, among the districts, there was a rather modest equalization mechanism, the relatively small “territorial equalization grant” (amounting to about 2% of local budgets).

The third identifiable period began with the reform of 1996 and lasted until 2000. The main element of the 1996 reform was the replacement of 40% of revenues from swiftly growing personal income tax with 20% of stagnating revenues from business tax. At the same time the allocation criteria among the municipalities were changed (see Table 2.2).

The impact of the system introduced in 1996 has been multi-faceted. The most important change was the weakening of strong equalization mechanisms operating among the municipalities within the particular districts and introduction of relatively strong equalization mechanism at the inter-district level. Therefore, since 1996, there have been equalization mechanisms both within and among the districts. The biggest losers were the large cities such as Prague or Ostrava, which lost 40% their revenues from personal income tax. Nevertheless, sizeable disparities in per capita revenues remained among the districts, and the central government therefore proposed yet another financial system for local government.

2.2 The 2001 Reform of Local Government Financing

The reform entered into effect in January 2001 and originally should have also allowed for the financing of fourteen new regions that were introduced at the same time. The substance of the new reform is an equal sharing of both parts of the personal income tax (paid by employees and by small entrepreneurs) and of part of the business tax and value added tax equally by all municipalities on a per capita basis. In addition, the municipalities were arranged into several categories according to their population size. Each category was assigned a coefficient reflecting the fact that larger municipalities and cities are also performing functions for outlying areas. However, due to the poorly prepared regional reform of public administration, this proved to be unrealistic and regions in 2001 were financed mostly by special grants. The new system is clearly over-stressing the solidarity principle over the principle of meritocracy and results in an extensive redistribution of sources while providing little incentives for local initiative.

Since the beginning of the transition, the development of the system of financing for Czech local governments has been far from straightforward. The main reason for

the frequent changes in the system is the lack of a broad agreement between the central government and representatives of local government on the basic principles of the system's design. The latest proposal shows that the rules are not yet stable and not likely to be in the near future. The considerable instability of the system of local government financing can be stated as one of its principle shortcomings.

2.3 Capital Expenditures of Local Government

Municipalities are much more important investors than would follow from their share of GDP or public expenditures. While their share of GDP permanently oscillates between 8 and 10% (see Table 2.3), total investment has never been lower than 15% since 1993.

Table 2.3
Public Budgets as a Percent of GDP

Public Budgets	1993	1994	1995	1996	1997	1998	1999	2000	2001
State budget	34.49	33.08	30.96	29.86	30.21	30.31	31.48	35.81	33.83
Local budget	8.94	9.67	9.54	10.80	9.02	8.78	9.42	9.79	8.33
Total	43.43	42.75	40.50	40.66	39.23	39.09	40.90	45.60	42.16

SOURCE: Ministry of Finance of the Czech Republic.

The role of municipalities in investment activity within the public sector alone is even more important. Although the size of local government budgets as a percentage of total public budgets has been decreasing since 1996, their share of investments from the public sector is growing slightly (see Table 2.4). The ratio of financial resources allocated to investment in municipal budgets is twice or even three times higher than that of the state budget (see Table 2.5). The share of investments in local budgets fluctuates around 30% while in the case of the state budgets the share is between 10–15%. Consequently, investments made by municipalities represent about *40% of public investments* in the Czech Republic.

Table 2.4
The Share of Local Government in Public Budgets [%]

Public Budgets	1993	1994	1995	1996	1997	1998	1999	2000	2001
State budget	79.41	77.39	76.44	73.45	77.01	77.52	76.96	78.53	80.25
Local budget	20.59	22.61	23.56	26.55	22.99	22.48	23.04	21.47	19.75
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

SOURCE: Ministry of Finance of the Czech Republic.

Table 2.5
Local Government Capital Investment Compared to Total Spending [%]

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001
Capital investment	28.46	29.64	31.26	25.72	28.91	27.06	26.38	33.15	29.14

SOURCE: Ministry of Finance of the Czech Republic.

The principal reason why local government capital investment within the public sector is so important lies in the way the competencies were assigned among the different levels of public sector. Local governments are responsible for capital-intensive investment areas such as water systems, sewage and sewerage systems, local roads and school buildings. At the same time, the municipalities are battling against the huge internal debts racked up by these investment areas under communism. Moreover, local representatives are exposed to considerable pressure from local inhabitants and businesses to solve fundamental problems hindering local development and improvement of the general standard of living.

Both these pressures (i.e., delegation of costly responsibilities from the central government and pressure from local subjects) result in a situation where municipalities allocate approximately double their revenues for investment.

However, there is also a negative side to this largely positive trend. This is the high dependency of municipal investment activities on state financial assistance. According to a survey performed by the Ministry of Finance in 1997, state grants covered 25.5% of municipal capital expenditures and state interest free loans another 5.1%. It can be expected that this situation, where state transfers cover a third of municipal expenditures, will continue. It is clear that a large proportion of these investments would not be implemented without such state support. Due to the considerable instability of the state support policy (which is guided by annual state budgets) municipalities are forced to adjust their investment priorities according to the focus of state support programs. This situation boosts investment activity as municipalities are forced to use the opportunity even if local representatives do not deem the investment essential. At the same time this phenomenon contributes to an increase in municipal debt. Finally, another weakness of such a model is that it contributes towards the creation of a mentality of dependency on the state and leads to the temptation to solve infrastructural deficits with cheap (subsidized) grants instead of expensive (non-subsidized) maintenance and repairs.

The survey also showed that commercial loans covered 17% of capital expenditures made by municipalities. Therefore, municipalities covered only 52.4% of their capital investments from their own resources. Inevitably, these average figures vary according to the size of the municipality and other factors. However, in general, it can be concluded

that the smaller the municipality is, the smaller its budget devoted to capital expenditures and the greater its dependence on transfers from state budget and state funds.

2.4 Financing of Self-governing Regions

In April 2000 parliament passed Act 128/2000, which enacted the establishment of fourteen self-governing regions. An attempt to endow the new regions with their own stable income base over which the elected regional bodies could exert their discretion failed—partly due to the fact that competences in the sphere of public sector provision and regional policy were transferred to the regions only during 2001. Therefore, it was difficult to specify exactly the level of required financial resources. As a consequence, both in 2001 and 2002, the financing of the regions proceeded only according to a temporary model in the form of the Act on Budgetary Allocation of Tax Revenues, which is annually adjusted. According to this Act for 2001, no own revenues were assigned to the regions. Consequently, the regions have been fully dependent on state specific grants.

As far as 2002 is concerned, the regions were allocated 2.52% of personal income tax (with the exception of personal income tax paid by small entrepreneurs) and the revenues of individual regions correspond to their population. The regions were also given 10% of revenues from the personal income tax paid by small entrepreneurs within the region but special coefficients were applied to mitigate differences between rich and poor regions. Despite these changes, the regions will remain at least 80% dependent on state specific grants even in the year 2002. The very low volume of own revenues hinders not only a significant own support policy but also limits their possibilities to participate in state support programs that require co-financing by final beneficiaries. Moreover, a weakness of the existing system of financing is the excessive stress on equalization.

3. DEVELOPMENT OF REGIONAL DISPARITIES AND POLICY

3.1 Development of Regional Disparities during Transition

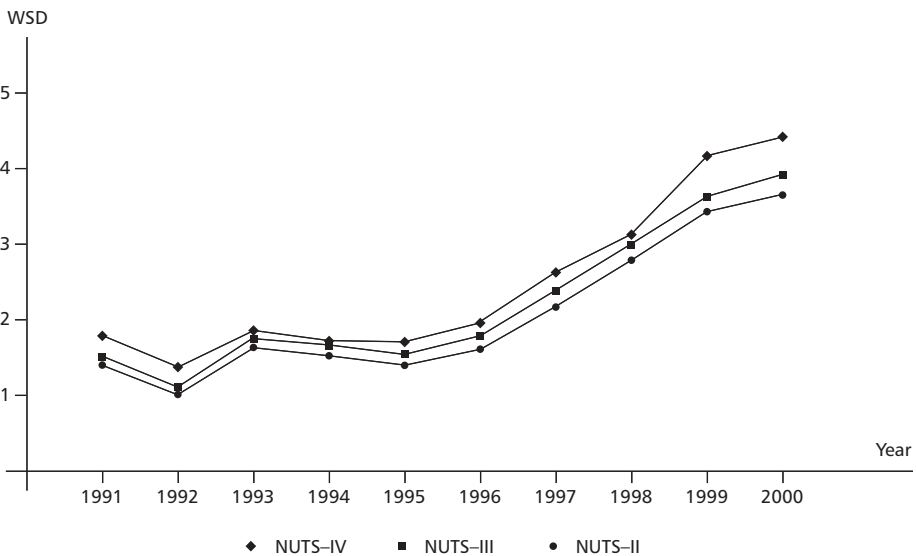
The Czech Republic entered the transformation period as a country with relatively minor inter-regional disparities. This was the result of the strong equalization policy pursued under communism. Equalization policy was quite effective but very inefficient and led towards the country overtly lagging behind West European countries in the sphere of societal development.

The general tendency of regional development in post-communist countries after the collapse of the system can be described as *differentiation*. Generally, diversified metro-politan regions have performed better than non-metropolitan, industrial and rural

regions (Hampl, 1999). The inter-regional disparities developed owing to a whole complex of interconnected factors such as vertical and horizontal geographic position, economic structure, industrial and entrepreneurial tradition, educational structure, development of technical infrastructure and the state of environment (Blažek, 1999; Hampl, 1999).

Regional disparities have started to deepen profoundly since the mid-1990s. The rate of economic growth plummeted, even turning negative at one point, and the rate of unemployment more than doubled between December 1995 and December 1998 and in several districts reached levels of serious concern (over 20% during 2000). In the EU, regional disparities are measured on the level of the NUTS II and NUTS III regions. (NUTS is the Nomenclature of Territorial Units for Statistics.) More specifically, the size of inter-regional disparities in the unemployment rate is most often measured by EUROSTAT by weighted standard deviation (WSD). The standard deviation is weighted by the size of the NUTS II regions—measured either by the number of economically active people or by the number of inhabitants.

Figure 2.1
Development of Inter-regional Disparities in the Czech Regions
NUTS II–IV Measured by Weighted Standard Deviation



SOURCE: Blažek (2001).

After some fluctuations in the first half of 1990s, the graph illustrates a steep increase in inter-regional disparities since 1995. The scale of disparities depends obviously on

the number of units (regions) used in analysis. Therefore, not surprisingly, the smallest disparities were found on the level of NUTS II regions (eight units) while the largest were found at the district level (77 units). However, given the large variance in the number of units on particular NUTS levels, the differences in disparities are surprisingly small.

Table 2.6

Regional Disparities in Unemployment According to NUTS II Regions
in the EU Countries (1999) and in the Czech Republic (2000)

Country	Rate of Unemployment [%]	Weighted Standard Deviation	Coefficient of Variation [%]	Number of NUTS II Regions
Austria	4.0	1.1	27.5	9
Belgium	8.8	4.3	48.9	11
Finland	11.5	3.2	27.8	6
France ⁴	11.4	2.5	21.9	22
Great Britain	6.1	2.6	42.6	35
Germany	8.9	4.3	48.3	38
Greece	11.7	2.0	17.1	13
Italy	11.7	7.9	67.5	20
Netherlands	3.3	0.8	24.2	12
Portugal	4.7	1.4	29.8	7
Spain	16.1	5.7	35.4	18
Sweden	7.6	1.6	21.0	8
Czech Republic	8.8	3.7	41.4	8

SOURCE: The data on the EU countries were published in the *2nd Report on the Economic and Social Cohesion*, Volume 2, Statistical Annex, European Commission, Brussels, 2001; rate of unemployment for The Czech Republic—The Ministry of Labor, own calculation of measures of variation for the Czech Republic.

NOTE: Ireland, Denmark and Luxembourg are not shown in the table as their territory consists of a small number of NUTS II regions.

Despite the fact that the Czech Republic ranks in comparison with many of the smaller EU countries, it cannot be stated that the inter-regional disparities within the Czech Republic are negligible. Of the EU countries of relatively comparable size only Belgium has more profound regional disparities than the Czech Republic. On the other hand, the Czech Republic does not suffer from such huge regional problems like some other transforming countries (e.g., Upper Silesia in Poland or the polarity between Budapest and the mostly rural rest of Hungary).

3.2 Formation of Czech Regional Policy

Despite some recent progress, the Czech Republic is still missing comprehensive and efficient regional policy. In the first half of the 1990s regional policy was only a very low priority and has only gained more attention recently.

Regional policy until 1996

In the Czech Republic the development of regional policy can be divided into three periods during the transition. The first period lasted between 1991–1992. During this period, the aims of regional policy were quite ambitious but no new programs were implemented in the regions. More important for future development was the second period (1992–1996) where the role of regional policy was intentionally marginalized. The reasons for this low profile approach by the Czech government were historical and geographical (small inter-regional disparities inherited from the former communist regime), economic (until 1996 an unnaturally low rate of unemployment of around 3 to 4%) and political (explicit one way liberalism and an unwillingness to intervene in the market). The official regional policy was very modest and consisted only of the offer of meager support to small and medium-size firms (in the form of soft loans) in assisted regions selected on the basis of the unemployment rate (i.e., higher than 5% in 1996).

Nevertheless, the Czech government gradually developed a whole array of policies with (intended or unintended) significant regional impacts. But these policies do not comprise a comprehensive approach to regional issues. Almost every ministry prepared some program with important regional impacts (Blažek, 1999). For example, at the beginning of the 1990s the government pursued (though not very frequently) the policy of “selective financial restructuralization” (i.e., writing off the debts from the communist period) of large companies whose collapse might seriously endanger regional labor markets. There are numerous other examples: the Ministry of the Environment distributes the resources from the Environment fund to projects aimed at improving the environment of the most polluted regions; the Ministry of Transport supports public transport in rural areas; the Ministry of Agriculture supports farmers in less favorable situations or in environmentally protected areas; the Ministry of Labor allocates funds for active employment policy to district job centers in areas of high unemployment; the Ministry of Trade and Industry supports small and medium-size firms and foreign investors through regional partners of the agency CzechInvest.

The main weakness of this approach lies in its institutional fragmentation and lack of horizontal coordination at the governmental level. Until 2000, this problem had been exacerbated by the lack of regional self-government, which would, had it existed, have played an important coordination role.

The third (current) period of Czech regional policy

In the mid-1990s there were two main stimuli to the development of a more integrated approach toward regional policy. Firstly, the internal conditions changed significantly, especially the growth in unemployment and the sharpening of regional disparities, and politically there was a significant retreat from neo-liberalism. Secondly, an important stimulus came from pressure exerted by the EU, for which economic and social cohesion is a high priority (consuming about a third of the EU budget). Moreover, the EU also conditioned the provision of support via pre-accession programs through the efforts of County Councils (CCs) including an increase in the efficiency of the public sector and the design of modern regional policy. Finally, the EU closely observes the overall developments in CCs and the findings are published annually. All the above contributed to the fact that the Czech government has recently taken several important measures in the area of regional policy.

The Ministry for Regional Development and Center for Regional Development were established in 1996 to promote regional development. Originally, the intention was to shift implementation of the most important sectoral programs with important regional dimensions into this ministry, but this has happened only in one case—the Program of Revitalization of the Countryside was transferred from the Ministry of Agriculture. Concerning legislation, the Regional Development Act was passed by parliament in 2000 (No. 248/2000). The Act defines the responsibilities not only with respect to Czech regional policy but also in preparation and future implementation of EU cohesion policy. In the area of programming, the government approved for the first time the strategy of regional development in the Czech Republic in 2000. This should guarantee a more efficient design of Czech regional policy. With respect to support programs, in addition to the regional support to SMEs, state regional support programs were approved by the government for the two most troubled regions (NUTS II North-west and Ostravsko). These programs provide support to municipalities in the regions in question in several areas, but mainly in the sphere of infrastructure and specifically business infrastructure such as industrial zones. Consequently, financing allocated to regional policy has increased significantly.

Significant effort is also devoted to preparation for the EU cohesion policy and to implementation of the pre-accession programs. In order to prepare for implementation of pre-accession support from the EU, completely new institutional structures were formed. The most important is the National Management and Coordinating Committee chaired by the Ministry for Regional Development and charged with overall coordination of the pre-accession structural aid.

Despite recently achieving significant progress, Czech regional policy still departs considerably from the EU cohesion policy. A comparison of the main differences between these policies is shown in Table 2.7.

Table 2.7
The Main Differences between Czech Regional Policy and EU Cohesion Policy

Sphere	Czech Regional Policy	EU Cohesion Policy	Remark
Programming	CR until recently without programming documents, now <i>over-programming</i> (two sets of programming documents—one for Czech RP the other for EU cohesion policy), standard programs, low invention, top-down motivation for drafting programming documents; however, recently some progress	Already the third generation of programming documents	Excessive emphasis on analysis, weak strategic component, no consideration of alternatives
Implementation structure	Prevailing sectoral approach	Different systems	
Integrity of approach	Narrow conception of RP and its insufficient coordination with other policies	Integrated multi-sectoral approach	Progress recently, esp. regionalization of sectoral policies and implementation of more integrated state support programs for effected regions
Incentives of RP	Limited spectrum of incentives used	Wide spectrum of incentives	Regional Development Act is consistent with the EU principles
Size of projects	Small projects prevailing	Prevailing large projects	
Selection of projects	Problems with transparency	Clear separation of management, monitoring and control function.	
Evaluation of efficiency and effectiveness	Weak tradition, performed infrequently and ad hoc	Systematic attention and pressure for further enhancement	Chance posed by preparation of the Monitoring System for Structural Funds (MSSF).

Table 2.7 (continued)
The Main Differences between Czech Regional Policy and EU Cohesion Policy

Sphere	Czech Regional Policy	EU Cohesion Policy	Remark
Partnership	Weak tradition, esp. in the case of projects on supra-municipal level	Different practice	
Involvement of private sector	Low participation of private sector in preparation for and limited awareness about cohesion policy	Strong role, often significant initiative	
Public administration	Huge instability (fourteen new regions, planned dissolution of districts and creation of smaller districts in 2003, large horizontal fragmentation of local government and unprecedented instability of their financing)	Different systems	Serious disadvantage given large expected role of regions, towns and municipalities
Volume of financial resources	Small but increasing	Many times higher	

SOURCE: Blažek (2001).

Probably the biggest enduring problems in Czech regional policy are coordination of regional development measures and programs. When an acute crisis develops in one of the regions, the assistance is usually *ad hoc*. Therefore, a sectoral approach to regional problems still prevails.

4. ECONOMIC AND SOCIAL COHESION POLICY: METHODOLOGY AND DEFINITIONS

The methodology used for gathering relevant information was based on an analysis of the activities of key institutional subjects. Firstly, the activities performed within the responsibility of all relevant bodies of central administration and their affiliated or subordinated bodies were overviewed. Secondly, tables summarizing all relevant technical information about relevant programs or policies were developed (for details and tables see Annex). The tables also provide a specification of origin of financial resources: for

example, state budget, off-budget funds, EU support, etc. Thirdly, on the basis of gathered information, an evaluation according to the principles of EU cohesion policy has been performed. Finally, the main observations about existing programs were summarized and some implications for possible future adjustments of existing programs and policies were derived. Unless otherwise stated, all data relate to the year 2000.

Table 2.8
Summary of the Structure of Support Programs
According to Priority Spheres of the EU Cohesion Policy

Sphere	Programs	Financial Resources [mil. EUR]			
		EU	State Budget	Off-Budget	
Infrastructure (P1)	Industrial Zones Support		11.24		
	MRD Regional Support Programs I		9.75		
	Countryside Revitalization		16.19		
	CBC/PHARE Large Infrastructure Projects	17.1			
	Grants for Tourist Regions		0.62		
	Support of Housing		132.12	21.59	
	Protection of the Environment			80.01	
	Support of Renewable Resources of Energy			9.21	
	Construction and Reconstruction of Water Related Infrastructure		39.88		
	State Fund for Transport Infrastructure			243.32	
	Subtotal		17.1	209.8	354.13
			581.03		

Table 2.8 (continued)
 Summary of the Structure of Support Programs
 According to Priority Spheres of the EU Cohesion Policy

Sphere	Programs	Financial Resources [mil. EUR]		
		EU	State Budget	Off-Budget
Business Promotion (P2)	MIT Programs of the Support of SMEs	3.31	88.04	
	MIT Regional Business Support Programs (Start and reconstruction)		3.9	
	Support of Research and Development		6.34	
	Energy saving and the use of renewable resources		6.3	
	Support of Risk Capital (Fund for Risk Capital and Czech Venture Partners)	4.89		
	EU Programs for SMEs (Euro Info Correspondence Centers, Europartenariat, Interprise)	0.09	0.16	
	Support of Participation in Trade Fairs and Expositions and of the Support of Propagation Activities		4.7	
	MRD Programs of the Regional Support SMEs		10.93	
	MRD Regional Policy Programs II (RegioGuarantee, Region 2, Regional Support Programs for Industrial Enterprises in Northwest Bohemia and Ostrava regions)		17.36	
	SMEs Support Programs in the Sphere of Agriculture			28.72
	Subtotal	8.29	137.73	28.72
		174.74		

Table 2.8 (continued)
 Summary of the Structure of Support Programs
 According to Priority Spheres of the EU Cohesion Policy

Sphere	Programs	Financial Resources [mil. EUR]		
		EU	State Budget	Off-Budget
Human Resource Development (P3)	Support of Research and Development (Export, Centers, Stratech)		32.68	
	CBC/Phare Small Projects Fund	1.9		
	Active Employment Policy		97.77	
	Palmif	1.2	0.3	
	Development of Social Services		9.77	
	Subtotal		3.1	140.52
		143.62		
Total		28.49	488.05	382.85
		899.39		

NOTE: Ministry of Culture programs were not included in the tables because of their specific character. Pre-structural instruments were not included in the tables as they began after 2000. Programs of support to non-productive functions of agriculture were not included.

5. EVALUATION

The tabular form provides a generalized evaluation of the main features of existing support programs according to the main principles of EU policy of economic and social cohesion (i.e., concentration, programming, partnership, additionality and transparency). Evaluation uses a scale of five grades where grade one indicates that a given criterion is hardly met whereas grade five indicates that a given criterion is fully met.

Table 2.9
 Summary of the Evaluation of the Main Support Programs
 According to the Principles of the EU Cohesion Policy

Type of Support	Program	Concentration	Programming	Partnership	Additionality	Transparency
Infrastructure	Support of Industrial Zones	2	4	4	4	3
	MRD support of development in selected regions	5	2	2	5	4
	Revitalization of countryside	5	4	3	5	3
	CBC Phare Large Projects	4	2	3	5	5
	Grants for Tourist Regions awarded by the Czech center of Tourism	1	1	2	4	4
	Construction of rental apartments and technical infrastructure	1	1	2	5	3
	Supporting construction of nursing homes	1	1	2	5	3
	Modernization of the housing fund	1	1	2	5	3
	Reconstruction of prefab housing	1	2	2	5	3
	Support for insulating private dwellings	1	2	2	5	3
	Environment support programs of SFE	3	3	3	3	5
	Support of investment projects for usage of renewable energy resources	1	1	2	3	5
	Transport Infrastructure support programs of SFTI	3	3	1	1	2
Pre-accession support programs	PHARE	5	5	1	4	3
	SAPARD	2	5	4	5	3
	ISPA	2	5	2	5	3

Table 2.9 (continued)
 Summary of the Evaluation of the Main Support Programs
 According to the Principles of the EU Cohesion Policy

Type of Support	Program	Concentration	Programming	Partnership	Additionality	Transparency
Business Promotion	MIT programs for SMEs	2	1	2	5	4
	MIT regional business support programs (Start, Rekonstrukce)	3	1	3	5	4
	Research and Development SUPPORT PROGRAMS of MIT (Technos, Park)	1	1	3	4	5
	Support of energy saving	1	4	4	4	3
	Support of Risk Capital (Fund for Risk Capital and Czech Venture Partners)	1	1	4	5	5
	EU programs for SMEs (Euro Info, Interprise, Crafts, Distributive Trade)	1	1	4	4	5
	Support of participation in trade fairs and of the support of propagation activities	1	4	3	4	5
	MRD programs for the regional support of SMEs (Region, Vesnice, Regenerace, Preference, Provoz, Hranice)	5	1	4	4	3
	Agriculture Support programs (Investice, Mládí, Export)	2	2	1	3	3
	Preservation and renewal of cultural heritage	3	3	1	3	3
Human Resource Development	Research and Development support programs of MIT (Export, Centers, Stratech)	1	1	3	4	5
	CBC Phare Small Projects Fund	4	2	3	5	5
	AEP (active employment policy)	4	4	1	3	5
	Palmif (Pro-active Labor Market Intervention Fund)	4	4	3	3	5
	Development of social services	1	4	4	3	5

NOTE: Five points represents high compatibility with the EU principles of policy of economic and social cohesion, one point represents the lowest score.

6. CONCLUSIONS AND POLICY IMPLICATIONS

An extensive set of support programs that are implemented by the central bodies of state administration towards both the public and private sector covers relatively evenly all three priority pillars of EU cohesion policy, i.e., development of infrastructure and investment in the environment, human resource development and business support. Therefore, from this point of view, the set of support programs is elaborate and balanced. In total, the volume of financial resources is massive and amounts to several dozen billion CZK (EUR billion).

Despite the sophisticated nature of support programs and the sizeable amount of financial resources, the package of support programs suffers from several serious weaknesses, which radically reduce their effectiveness and efficiency. In the case of the municipalities, the basic weakness is the instability of their financing system. Frequent and radical reforms of the system of local government financing (and therefore also significantly reduced predictability of revenues in the future) limit the possibilities of municipalities to participate in different support programs. As a consequence, participation in state support programs that as a rule require co-financing from municipalities becomes relatively risky ventures. On the one hand, this lowers the interest of municipalities in submitting project proposals; on the other hand, it contributes towards the growth in municipal debt (a sizeable proportion of municipal debt represents financial obligations connected with drawing resources from state support programs). This weakness is compounded by the fact that a majority of municipal projects are implemented from the resources provided by the state budget on an annual basis and consequently these resources have to be allocated, committed and administered into the accounting system within the year. The financing of funds operating on a multi-annual basis is rather an exception.

As far as support programs for entrepreneurs are concerned, the principal weaknesses are insufficient impact and a cumbersome administrative procedure. Both these weaknesses are closely connected with the fundamental shortcoming of the support programs in general, which is their enormous fragmentation. In the Czech Republic public support is provided via several hundred programs and sub-programs, which as a rule suffer from insufficient financial resources and require different criteria to be met for each individual program.

Excessive fragmentation of support programs thus drastically increases the administrative costs of implementing these programs, especially projects' planning, evaluation, selection and contracting. This, in turn, increases the costs of financial and physical controls. The high costs of administration squeeze not only support programs' promotion expenditures among potential beneficiaries, but also the amount of resources allocated to supported projects themselves. Another negative aspect caused by extreme fragmentation is the complex and unclear nature of the whole system of support pro-

grams. This hinders access to these programs particularly to small and medium-size enterprises (SMEs). For SMEs it is difficult to find out what kind of support programs are on offer, and more notably, difficult to acquire the specific knowledge needed for project application and implementation.

A key source of problems with coordination is the lack of application of the principle of programming for evaluation of social and economic relevance and effectiveness of support schemes. In the same vein, the support programs are only very exceptionally tied to corresponding sectoral strategies. The condition of a proposed project to be included in local or regional development strategy is in fact applied only in a single support program financed by the Czech financial sources, the countryside revitalization program. However, it should be stressed that over the last two years a significant improvement in this sphere has been recorded, and as a rule relevant sectors have approved strategic programming documents, though even now the situation is far from ideal. Frequent weaknesses observed in programming documents are their limited mutual consistency, a tendency to overlap together with a somewhat formal approach towards their drafting that stifles invention.

Owing to the limited coordination of supported projects via the principle of programming, the principle of partnership is also often executed only in a formal sense. The same criticism concerns the issue of transparency; a clear and equal approach towards all subjects is supposedly applied, but in practice there is a huge overhang of demand over supply due to limited financial resources allocated to individual support schemes.

A solution to all these shortcomings is possible only by a radical reduction of the number of support programs, which should be formulated more broadly and should correspond to priorities defined by corresponding national and regional strategic documents.

A possible impetus for such a radical restructuring of state support programs, especially those aimed at supporting final beneficiaries of decentralized bodies of public administration, might stem from the newly introduced regional self-governments. It is likely that after solving the fundamental problem of their very existence, the representatives of new regions would expect that the state would decentralize responsibility over at least some support programs. Moreover, the government itself is becoming more and more aware of excessive fragmentation of its support programs, and therefore recently decided to shift all responsibilities for support to SMEs to one ministry (the Ministry of Trade and Industry). This indicates that the role of this ministry is rather weak and even opposition politicians feel that after the parliamentary elections this ministry might be abolished. This would inevitably cause changes in the package of support programs administered by the ministry both in the sense of their number and focus and procedural matters.

Nevertheless, the outcomes of all these factors and different interests is difficult to assess as there are permanent attempts from varying pressure groups to establish new support programs. Consequently, it is unlikely that a radical change in the system of

support programs would be accepted; more likely is a gradual modification of a package of support programs.

Looming EU accession is also having immediate effects on the reorientation of Czech regional policy. More specifically, EU accession would see Czech regional policy come under the authority of the EU itself. The task of national regional policy should be primarily to eliminate the leverage effect of support from the Structural Funds (SFs) in the form of matching grants, as poorer regions would not be able to provide sufficient financial resources for co-financing eligible projects. Therefore, Czech regional policy might provide, for example, an additional 15% of the cost of co-financing projects implemented in the most needy regions.

In much the same way, towns and municipalities should already pay special attention to healthy financial management as large debts might prevent them from access to the generally very favorable support offered from the SFs. The municipal debt represents not only danger for the stability of public finances. After accession (and to some extent even now) the CCs will be obliged to proceed towards the convergence criteria defined by the Maastricht Treaty. Sound financial management of municipalities is especially relevant given their expected prominent role in the future co-financing of SF programs (municipalities allocate more financial resources to investment projects than the state itself).

The reorientation of national regional policy towards the EU cohesion policy would also require a change in its time horizon from the current annual programs to a multi-annual approach. The Czech Republic also lacks the evaluation culture necessary to guarantee effective and efficient use of public sources. This is true of both specific regional policy and the public sector in general. Furthermore, along with the mostly technical changes in national regional policy there are also more conceptual questions that must be clarified.

One of the big challenges facing CCs is a gradual switch from low-road to high-road strategy of competitiveness (see also Porter, 1999). The current advantage of low costs does not offer a sound basis for catching up with West European countries. Therefore, for example, the current emphasis of state policy for inward investors should refocus from traditional investment incentives to after-care programs aiming at maximizing the effects of existing foreign investments. Also, emphasis should be placed on shifting the structure of investment towards the more sophisticated, higher added value industries. The goal should not be an immediate rush to open high-tech industries but medium-tech would be a good start (e.g., customer service centers for software producers, or the opening of local offices of international audit or consultancy firms). Secondly, from a regional point of view, it would be desirable to promote less uneven spatial distribution of FDI (foreign direct investment). Such a promotion would be best achieved by a combination of “hard measures” such as the provision of adequate infrastructure, and “soft measures” including territorial marketing.

However, perhaps the most significant change in the sphere of regional development and regional policy in comparison with the beginning of the transition is the existence of relatively mature entities, especially self-government bodies in larger towns, regional development agencies and others. However, the regional self-governments are only now learning how to play their role effectively and it will take time before they will fully establish themselves. Unfortunately, some of the Czech regions seem to replicate the main weakness of the support program—i.e., the huge fragmentation into smaller programs. Several of the fourteen self-governing regions are preparing their own tiny support schemes aimed mainly at supporting development of infrastructure by municipalities or tourism-related activities, partly to justify their significance or even very existence.

Currently, however, even the basic framework for the operation of new regions is not established. Competencies are unclear; moreover, additional transfers of competencies are being prepared and property transferred to the regions is saddled with huge internal debt. However, the most visible symbol of weakness of the new regions is their financing system. The regions are receiving by far the largest share of their incomes in the form of special grants for education (about 90% of their total incomes). The representatives of the regions are now fighting for a larger share of public budgets and the means to generate real sources of own revenues.

Therefore, in the future, the initiative and qualification of local and regional representatives will thus become important factors in local and regional development. Of principal importance is the need to shift priorities in regional development strategies from the current stress on technical infrastructure towards business support (now starting but mostly limited to building industrial zones) and especially towards the development of human resources (retraining, life-long learning, etc.), which remains an undiscovered area for most Czech municipalities. Investments into human resources would increase not only the competitiveness of domestic firms but also the attractiveness of the country for investors in the tertiary or quaternary sector or—within the secondary sector—in medium-tech and even high-tech industries. Obviously, this task is a challenge not only for the state but also for the municipalities, regions and private firms whose current interest in workforce education and research is insufficient. These changes would help the switch from a low-road to a high-road competitiveness strategy and thus help facilitate a real integration of the Czech Republic into the wider European economy.

ENDNOTES

- ¹ Until 1990, at the district level functioned bodies *elected* under communism. These representative bodies were abolished in autumn 1990. Since then, districts are performing only the tasks of state administration. These bodies of state administration are called *district offices*.
- ² Establishing fourteen regions was approved by constitutional law in 1997. The regions started to function in January 2001.
- ³ Firstly, however, a 30% share of revenues is allocated to the municipality where the entrepreneur has a permanent address.
- ⁴ All the data relating to France exclude the French overseas territories.

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Capital Investment Funding in Hungary

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Capital Investment Funding in Hungary

Executive Summary

Károly Jókay, Zoltán Kristóf, Gábor Szepesi

INTRODUCTION

The overall goal of this study is to serve as a basis of comparison between the capital investment support systems of other transition countries with a level of development similar to Hungary. The range of capital investment funding discussed in this paper is limited to infrastructure, business promotion and labor force development. The analysis, not all of which is summarized below, is divided into the following chapters:

- A short description of the Hungarian public administration system and model of self-governments/municipalities, with special regard to the allocation of development responsibilities at each level.
- A description of significant anomalies in development levels between certain Hungarian regions and the measurements used to identify and describe these anomalies.
- Inventory of financial resources with regional aspects, that is, funds and development resources flowing into the public sector, in the areas of infrastructure, business promotion and labor force development.

1. PUBLIC ADMINISTRATION AND REGIONAL DEVELOPMENT LAYERS

Public administration in Hungary is divided between state public administration and public administration performed by local government. Hungary has nineteen counties (NUTS III level—Nomenclature of Territorial Units for Statistics) and over 3,100 municipalities (NUTS V level). The NUTS II level is represented by seven regions. Beyond planning and coordination, regional officials have few functions. The NUTS IV level exists only as informal micro-regions and associations with no funds, self-government or administrative functions. Each municipality is equal before the law. There are two elected layers of governance: parliament and over 3,100 municipal assemblies.

Hungary's NUTS II level regions were created after nearly six years of intense debate that included options to turn Hungary into one NUTS II region together with general disagreement over the defining of inter-regional boundaries. Boundaries were not based upon demographic, economic or geographic fault lines but rather by political compromise; the nineteen counties were retained and added together to form regions. The next debate, naturally, centered on which "poorer" counties to include in the Central Region dominated by Budapest which exceeded 75% of the EU reference GDP per capita figure by the late 1990s.¹ Regions stretch laterally over diverse economic and geographic zones in an arbitrary manner. Moreover, existing county boundaries do not reflect economic, topographic or political conglomerations. Each county, with a capital city and perhaps a powerful "second city," then added to the debate over which city in each region should be considered as the headquarters for regional planning and organization. The outcome is that cities take turns providing headquarters, or county governments rotate the provision of the logistical and administrative support needed to conduct the limited tasks assigned to the Regional Development Councils. What the EU first proposed as a rational method of ensuring regional cooperation and investment resulted in seven distorted regions optimizing political and poverty considerations, rather than organic regional considerations. A section in the annex on regional disparities based upon the county and the NUTS II level regions, as units of comparison, will demonstrate the arbitrary and purely illustrative nature of these units.

1.1 Mismatch of Roles and EU Expectations

Two pieces of legislation guide regional development in Hungary, the 1996 and 1999 Acts on Regional Development. Regional development naturally includes the private, voluntary, non-profit and international sectors. However these laws, in addition to defining the NUTS II regions listed above, assign specific regional development roles (and allude to funding) for the following levels: national, regional, county and the micro-region. Regions have a partnership role in this system, while the NUTS IV level micro-regions only exist as voluntary associations created by the NUTS V level municipalities. Neither the NUTS II nor the NUTS IV levels considered critical by the EU pre- and post-accession funding sources have administrative or self-governing roles. Concurrently, the NUTS III level, counties, and the NUTS V level, municipalities, both of which possess democratic legitimacy and have true public administration functions, lack funding and authority to conduct capital investment for regional development. This political and economic tension has made it difficult for Hungary to organize its SAPARD offices and to develop the skills and institutions needed to eventually compete with successful EU regional grant applicants such as Ireland (one NUTS II region), Catalonia and Alsace.

1.2 Hungary's Regional Development Dilemma

Those organizations with the greatest democratic legitimacy and citizen involvement have the least authority and certainly no own sources of funds with which to conduct regional development. Conversely, the National and Regional Development Councils and the County Regional Development Councils control funds for which municipalities and micro-regional associations, private businesses and NGOs have to compete. Ministries, national agencies and other authorities dominate the Regional Development Councils and the National Regional Development Council and may decide over the allocation of funds and supervise their use, while micro-regions, led by municipalities, are in a subordinate grant-seeking position even though their plans may reflect true cross-sectoral and grass-roots interests, both indicators of subsidiarity, an oft-cited goal of EU funding.

1.3 Regional Development Councils

Both the National and the Regional Development Councils make funding decisions, adjudicate over potential conflicts among the plans of lower level organizations, supervise and audit the use of grant funds by applicants and have the power to coordinate and override the goals and plans of lower level organizations at the county and micro-regional level. Both the Regional Councils and the National Council have the authority to rank counties and micro-regions in order of priority and can develop their own systems of classification, albeit in an EU-compatible fashion.

The Regional Development Councils were only formed under pressure from various EU funding sources that require plans to be made on a regional basis. Instead of creating regional governments or authorities, Hungary's seven "statistical-planning" regions form the target areas for EU funding, and legislation requires that the national budget allocate funds to each region annually. Representatives of the County Development Councils, the county assembly presidents, are the only elected officials on the Regional Development Council. The rest are delegated and subject to ministerial veto if conditions deem it necessary.

The County Development Council is the first level of organization dominated by elected officials of a self-governing body. Their role is to coordinate the various plans of municipalities and micro-regions, as well as of NGOs and private businesses. The County Development Council prepares financial plans and takes part in the allocation decisions regarding the various available national equalization funds. The Council gives grants as well as supervising the implementation and monitoring the use of funds. The Council itself may seek funds for its own operations and for the giving of additional grants. Some counties have created budgetary agencies to provide administrative sup-

port for the Councils. Others use existing administrative staff, or create non-profit foundations either alone or in cooperation with private enterprises and municipalities. Members include the county assembly president, mayors of cities with county rights within their territory and development associations created by municipalities as well as others.

Development associations established by municipalities have only one legally mandated function: approving micro-regional development plans. Given that members can only be municipalities, these development associations are governed entirely by elected officials. There are 176 such micro-regional associations and only 152 “official statistical” micro-regions, indicating that the Statistical Office’s micro-regions do not necessarily reflect legitimate NUTS IV level micro-regions that are voluntarily created and organic in nature.

2. REGIONAL DIFFERENCES AND THE TRANSITION DECADE (1990–1999)

Before 1990 the socialist system made attempts to even out social and economic differences using administrative measures in line with the ideology of the day. Between 1950 and 1990 the most advanced region was characterized by heavy industry; chemical manufacturing and mining in the mountains of northwestern and central Hungary, essentially created a north-south divide where none had existed before. This industrial zone relied on coal mining and upon the import of raw materials such as iron ore from the Soviet Union, and its traditional heavy industry exported on a barter basis and ultimately for “convertible rubles” to the CMEA.

After the political changes in 1989–90 Hungary’s economy rapidly reoriented itself to trade with the European Economic Community, and within that, Germany. Economic transformation, rapid privatization and quick liquidation of loss-making socialist enterprises, combined with the disappearance of both the CMEA and the Soviet Union, led to dramatic increases in unemployment and even sharper regional differences. Foreign investment poured into Budapest and western Hungary while areas formerly dominated by heavy industry received scant attention. With the collapse of both the CMEA and internal markets, the entire industrial belt faced bankruptcy and high unemployment. With essentially no labor mobility, unemployment in the 20–30% range dominated in the former industrial towns. However, formerly underdeveloped border regions with no prior industry realized that they now had major strategic advantages due to open borders. Greenfield investment moved from the Austrian border along major roads to Budapest, bypassing the former industrial zones.

The structural and transformational crisis peaked in 1993–94. Macro indicators such as unemployment, inflation, public debt and international sovereign debt began to

improve significantly. Services, the financial sector and export-oriented manufacturing showed significant expansion. The structure of the economy shifted to export-oriented manufacturing and services funded by international greenfield investors in automobiles, electronics and components. The industrial crisis zones remained in place, showing little change as investment and growth took place in areas previously not afflicted by socialist heavy industry.

Several regions began sustainable development in the mid-1990s, reinforcing gaps among the successful and peripheral areas. The development gap between wealthier and less fortunate areas grew not as a consequence of any continuing structural crisis, but rather as a consequence of differential growth rates and development patterns. In other words, less fortunate areas also began to improve by the late 1990s. Greater Budapest and the northwest of Hungary, as most but not all of the indicators cited below will demonstrate, increased their advantage over the rest of the country.

2.1 Budapest's Dominant National Role

Hungary's capital plays a disproportionately dominant political and economic role, since its economic indicators in many respects are a notch above the nearest large city. The largest gaps in development and other economic indicators are not among regions or cities in rural Hungary, rather between Budapest and the rest of country. When greater Budapest, or an outer ring of villages and cities essentially a part of the metropolis are included, then this dominance is even more evident. Consequently the Central Region that includes Budapest is an anomaly. (Given that Buda and Pest were united during the golden age of the Austro-Hungarian Monarchy in 1873, the modern city was built to govern over a kingdom triple the size of contemporary Hungary.)

With 1.8 million residents within the city limits and another half a million in the surrounding areas, Budapest is Central and Eastern Europe's largest city, encompassing over one fifth of Hungary's population. Including the agglomeration areas, Budapest includes nearly a quarter of Hungary's population. Hungary's next tier of large cities barely approach 200,000 in population, resulting in a 10:1 difference in city size between the largest city and the second largest cities.²

When unemployment rose above 20% in the industrial belt, Budapest, always a magnet for labor resources, never suffered more than 7% unemployment. Over 65% of foreign direct investment in Hungary appeared in Budapest, where services, in particular financial services, dominate. As a result, 35% of Hungary's GDP, and more than half of its personal income tax and VAT receipts are produced there.

2.2 Regional Differences in Major Indicators

Official unemployment was first defined and measured in explicit quantities after the collapse of socialism. In the prior system, unemployment was disguised “within the gate” and restrained by administrative methods. After the collapse of the CMEA as an export market and the rapid restructuring of the domestic economy, unemployment reached a maximum national average of 12.1% in 1993. (Since then national unemployment dropped below 6% signaling that some areas in Hungary actually had labor shortages in 2000–1). That 1993 average included a low of 7% for Budapest and rates of over 25% in some blighted industrial areas. Unemployment remained below the national average in the large cities and Budapest given the social and welfare infrastructure in place that allowed low-paying jobs to persist. A special feature of Hungary’s structural unemployment is that it was not confined to only the blighted zones, but since there were quite a few commuters living in distant villages, their release transmitted industrial unemployment to locations far from the original problem. These long-term, long-distance commuters who only went home on weekends were let go first. As a consequence, unemployment that emerged in northern steel mill towns was rapidly transmitted to rural agricultural areas in the plains.

Those agricultural areas were already in crisis when the newly unemployed commuters returned home. Thus pockets of industrial malaise spread unemployment nationwide. Fortunately the crisis broke in 1994, with long-term unemployment only really evident in the original crisis zones. In 2000 national unemployment had dropped to 6.4%, with the worst county rate at only 11%. By late 2001 the national rate slid below 6%, with only 4% in Budapest, essentially showing a full employment situation. By late 2002, the Central Region (including Budapest) showed an unemployment rate of 4%, with the worst region measuring 8% unemployment. The absolute and relative unemployment rates dropped by 2002, and the gap between Budapest and the poorest region also narrowed to 2:1 versus a 4:1 difference in the most difficult transition years of the early 1990s.

Differences in income and consumption correspond directly with regional differences in economic development. Accordingly, the highest indicators are produced by Budapest and northwest Hungary. A useful indicator for the consumption of durables by both the population and businesses are the number of cars per 1,000. The most rapid growth was shown in the suburbs of Budapest, as over 200,000 people left the city center in the 1990s.

2.3 Infrastructure at the Settlement Level

The gap in urban infrastructure such as water, gas, sewage treatment and telephone service has rapidly closed during the 1990s. This meant an improvement in living

conditions throughout the country, even in blighted areas. Economic renewal was not hostage to the lack of water, gas or phone lines, but rather largely determined by factors such as proximity to borders and transportation access. Regarding water treatment, there is nearly universal access to piped drinking water in Hungary, while access to sewage treatment is more limited.

3. REGIONS AS UNITS OF COMPARISON

When using regions as a basis for comparison, Central Hungary with Budapest dominates all indicators of economic development and output. In addition, the two northern Transdanubian regions form the top third. South Transdanubia, however, shows a lack of development similar to areas in the plains or northeastern Hungary. Development trends show an increasing gap in terms of income, consumption and general economic development between the most developed and least developed regions. On a positive note, urban and settlement infrastructure such as water, gas and sewage service has shown significantly decreased disparity between the wealthy and less fortunate areas of the country.

Differences within each region are often larger than differences among regions. Since each region is a conglomeration of poorer and more developed counties and micro-regions, comparing regions involves creating averages that may not apply to any specific place within the region. Each region contains successful micro-regions, groupings of villages or urban areas, whose results are distorted by the effect of the rest of the arbitrary region. Development seems to follow in lines *completely unrelated* to the boundaries of the NUTS II regions or other political units, while other forms of development converge on and emerge from city-states that act as islands in otherwise failed regions. (An example would be Nyíregyháza, with only frictional unemployment, surrounded by a county with an unemployment rate ten times the rate of its county capital and a regional unemployment rate double that of Budapest).

Regional development programs intervene in market trends by attempting to pull up poorer regions, but the overall effect of such interventions pales by comparison to the volume of market-driven funds that create and reinforce these regional tendencies and differences.

4. INVENTORY AND ANALYSIS

The inventory and analysis of regional development funding in Hungary in the annex covers infrastructure that includes facilities that are either directly or indirectly indispensable for the alleviation of regional anomalies, upgrading underdeveloped areas and the provision of development opportunities for a given geographical unit, municipality, region, self-government or population.

The definition of infrastructure includes primary industry and service generation factors which are regarded by several industries, regardless of their output, as their input elements. Their presence is indispensable in regional development and the effective organization of production, consumption and services. Infrastructure could also be described simply as an economic base; nevertheless, this term is not deemed to be definitive enough.

The inventory in the annex details the funds that contribute to regional development projects and the relevant financial volumes are also indicated. Here, only such funds will be discussed that have or ought to have some regional aspects. However, the legislative stipulation of the many municipal responsibilities was not followed up by the allocation of adequate central funding; consequently the limited financial possibilities of the self-governments and municipalities proved to be a barrier to kick-starting the necessary infrastructure development projects. The insufficiency of funds contributed by the self-governments and municipalities themselves caused the environment protection projects to become far too dependent on central budget allocation, and the volume of renovation projects falls short of covering the annual depreciation rate of assets.

As EU accession approaches, there is an increasing need for local public capital investment infrastructure projects. However, given the high number of austerity measures, the level of government support provided for self-governments and municipalities is constantly decreasing in real-terms. Therefore, in view of the decreasing real-term revenues of self-governments and municipalities, a shortage of funding for capital investment projects can be expected in forthcoming years.

The annex also analyzes the volume of regional development expenditure in the individual sectors, i.e., the role the government plays in the sectors of water management, sewerage, waste management, provision of gas, industrial parks and tourism. Primary data are available on the magnitude of funds flowing into the individual sectors, but it is difficult to identify the distribution of funding sources per individual project or project type. The available data clearly reflect the magnitude of certain centralized funds, e.g., the absolute and relative volume of targeted and addressed support grants allocated to capital investment projects, but the distribution of the funds used and their absolute volume by segment cannot be identified. In other words, there is no national or regional breakdown to indicate the volume of grants by individual completed infrastructure project.

5. EVALUATION AND CONCLUSIONS

For the purpose of this paper, the Hungarian research team proposed a scaling system to evaluate domestic and EU regional development funds aimed at improving infrastructure in the transitional countries. That grading system and general results are reproduced below. Comments on each EU criteria such as concentration, programming, etc., are

given at the end of this executive summary. The tabulated evaluation along five predefined criteria uses a scale of five grades where grade one indicates that a given criterion is hardly met whereas grade five indicates that a given criterion is fully met.

5.1 Concentration

Under the criterion of concentration the analysis asks whether the given funds are provided in a coordinated way and focused sufficiently on the tasks to be implemented, or scattered across various sectors.

- Programs scored the highest grade where the equalization of regional anomalies is a fundamental goal.
- Programs where apart from the equalization of regional anomalies other aspects (sectoral ones) are also significant scored four points.
- Programs where regional equalization and sectoral aspects carry approximately the same weight scored three points.
- Programs where regional equalization is only a subordinated aspect have scored two points.
- Programs where the equalization of regional anomalies plays no part at all scored one point.

5.2 Programming

- Programs that are fully in line with a development strategy that encompasses several sectors or are part of such a strategy have scored five points.
- Programs that are to a high extent in line with a development strategy encompassing several sectors have scored four points.
- Programs where the development strategy encompassing several sectors carries approximately the same weight as the given development projects have scored three points.
- Programs where compatibility with the development strategy encompassing several sectors is only traceable have scored two points.
- Programs that are incompatible with a strategy encompassing several sectors have scored only one point.

5.3 Partnership

Under the criterion of partnership we analyzed the scope of government coordination, whether all the stakeholders have been sufficiently involved in the decision-making process and whether there is central dominance or the decisions are based on consensus.

- Programs and funds where the stakeholders are fully involved and the decisions on the allocation of funds are not automatic score five points.
- Funds where partnership is mostly visible but is not always perceivable in the decision-making processes score four points.
- Funds where partnership in support issues is only formal, and one of the parties outweighs the others score three points.
- Funds where there is only some semblance of cooperation score two points.
- Programs where decisions are quite openly made without any cooperation score one point.

5.4 Additionality

- Programs that may usually be implemented with 50% or more matching funds scored five points.
- Programs scored four points where substantial matching funds are required.
- Programs scored three points where more than nominal matching funds are contributed.
- Programs scored two points where there is only a nominal matching fund requirement.
- Programs scored one point where no matching funds are required.

5.5 Transparency

- Five points were scored by programs where the terms and conditions as well as the procedure preceding the award of the grant are absolutely transparent, and information—(a) on the size of the program, (b) the amounts of committed vs. uncommitted funds at any point of time during the program and (c) the list of grant recipients—is clear and available to all interested parties.
- Programs that have less transparent or fairly complicated and intricate components in their terms, conditions and proposal evaluation and monitoring processes scored four points.
- Three points are scored by programs which are fairly transparent and can be kept track of, but contain elements in the terms and conditions, the awarding procedures or in the use of funds that are uncertain and resist the scrutiny of the public.
- Two points are scored when the terms and conditions are somewhat transparent when the program is launched, but as the program progresses they become increasingly nebulous, ending up completely opaque at the end of the day.

- One point is scored when it is only the outline of the program that is perceivable, but the terms and conditions for the submission of proposals and the proposal evaluation procedures are only known by the initiated.

Table 3.1
Assessment of Major Regional Development Programs
in Hungary

Regional Infrastructure Support Type	Concentration	Programming	Partnership	Additionality	Transparency
PHARE program	5	5	1	4	3
SAPARD program	2	5	4	5	3
ISPA program	2	5	2	5	3
Targeted and addressed grants	4	2	3	3	4
Rural development targeted appropriation	5	4	4	5	3
Economic development targeted appropriation	3	4	2	5	2
Regional economic development targeted appropriation	3	4	2	5	2
Targeted appropriation for small and medium businesses	3	4	2	5	2
Targeted appropriation for tourism	3	3	2	5	2
Environment Fund targeted components	3	2	3	5	2
Water management targeted appropriation	3	3	3	5	3
Targeted appropriation for road maintenance and development	2	2	3	5	4
Tax relief	4	4	2	1	5
PHARE programs for human resource development	5	5	1	4	3
Labor Market Fund	4	4	4	3	4
Labor force development under the Ministry of Social and Family Affairs—PHARE	4	5	3	5	2
Labor force development under the Ministry of Social and Family Affairs—community works program	4	4	2	1	4
Student loans	1	1	1	1	2

6. ANALYSIS OF IMPLICATIONS

6.1 Concentration

- Disparities in the levels of unemployment have moderated in the 1990s as a consequence of economic growth, with foreign investment perhaps levelling out inequalities in physical infrastructure.
- Income disparities between Budapest and the rest of the country, the central region and northern Transdanubia versus the rest of the five regions have widened as a consequence of high income jobs being created by foreign investment.
- The apparent income gap between city and rural areas has widened.
- Unemployment dropped to 6% on average in 2002, with 4% in Budapest and only 8% in the worst-off region. This indicator shows relative and absolute improvement for all regions.
- Regional policy reinforces successful and otherwise attractive regions. With the exception of physical infrastructure such as roads, water and waste water facilities, regional policy does not overcome regional disadvantages.
- Telephone (fixed and mobile) service is universal with over 50% penetration of both throughout the country. There are few disadvantaged areas regarding access to the most advanced telecom services.
- Instruments to attract investment to less advantaged areas such as local tax exemptions, corporate tax breaks and relief from some payroll taxes in distressed areas have been deemed as incompatible with EU membership. Individual exceptions are being negotiated for the largest investors. Local tax policy will be handicapped by EU requirements for equal treatment regardless of the underlying economic condition of the community giving tax exemptions to encourage private investment.
- Development funds are scattered across sectoral ministries and national agencies.
- Poorer areas do not have the capacity to plan, prepare or execute projects that require a contribution from their own funds.
- Investment follows existing (Győr–Székesfehérvár–Budapest) communications links and anticipates improvements to physical infrastructure when seeking new sites (Nyíregyháza).
- Foreign investors attracted by tax benefits and cheap labor have begun to select sites and to shift production from Hungary to Romania and Ukraine where labor remains relatively inexpensive.
- Public investment in communications and environmental infrastructure seems to facilitate greater regional equalization than industrial development subsidies and tax schemes.

6.2 Programming

- Cross-sectoral strategies do not seem to guide the distribution of ministerial and national agency funds
- There are dozens of funding channels for similar projects with no apparent coordination.
- Regional and national plans seem to be written for providing the prerequisites of EU funding under Interreg, PHARE and other programs, rather than being truly comprehensive, bottom-up documents.
- The NUTS II regions face the constitutional and administrative challenge of developing executive bodies and public oversight so that they may receive and guide the use of EU funds up to and after accession.

6.3 Partnership/Subsidiarity

- Regional institutions, local governments and “socio-economic partners” associated by and with national governments are not effectively involved in the selection, design and execution of public investments in:
 - 1) local infrastructure;
 - 2) income/employment promotion;
 - 3) human resource development.

6.4 Additionality

- Co-financing is interpreted as the host country’s contribution to a project funded in part by the EU.
- Beneficiaries such as municipalities, counties, micro-regions and regions do not have the financial capacity nor authority to provide proper co-financing, co-payments or “self-contributions.”
- National ministries and agencies require co-financing in domestic projects by beneficiaries such as municipalities. These are seldom in cash and in reality do not exceed 5–10% of the total project cost. (Often this is in the form of in-kind contributions or the designation of other donor funds as “self-contributed.”)
- There are proposals being formed by the new Socialist government to design a special equalization fund to give poorer communities grants that they can use in co-financing. The lack of own source capital funds, and the inability to generate operational surpluses and local taxes are the major obstacles and dividing lines that

define whether a community is able to take part as a “partner” using the principle of “additionality.”

- Future EU co-financing requirements seem to be met by national-level co-payments that appear as a specific line-item in the state budget.

6.5 Transparency

- While the evidence is anecdotal and sparse, it seems that formal regional development grants and programs, both domestic and those donated by the EU and others, are run on a transparent basis.
- Public procurement laws, appeals processes, the State Audit Office and other investigative offices are available to address the complaints of bidders.
- In an informal sense, selection criteria are not clear, and the on-going and *ex post* external review of public funds does not seem to be adequate.
- The complaint of many bidders seeking public funds is that their bids are collected by an agency, the bid is cancelled for technical reasons, then re-announced with the ultimate winner (who may have not even been a part of the original call for bids) having been given access to the rejected bidders’ materials. Using this method, unstoppable bids can be assembled.

ENDNOTES

- ¹ The Central Region municipalities seek to remove Budapest from the region in order to stay below the 75% of the average EU GDP threshold farther into the future.
- ² Budapest’s traditional “twin city” was Vienna, while most of the next tier cities of historical Hungary are now in countries surrounding Hungary, such as Bratislava, Timisoara, Kosice and Uzsgorod. Budapest simply has no competition for resources within Hungary and is thus forced to compete with Vienna and other large cities in Central Europe. Hungary’s road and rail network is entirely Budapest-oriented since other regional hubs now lie in surrounding countries and the transportation system has not recovered from the shock of two world wars and several changes in borders in the 20th century.

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Mudite Priede, Agita Strazda

1. CONCENTRATION

1.1 National Policies and Activities Addressing Regional Disparities

In the mid-1990s, the government of Latvia, and in particular the Ministry of Economy and the Ministry of Environment and Regional Development, acknowledged the need to identify problem regions within the country and started to plan national level programs to address the development issues of these regions. As a result, there is no shortage of statistics available at the *pagast* level (the lowest local government level in Latvia), and the Annual Statistical Yearbook offers a mass of data covering a wide range of indicators. Using this data and other sources, the Ministry of Environmental Protection and Regional Development has published a booklet of over thirty maps that show the variation at *pagast* level of a selection of socio-economic and other indicators.

In this context, work initiated by the Ministry of Economy some years ago sought to identify the major types of problems that regions in Latvia face. These were grouped as follows:¹

- Regions that feature poor socio-economic development;
- Regions with poor agricultural development;
- Regions experiencing economic decline;
- Regions along Latvia's borders, especially those territories in the east;
- Coastal regions;
- The Riga metropolis;
- Regions with transportation corridors such as Via Baltica and the West–East transport corridor;
- The region containing the radar station at Skrunda;
- The Liv Shore.

Given such a comprehensive list, it is not immediately apparent just what parts of Latvia, if any, are considered problem free. Furthermore, the means by which such

regions might be defined were not specified, nor in some cases was the nature of the problems.

The rationale for identifying problem regions must be that, once identified, these regions can benefit from policies directed at solving the specific problems that each region faces.

The following initiatives are those that demonstrate the significant attempts that have already been made to address the question of regional development:

- Latvian Regional Development Policy;
- The identification of problem areas and the establishment of the Regional Development Fund;
- Latgale Development Project;
- Urban and rural pilot projects under the SPP;
- The Coastal Investment Strategy;
- Support for preparation of municipal and regional development plans;
- Rural Development Program;
- SME Development Program.

Each of these has been described in some detail in the report on the CD attached to this volume, but it is useful at this stage to note the objectives of the Latvian Regional Development Policy, which offers a comprehensive and wide-ranging approach to the subject. These are elaborated as:

- Creating the preconditions for ensuring a favorable and equal living environment, living and working conditions in all regions of Latvia;
- Decreasing and averting unfavorable regional differences and supporting preservation of positive differences;
- Ensuring sustainable development in Latvia and its regions, bringing the economic activity in line with preservation and enhancement of cultural and natural heritage;
- Creating preconditions for the integration of Latvia into the EU and the processes of its regional development.

Unfortunately, the development of regional policy in Latvia suggests that, despite the existence of the Latvian Regional Development Policy, there is considerable uncertainty about the nature and scale of the regional disparities, even though much work has been undertaken by the statistical office and the ministries in identifying problem regions. There is a lack of clear objectives associated with the actions currently underway, although this is understandable given the lack of quantified information. The concept has not been followed by regional development policy or activity programs to address disparities through coordinated regional investment programs. The programs mentioned above chiefly exist on paper; nonetheless, they can hopefully be used for developing specific programs for particular regions in the future.

There is also little evidence of any monitoring and evaluation processes to determine the effectiveness of the strategies and little coordination among the policies and strategies that exist within the various ministries, despite the existence of numerous inter-ministerial working groups.

Thus, in reality the only policy and financial instruments addressing regional disparities are the Program for Assisted Regions and the Regional Development Fund.

With the limited resources available to address all the problem regions, the decision was taken to identify those deserving of special assistance by reason of suffering long-term negative economic and/or social development trends. The Law on Assisted Regions is the enabling legislation that determines the general procedure for granting the status of assisted region and for promoting its economic development.

The power for granting and withdrawing the status of assisted region rests with the Cabinet of Ministers. The decisions are to be based upon statistical data, experts' estimate of the regions' development prospects and other indices but the Law is not specific about how these data, estimates and other indices are to be determined. Collectively, the assisted regions should not constitute more than 15% of the national population.

The problem regions were identified on the basis of ranked statistical indicators agreed to by the Cabinet of Ministers. One of the consequences of ranking of regions using a mix of indicators is that it is not then possible to determine what specific problems face the selected regions. It is therefore not possible to use the identification of troubled regions to help shape national sectoral policies to address specific regional problems. It is not surprising that other than the establishment of the Regional Development Fund, no national sectoral policies directed at these assisted regions materialized. In support of the Regional Development Fund it should be said that the fund still managed to create a significant number of jobs and support entrepreneurship activities in the most deprived regions of Latvia.

Other sectoral programs addressed the regional disparities in a fragmented or *ad hoc* way, typically with little coordination between sectoral policies.

1.2 Activities of Local and Regional Governments in Addressing Regional Disparities

According to several legal acts, the Local Government Law, the Spatial Planning Law and the Regional Development Law, local and regional governments are responsible for preparing and managing socio-economic, territorial and spatial plans for their areas. The majority of local and regional governments have developed such plans and, in tandem with their budgets, have attracted other investments to assist their implementation. Several years ago bigger cities and districts took the lead in initiating development policies for territories larger than one rural municipality or district and the Ministry of

Environment and Regional Development supported this process. Thus the first regional macro-level development program was created—the Latgale Development Program (the most deprived macro-region in Latvia on NUTS III level) in cooperation with the newly established Latgale Development Council. This was followed by the establishment of the Latgale Development Agency, which is responsible for the actual implementation of the program and attracting inward investment.

Other local and regional governments followed this example and a total of five planning regions have now been established in Latvia, the territories of which correspond to NUTS III level. The process of the development of planning regions was held up by slow government decision-making regarding local government and regional reform. Local and regional governments acknowledged the need for bigger regions for economic development purposes whilst the government debated whether to classify three, five or nine regions. Naturally, EU Regional Policy requirements regarding the programming and management of regional programs also influenced the process.

All planning regions have been voluntarily set up on the base of agreements between all levels of local and regional governments within the particular regions. All planning regions have councils as decision-making bodies, which are chaired according to a rotation principle. All municipalities that signed the agreement on the establishment of planning regions have assigned certain financial resources to run the development agency. The government has recently assigned resources from the state budget to aid the building of the Regional Development Agencies in the five planning regions.

Each of the planning regions has undertaken SWOT analyses of the regions and begun preparation of regional development strategies.

There is an ongoing debate concerning possible regionalization in Latvia. This debate was very topical more than a year ago, when Latvia had to make the decision on how the PHARE Social and Economic cohesion will be managed in the country. Since there were no administrative regions of NUTS III level, planning regions were involved in preparation of PHARE social and economic cohesion projects. This raised even more questions concerning the pros and cons of bigger administrative regions. Another problem related to regionalization was the redistribution of functions from central to regional level—something that the ministries were not capable of carrying out at that point in time.

After the EU expressed the strong view that Latvia will be treated as one NUTS II level and money will be assigned on the base of one single programming document (National Development Plan), it created embarrassment regarding the further development of regions (planning or administrative). At present there is a noticeable slowdown in the further development of regional reform, especially as parliamentary elections are looming. Nevertheless, planning regions still actively deal with planning issues and attraction of investments.

1.3 EU PHARE Social and Economic Cohesion Funding

The rationale for adopting a regional development approach is that it promotes economic and social cohesion by providing a mechanism by which resources (whether local, regional, national or international) can be allocated on the basis of identified and agreed priorities. Whether those priorities are about reducing regional disparities (the equity approach) or about the best allocation of limited resources on a straightforward cost-benefit approach at the national level (the efficiency approach) is a question to be answered.

With the introduction of the first year of EU PHARE Social and Economic Cohesion (EU SEC) funding, the government agreed with the EU that 10 million EUR of EU SEC money will go to the regions on the basis of regional development programs. Since there was no coherent national level regional policy addressing regional issues (the National Development Plan was still in the development stage) the solution was to assign money for the regions (planning regions) that were most able to manage EU SEC funds. The planning regions were required to submit expressions of interests certifying that they have political and administrative management of planning regions (Development Council and Development Agency), that they have a regional development plan and investment project proposals in line with this development plan. All five planning regions submitted the expressions of interests and the decision was made by the Cabinet of Ministers that the first year assistance would go to the Latgale and Zemgale regions. The resources were planned to target capacity-building of the Regional Development Agencies to prepare and manage grant programs and to pilot projects in the sphere of productive investments and the support of entrepreneurship.

However, the following year the decision was reversed, i.e., there was no longer to be a regional approach. This was brought about by the following statement in the EU document, *PHARE 2000 Review*:

“... smaller countries such as the Baltic States and Slovenia whose national territories equate to a NUTS II like region may opt only for sectoral schemes at the national level, generally including some form of regional concentration. ... A country's choice of implementation structure is also flexible. Regional programs need not be implemented by regional structures. They can be implemented by national ministries/agencies, if more appropriate.”

Thus PHARE Social and Economic Cohesion money in 2001 was available nationwide, which resulted in better prepared investment projects in the bigger Latvian cities. The selection of the projects was made mainly on the basis of the quality of the projects, but did not take in account any national or regional programming documentation.

This decision led to the creation of a lack of motivation among the planning regions to continue the development of arrangements necessary for preparation and management of regional programs.

2. PROGRAMMING

2.1 National Planning Framework

National programs are medium- and long-term target programs focused on priorities of the state. National programs cover the aggregate of activities to be implemented by the government in a certain area or a sector where such implementation is important for the development of society and the Latvian economy. Regulation No. 129 of the Cabinet of Ministers of May 9, 1995 on the Procedure of Development and Implementation of National Programs currently guides issues linked with the development of national programs. Out of fifteen programs included in the list of national programs approved by the Cabinet of Ministers, eleven programs are already developed and approved by the government.²

Table 4.1
List of National Programs

Drafted/implemented national programs:
1. National Program of Quality Assurance (responsible institution—Ministry of Economy);
2. National Program of the Development of Energy Sector (Ministry of Economy);
3. National Program for the Development of Small and Medium Sized Enterprises (Ministry of Economy);
4. National Program on Foreign Trade (Ministry of Economy);
5. National Program on Biological Diversity (Ministry of Environment Protection and Regional Development);
6. National Program on Development of Tourism (Ministry of Environment Protection and Regional Development);
7. National Program of Transport Development (Ministry of Transport);
8. National Program on Information (Ministry of Transport);
9. National Program on Road Traffic Safety (Ministry of Transport).
10. National Program on Culture (Ministry of Culture);
11. National Program: Population of Latvia (National Health and Social Security) (Ministry of Welfare);

Table 4.1 (continued)
List of National Programs

Programs in the process of drafting:
<ol style="list-style-type: none"> 1. National Program for Protection of the Environment of the Baltic Sea (Ministry of Environment Protection and Regional Development); 2. National Program on the Regional Development of Latvia (Ministry of Environment Protection and Regional Development); 3. National Program on Construction (Ministry of Environment Protection and Regional Development); 4. National Program: Production and Utilization of Biological Fuel in Latvia (Ministry of Agriculture).

The programs listed above are sector policies and programs that have no funds assigned to them, but which serve as a base for ministries' bidding applications to the annual budget. In short, this means that some of the activities or projects within each sector program are implemented depending on the decision of the Cabinet concerning specific ministry allocations.

At one stage the Regional Development Council initiated the debate on the need to evaluate sectoral programs in light of the regional dimension taken into account in preparing these programs. The problems with the various regional initiatives undertaken by ministries are the lack of clarity of purpose and the consequent uncertainty of the strategies employed together with the difficulty in assessing the effectiveness of their contribution to the regional development objectives as set out in the Regional Development Plan. The preparation of the National Development Plan is seen as a way to establish a coherent approach in dealing with regional development issues, but this is still some way off.

2.2 EU Structural Funds

National Development Plan

The EU has emphasized that it is particularly important for applicant countries to ensure that the plans do not focus exclusively on regional or sectoral issues but take full account of the national and international context. The various national plans will therefore need to start from an understanding of the ability of the applicant country concerned to meet the three types of condition for accession to the EU.³ This means that

attention will need to be paid to the National Program for European Integration and the National Budget and sectoral program (including the Public Investment Program). Regional development strategies can only be fully effective when they are developed with an appreciation of their wider context.

Nonetheless, while activity across all of the national territory of applicant countries will be eligible for assistance, the National Plans will be expected to include a description of regional disparities and development gaps and, where appropriate, proposals to respond to these. Such proposals may either be treated by a specific measure(s) or horizontally (that is to say across a number of sectoral measures). This raises a number of questions such as whether different regions should be eligible for different types or simply different levels of assistance or whether all disadvantaged regions need to receive assistance during the same programming period. However, perhaps the most fundamental questions to be resolved relate to the definition and delineation of regions.

If we were to follow the current practices within the EU in relation to Objective 1 regions the national development plan would include (among other things):

- A description of the current situation with regard to regional disparities and development gaps;
- A description of the appropriate strategy to achieve the regional development priorities selected, quantified where they lend themselves to quantification;
- A prior appraisal of the expected impact, including that on jobs, of corresponding operations with a view to ensuring that they yield medium-term economic and social benefits in keeping with the resources deployed.

However, the plan does not state how this vision will be implemented.

The NDP sets three priority areas:

- 1) Promotion of employment and competitiveness,
- 2) Development of human resources,
- 3) Development of infrastructure.

Yet, the identification/selection of development objectives/targets to be followed by action plans (and later by concrete projects) is missing. Nor is there an identification of the ways to achieve the objectives (e.g., financial planning, coordination between various sectors, type of activity or action plan, etc.).

The definitions of strategic objectives and development trends for each of the regions is presented in the plan, but no measures are suggested to address the regional disparities.

3. PARTNERSHIP/SUBSIDIARITY

3.1 National Funding Mechanisms

To date, there has been no common partnership system in place with respect to the planning, managing and monitoring of national programs and funding mechanisms; in the main the programs have been administered by ministries or state agencies. Management and monitoring have been performed through councils, boards, coordination committees and commissions consisting of representatives of various ministries and state institutions linked to a particular program or fund. In some cases social partners have been involved at the consultation stage, but the only social partner continually involved in managing and monitoring of state assistance programs was the Union of Local and Regional Governments of Latvia. Even in the case of the Assisted Regions Program and the management of the Regional Development Fund the only social partner was the Union of Local and Regional Governments, whereas the other members of the Regional Development Council were representatives of the ministries and even MPs. With the introduction of EU Structural Funds (involving preparation of National Development Plan, SAPARD, EU Social and Economic Cohesion, Special Preparatory Program for introduction of EU Structural funds in Latvia) the role and composition of the Regional Development Council will be changed.

3.2 EU Structural Funds

Starting in 2000, one of the responsibilities of the Latvian administration was to monitor EU pre-accession financial instruments. Therefore procedures to ensure effective monitoring of PHARE, ISPA and SAPARD activities were set in place and monitoring committees were established.

During the organization process of the SAPARD and ISPA Monitoring Committees (MC) experience already has been gained on the involvement of social and economic partners in discussions to ensure effective and qualitative implementation of the programs.

The composition of the SAPARD and ISPA Monitoring Committees is stipulated in the national legal acts. It ensures that the SAPARD MC consists of representatives from line-ministries, local municipalities, different non-governmental and socio-economic institutions and representatives from the EU.

Membership of the ISPA MC is already stated in national legal acts as well as in the Rules of Procedure for the ISPA MC. It consists of representatives from line-ministries, the EU and local municipalities as well as contractors. After discussions held with environmental NGOs it has been agreed to ensure the possibility for them to participate in the ISPA MC as observers.

It is envisaged that the Structural Funds MC will consist also of the representatives of social partners and statutory bodies representing equal opportunities, environment, poverty and rural development dimensions. The organizations to participate in the process will be identified at a later stage during a consultation process based on the partnerships established during the preparation of the Development Plan.

Taking into account the experience gained during the development of the monitoring system for the EU pre-accession financial instruments, first steps have been taken for establishment of the Structural Funds MC. In the guidelines adopted by the Cabinet of Ministers on March 19, 2002 it is proposed that representatives of public authorities, social and economic partners and others will form the committee. The following membership structure is expected:

- Ministry of Finance—Chairperson (representative of Managing Authority);
- State Treasury (representative of Paying Authority);
- Partner Institutions (Ministry of Welfare, Ministry of Agriculture, Regional Policy and Planning Directorate);
- Intermediate bodies;
- Line-ministries (Ministry of Economy, Ministry of Education and Science, Ministry of Transport, Ministry of Environmental Protection and Regional Development);
- Five planning regions and Union of Local Governments;
- Social partners;
- Statutory bodies representing equal opportunities, environment, poverty and rural development dimensions;
- European Commission (Observer);
- International Financial Institution—European Investment Bank (Observer).

The Cabinet of Ministers will clearly define responsibility of each body involved in the management of Structural Funds. The Monitoring Committee will be the only decision-making body led by the Managing Authority. The Monitoring Committee has the right to establish specific task-oriented working groups if necessary (the text of the guidelines adopted on March 19, 2002 states that the Monitoring Sub-Committees could be established; however, now it has been agreed that this approach will not be followed and only one Monitoring Committee will function for monitoring of the Structural Funds).

3.3 National–Regional–Local Partnership

The new Regional Development Law provides for the establishment of a National Regional Development Council (NRDC) that will perform the functions of the coordinating institution in the area of regional development at the political level. The NRDC will include representatives from the Cabinet of Ministers and appointed representatives from five planning regions. It is planned that upon its creation the NRDC will take over the functions that the management group is currently performing. However, the most probable outlook is that this will happen no earlier than January of 2003, which clearly indicates that the current state of play will remain at least until the finalization of the Development Plan.

The status of planning regions is also legitimized with the adoption of the Regional Development Law, while the representatives of all five planning regions have been actively participating in the preparation of the National Development Plan, and according to the new amendments to the decision on the Management Group of the National Development Plan, they are involved in the process at operational and decision-making level.

Coordination of each planning region will be carried out by the Planning Region Development Council (PRDC). The council will provide coordination of the development of the planning regions in line with the priorities identified in strategic development planning documents. In each planning region a joint agency of local governments—the Planning Region Development Agency (PRDA)—will be established to ensure coordination between municipalities, and to assist municipalities in planning and promoting projects of a regional scale.⁴

4. ADDITIONALITY

4.1 National Funding Mechanisms

The requirements, procedures and system of co-financing investment projects from national funding mechanisms were determined by sources of funding and differed from case to case. Co-financing for investment projects in the 800+ program constituted funding from the state budget, PHARE program, DEFCO (or other foreign donor) bank loan and local or regional government own resources.

4.2 EU Structural Funds

The process of budget planning, approval and implementation in the Republic of Latvia is regulated by:

- The Law on Budget and Financial Management (adopted by Saeima on March 24, 1994);
- The Law on Local Governments Budgets (adopted by Saeima on March 24, 1994).

The existing legislation in the field of the state budget and financial management—the budget development and performance, including activities of control and responsibility, as well as the existing methodological documents (procedures)—provide the framework for the management of the EU pre-accession financial instruments and Structural Funds. As a consequence, there is no need to elaborate new legislation or make amendments to existing legislation of the Republic of Latvia.

Since 1997, the annual state budget law has been developed according to the program principle. The Law on Budget and Financial Management states that the budget program is an interrelated totality of measures and services that are oriented towards a common objective or a set of closely related objectives.

EU financial support—pre-accession financial instruments ISPA and SAPARD—are planned within the state budget program of the relevant line-ministry: e.g., the Ministry of Environmental Protection and Regional Development is responsible for implementation of projects in the field of environment protection financed by ISPA and the Ministry of Agriculture is responsible for implementation of projects financed by SAPARD.

Strict planning and accounting is assured through single economic classification codes of budget expenses on foreign financial support and state budget co-financing.

The Law on Budget and Financial Management foresees the mid-term planning of the state budget. Mid-term planning of the state budget is the process where available resources are identified for a period of five years and the use of the resources is assured according to government defined priorities. At the same time the resources of the EU funds and state budget co-financing are planned for the complete implementation of the program (project) including the total required financial input. The implementation follows this procedure: where planned projects for the state budget program are implemented for a period longer than the current budget year, the required resources from the EU funds and state budget co-financing are stated as long-term public commitments (in an annex to the annual state budget law). The long-term public commitments include public investment projects, payments for loans and credits, payments within international programs, projects and leasing.

The state budget law contains long-term public commitments showing all the necessary financial resources required for the next year, the year after that and the total amount for the completion of a project. Thus parliament approves the commitments of a program for the total period of its implementation. Long-term programs (projects) approved by the government are included as long-term state commitments, and the re-

spective financial resources are planned according to the stated time of program (project) implementation, e.g., if the program (project) implementation period is stated for 6 years the financing of the program (project) is included as a long-term commitment for the total implementation period. The financial aspects of a program (project), split up into several years, can be updated taking into account the rate of progress of the program (project) implementation. The same is applicable to programs (projects) under the EU pre-accession financial instruments—ISPA and SAPARD.

Public investment projects are included in the Public Investment Program (PIP). The government approves PIP every year for the next three years, where the following information is specified: PIP projects grouped by ministries, the total costs of projects financed from ISPA pre-accession financial instrument and grouped by years—up to complete project implementation, as well as all financial sources—financing from EU financial support funds and proper national co-financing (state budget, local governments' budgets and co-financing from the private sector).

Latvia proposes to use the same approach for the implementation of programs financed by the EU Structural Funds. The resources of the EU Structural Funds and related state budget co-financing will be planned as long-term public commitments (included as an annex to the annual state budget law), specifying the total required financial resources for the next year, the year after that and the final amount up to the end of the project implementation. The commitment will be made to cover the total program period of the SPD.

Appropriate funding of the EU Structural Funds will also be planned within the state budget program of each related ministry (partner institution). Both groups of financial resources—financing from the EU Structural Funds and state budget co-financing will have their own economic code of budget expense. The information will be provided on planned EU Structural Funds resources as well as on related national co-financing (contribution) for all levels of SPD—from the projects up to the priorities of the SPD. There will be a planned state budget program for each priority in the SPD.

The budget and financial management law and the annual state budget law allow transfers of financial resources between priorities that are included in the state budget programs. On the basis of proposals by the Managing Authority, the Monitoring Committee will take decisions on transfers of funds between priorities regarding structural instruments. In case of transferring funds within the framework of one budget program there is no need to amend the state budget law—transfers can be made at the management level (related ministry level). Depending on the final beneficiary for implementation of a project, projects can be co-financed solely by the state budget as well as co-financed by local authorities, the private sector and other institutions. Sources of national co-financing will be determined at the stage of project preparation. The co-financing from local authorities can be set as a compulsory precondition for implementation of projects by local authorities.

Taking into account the current system of management of the EU pre-accession financial instruments during the approval process of projects, the total financial flows and sources are reviewed and accepted. The co-financing of the state budget is approved in the annual state budget law.

In order to ensure availability of the co-financing that is not approved in the annual state budget law co-financing agreements are concluded where the amount of co-financing is stated.⁵

5. TRANSPARENCY

5.1 National Funding Mechanisms

The clarity and transparency of information relating to the availability, allocation and utilization of national funding programs has been poor to date. Even with funds that have existed for several years potential beneficiaries did not have sufficient information about the selection criteria or even about the availability of the particular funding.

Only in rare cases was the distribution of funds clearly defined and adequately publicized. Moreover, the project selection procedure in the majority of cases has been unclear. The latter situation has been better only in the cases when co-financing existed from foreign donors (e.g., World Bank–Municipal development fund, Program 800 + —PHARE). Worse still, there has been no *ex post* monitoring or evaluation of projects.

5.2 EU Structural Funds

The guidelines on management, monitoring, evaluation and control system of the EU structural instruments passed by the Cabinet of Ministers of the Republic of Latvia state:

According to the Regulation 1260/1999, as well as the EC Decision 94/342 on information and publicity for the activities related to the assistance provided within the framework of the Structural Funds and other financial instruments in the EU Member States, as well as in accordance with the Latvian legislative acts it is being established that:

The Managing Authority ensures the realization of the proper information and publicity measures in relation to the Development Plan.

The Managing Authority is responsible for the implementation of the information and publicity measures in relation to the Structural Funds. The Managing Authority may delegate certain publicity functions to the partner institutions as well as to the intermediate bodies.

The objective of the information and publicity measures is to inform the Final Beneficiaries as well as the social and economic partners, non-government institutions and other parties interested in the possibilities provided by the Structural Funds, the role of the EC and other institutions involved and the results achieved, thus ensuring the transparency of the assistance provided.

The Managing Authority ensures the preparation of the unified information strategy and the necessary complementary documents in the following fields:

- availability of the information;
- publicity provisions for the stakeholders involved in the implementation; compliance verification.

The Managing Authority ensures that the information useful for the final beneficiaries, social and economic partners, non-governmental organizations and other parties interested will be supplied in the most appropriate format and via the most suitable channels for the recipients. For the purposes of provision of information on the requirements and the procedures for the final beneficiaries the information guidelines and other explanatory documents will be prepared. Society at large will be informed on the progress of the measures undertaken within the Structural Funds intervention using the traditional media relation methods, such as press releases, publications in the local and national press and conferences. The Managing Authority may delegate certain information and publicity functions to the partner institution or intermediate body.

Internet has an important role to play in the information dissemination. Other high technology possibilities, such as web-conferences and others, may be employed as well.

The possibility to initiate regular news bulletin will be considered with the intention to raise the awareness of the social partners and the public at large.

In order to increase the understanding of the assistance provided by the European Community, the Managing Authority will ensure the introduction of the requirements related to information provision including the visual guidelines for the final beneficiaries to be the integral part of the project documentation set. Some other requirements to the final beneficiaries concerning the information strategy will be defined at the later stages of the preparation of the plan and its program complement.

In order to identify other information needs of the final beneficiaries sociological surveys and other types of minor scale research initiatives will be introduced.

Table 4.2
Evaluation of Regional Development in Latvia

Support	Concentration	Programming	Partnership	Additionality	Transparency
PHARE program	4	3	4	3	3
SAPARD program	5	4	4	4	4
ISPA program	5	4	4	5	3
European Union Cross-Border Cooperation programs (CBC, Baltic Project Facility, and CREDO)	4	4	4	3	5
Earmarked subsidies for territorial planning	4	4	4	4	4
Regional development fund	4	3	4	3	3
Public Investment program	1	3	2	3	2
The Municipal Development Fund	3	3	4	5	4
The Rural Development Program	3	3	4	4	3
The SPP Urban Pilot Project	5	4	5	5	4
The SPP Rural Pilot Project —Ministry of Agriculture	5	4	5	5	4
The 800+ Program—(water management)	5	4	3	5	3
Program 500—(waste management)	5	4	3	5	3
State Road Fund	4	3	4	4	3
The Port Development Fund	1	2	4	3	3

ENDNOTES

- ¹ *Regional Economic Development in Latvia, The goals of regional economic policy*, Dr. Edvins Vanags.
- ² Report of the Ministry of Economy on National Economic Development.
- ³ These are the Copenhagen conditions:
 - Guarantees for democracy and respect for human rights and good-neighbourly relations;
 - Developing a viable market economy able to withstand competition in the Union's internal market;
 - Ability to meet obligations related to Community Acquis (EMU, standards, etc.).
- ⁴ The Position Paper of the Republic of Latvia on Chapter 21: Regional Policy and Coordination of Structural Instruments.
- ⁵ The Position Paper of the Republic of Latvia on Chapter 21: Regional Policy and Coordination of Structural Instruments.

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- 8) Materials and reports from Special Preparatory Program for Introduction of EU Structural Funds in Latvia.
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Capital Investment Funding in Lithuania

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Capital Investment Funding in Lithuania

Executive Summary

Gediminas Kuliesis, Vitalis Nakrosis, Algirdas Petkevicius, Sarunas Radvilavicius

INTRODUCTION

This research is aimed at describing and assessing the capital investment funding mechanisms in Lithuania. Thus it consists of two parts: inventory and assessment. While the first part includes a description of investment distribution mechanisms and investment figures, the second is focused on evaluating the impact of the programs on regional development. Only those programs or instruments are analyzed which have a direct or implied impact on the reduction of regional disparities within the country. The assessment is based on their compliance with the principles of concentration, additionality, partnership, programming and transparency.

In this research *concentration* is the priority given in its distribution to the correction of inter-regional disparities; *additionality* shall mean co-financing between levels of government, socio-economic partners and/or final beneficiaries; *partnership* is consultation arrangements between levels of government and socio-economic partners in identification, design and implementation, linked to *subsidiarity*, the assignment of responsibilities to the lowest efficient level; *programming* means compatibility with coordinated multi-sectoral development strategies and *transparency* is the clarity and availability of criteria and procedures for allocations.

The following governmental programs are analyzed in this research:

- 1) The State Budget, including the State Investment Program.
- 2) The EU Structural aid programs.
- 3) The Municipal Business Development Funds.
- 4) Other funds.

The State Budget, including the State Investment Program

Within the state budget, the general programs, the special programs and the State Investment Program are analyzed. Their status is defined, and the principles of funds' allocation outlined. While the state budget and the state investment program are both analyzed and described as investment allocation documents, special attention is given to

specific components of the budget, i.e., business support programs, road maintenance and development program, as well as the special program for the closure of the atomic power plant in Ignalina.

The EU Structural aid programs

Within the EU Structural aid programs, research is focused on the EU structural pre-accession initiatives (ISPA, SAPARD, PHARE 2000 and PHARE 2001), as well as other PHARE supported initiatives, such as the small project facility.

The Municipal Business Development Funds

The municipal business development funds are described as a source of funding that may have an impact on strengthening territorial competition together with the formation of a business-friendly environment.

Other funds

“Other funds” include the Municipal Infrastructure Development Program, which includes loans from various international organizations and must be co-financed by the municipalities. Finally, the system of equalization of municipal revenues is described, albeit briefly.

1. REGIONAL DISPARITIES AND INVESTMENT CONCENTRATION

In this section, the research attempts to interconnect the objectives and mechanisms of investment allocation with regional disparities. It also tries to present a general theoretical overview to whether concentration of investment either in lagging regions or in centers of growth can make economic or social sense.

It is emphasized that the measurement of regional disparities in Lithuania has been firmly based on two major indicators—GDP per capita and unemployment. Living conditions, efficiency and others may also be used from time to time but they tend to have little impact on the identification of problem regions or the design of measures to tackle inequalities.

In terms of GDP per capita, discrepancies between Lithuanian regions are considerable and the trend suggests that this will further increase. In 1996–1999, difference in GDP per capita in the counties of Vilnius and Tauragė (the richest and the poorest respectively) increased by 2.4 times. In three counties out of ten (Tauragė, Šiauliai and Marijampolė) GDP per capita was below 75% of the national average, and another county (Panevėžys) will probably also soon fall into this category. According to the preliminary National Development Plan:

There are substantial disparities in the distribution of GDP per capita in Lithuania. In 1997, in comparison with national share of GDP per capita (national average = 100), Vilnius county accounted for 121%, Klaipėda county 106%, and Panevėžys county 101% of Lithuania's average. At the other extreme, Tauragė county accounted for 65% of the average, Marijampolė county 79%, Alytus county 84%, Šiauliai county 87%, Telšiai county 88% and Utena county 90% of the national average. During the period 1996–1997, the share of GDP per capita increased in Vilnius (from 28.5% to 29.3%), Kaunas (from 19.5% to 20.2%) and Marijampolė (from 4.2% to 4.3%) counties. During the same period, the share of GDP decreased for Klaipėda (from 12.4% to 11.9%), Šiauliai (from 9.7% to 9.5%), Tauragė (2.6% to 2.3%), Telšiai (4.5% to 4.3%) and Utena (5.1% to 4.9%). These trends point to increasing regional disparities within Lithuania.¹

In terms of unemployment, the 1999 data suggest that in three counties out of ten it was below 7.5% (Vilnius, Kaunas, Klaipėda), in two counties between 7.5% and 10% (Telšiai, Utena) and in the remaining five counties between 10 and 12.5%.²

In terms of gross earnings, in 1998 one county had 110% of the national average (Vilnius), three counties between 100 and 110% (Utena, Telšiai, Klaipėda), three counties between 90 and 100% (Alytus, Kaunas, Panevėžys), two counties between 80 and 90% (Marijampolė, Šiauliai) and one county between 70 and 80% (Tauragė).³

In 1998 the number of visitor nights per 1,000 residents was over 500 in the county of Klaipėda, between 150 and 500 in the counties of Vilnius and Alytus, between 75 and 149 in the counties of Utena, Kaunas and Šiauliai and less than 75 in the remaining counties.⁴

There are significant disparities in the distribution of FDI (foreign direct investment). In 1999 Vilnius county attracted about 61% of total FDI, Klaipėda county about 13.1%, Kaunas county 12.2%. The least amount of FDI was attracted by Tauragė and Marijampolė counties (0.3%), Utena county (1.4%) and Telšiai county (1.8%).⁵

The distribution of small enterprises (less than ten employees) per 1,000 people is also uneven (based on 1998 data). The greatest numbers of small enterprises are established in Panevėžys, Marijampolė and Telšiai counties (sixteen per 1,000 people). The smallest numbers of small enterprises are established in Alytus, Tauragė and Vilnius (10 per 1,000 people). Yet only an average of nine out of twelve small enterprises are active. The difference between established and active enterprises indicates the downturn of economic activity in certain counties. On average, three out of twelve small enterprises per 1,000 people are not active. This indicator is greatest in Marijampolė (8.7 enterprises per 1,000 inhabitants of 16/1,000 are not active), Utena (6.9/1,000), Telšiai (6.4/1,000), Šiauliai (4.2/1,000) and Alytus counties (3.8/1,000). According to the enterprise survey of 1999, the greatest number of enterprises that increased their output

during 1998 were based in Utena county (55.8%), Vilnius county (37.7%) and Šiauliai county (31.7%). However, with the exception of Utena county, compared with 1997, the number of enterprises that increased their output fell considerably.

There are substantial disparities in production sales. In 1997, 22.8% of all production was sold in Telšiai county (primarily due to the oil refinery), 21.3% in Kaunas county and 15.4% in Vilnius county. At the other extreme, only 0.7% of all production was sold in Tauragė county, 3.5% in Utena and Marijampolė and 5.8% in Alytus.

Thus, we can conclude:

- 1) In general, the development in the counties of Vilnius, Klaipėda and Kaunas predominates. The county of Vilnius enjoys a privileged position because of comparatively well-developed infrastructure, the status of capital city, the supply of skilled labor, the presence of amenities and conveniences that other regions may be (and, indeed, are) lacking. Klaipėda county enjoys the benefits of having a large port and related infrastructure; it is well established as a point for transit of goods. It may also boast of comparatively well-developed amenities and infrastructure, municipal services and skilled labor. However, the benefits are absorbed, and industrial clustering and the process of innovation take place primarily in the cities of Vilnius and Klaipėda and their suburbs. In fact, if the county of Vilnius is taken without the capital city, its macroeconomic indicators may be even worse than in most other counties, particularly owing to severe under development of the southeastern (ethnically Polish, Belarusian or Russian) parts of the country. These issues are, however, quite unlikely to influence regional development policy, since, resources being scarce, the government distributes its limited funds, if at all, on the basis of county level indicators only.
- 2) The poorest counties of Lithuania can be considered those of Tauragė, Marijampolė, and Šiauliai (in which a lot of industries closed, unemployment drastically increased and the overall situation deteriorated in 1999–2000). However, the counties of Telšiai, Panevėžys and Alytus have little to cheer either. The situation in the county of Utena looks comparatively favorable, but this stems from the high earnings from the Ignalina atomic power plant that will close in 2004. The multiplied effect on the county's economy of this power station is now considerable, and the county is likely to suffer greatly after its closure. Therefore a lot of donor support is already provided for this county in an attempt to cushion the expected social and economic shock.
- 3) Only the counties of Vilnius, Klaipėda and Kaunas have comparatively favorable economic development backgrounds and prospects, while in all other counties, and also outside the cities of Vilnius, Klaipėda and Kaunas, economic depression, high unemployment and low wages, lack of public infrastructure and skilled labor are common features. Indeed, it would be incorrect to say that these territories have

any potential to attract national or foreign investment, to form industrial clusters or to develop research and development enterprises. While the cities of Panevėžys and Šiauliai may have such potential, subject to significant efforts and investment, all other cities in Lithuania are predominantly rural.

In view of the fact that regional disparities do exist and tend to widen, the question arises whether the Lithuanian government responded appropriately to the situation by introducing specific financial instruments. Our conclusion is that, while regional development plans must be drafted under the Regional Development Act, they have little impact on material allocations. The most significant resources currently available are those of the state budget and of the EU pre-accession aid. They are not, however, regionally focused, with the exception of PHARE 2000 and 2001 Economic and Social Cohesion initiatives, which were targeted at specific regions because of particular political circumstances that no longer exist.

Thus there are very few, if any, instruments of central government aid to lagging regions, with the exception of temporary and fragmented solutions. Moreover, it is noted that a clear preference of the government, even though it is not explicitly recognized, is to promote the development of “growth poles” by introducing nationwide grant schemes or investing comparatively high shares of funds in their public infrastructure.

It is also apparent that regional development attracted more attention in 1999–2000 than now. The reason for this would appear to be an incorrect interconnection of national regional development policy with EU structural aid. Since the EU structural aid is called “regional policy” there was much confusion about the real content of this term. In 2001, however, the understanding of the EU policy changed and so changed the material basis of regional policy. No longer supported from the EU structural pre-accession initiatives, this policy became more a declaration. The policy of support to specific regions was replaced by the policy to promote market development in all regions (which, in effect, means no real regional policy).

1.1 Programming

In the field of programming, the key issues addressed in the research are the coherence of national and regional development planning documents. A broad conclusion can, however, be offered that there is little coherence in some fields. The lack of coherence is reflected in the following facts:

- 1) While the Regional Development Act requires each county to draft its development plan, the procedure for drafting the state budget or the state investment program does not include a stage at which these plans could be considered. Only

the submissions from the county governors are considered. These submissions are, however, related exclusively to direct administrative competencies of county governments (which are quite limited).

- 2) While the National Development Plan is re-drafted each year, its designation is confined to the EU Structural Funds only. These funds shall be available when Lithuania accedes to the EU. Until that time, the Plan is treated as an exercise. It may, however, have a great impact on allocation of EU PHARE resources, but has limited impact (if any) on allocation of ISPA and SAPARD resources.

While the weaknesses outlined above are quite apparent, there were recent steps taken towards the strengthening of the connection between the state budget and various other documents. The reform of the budgetary structure implemented in 2000–2001 brought together many off-budget programs that were previously not monitored by the Ministry of Finance. The reform also resulted in including all non-returnable international aid to the state budget. As a result, the coherence of spending within the state budget is strengthening. There is, however, still little coherence between regional and national development programs. In fact, these programs have little impact on actual spending and only the submissions to the state budget (which should theoretically be based on strategic activity plans and sector development programs) matter.

From a theoretical point of view it is noted that very frequently development plans and programs are too general and may have little impact on development. The fact that most advanced countries do not have national development planning or acquired it only recently, as well as the fact that in many such countries regional development policy appeared only recently, is very telling.

1.2 Partnership

The research has come to the conclusion that the principles of partnership are observed only in EU-funded programs. The municipalities or social partners do not have the possibility to comment on the draft state budget or the state investment program. Neither do they have a possibility to intervene in the allocation of resources outside their direct competencies.

However, this is not necessarily to be taken as negative. It is acknowledged that there are too many different interests at stake that may prevent the government from conducting far-reaching consultations. At the same time, it is recognized that local governments or even social partners may intervene in the process of budget planning if the intervention has a sound basis.

At the same time, it is noted that in the EU-funded programs the principle of partnership is fully observed. The EU's officials require that extensive consultations be

undertaken. Since programming for EU structural funds exists for a limited period of two years only, and since the major documents are now considered a part of an “exercise,” the system has not yet included full-scale consultations. While it is likely that they will be conducted in the near future, they are currently more limited in scope (but still impressive compared to other governmental programs).

1.3 Additionality

The principle of additionality is assessed in the light of both co-financing of international aid by all national sources (including central government, municipalities, private partners) and co-financing of central government initiatives by the municipalities.

A broad conclusion is that the principle of additionality is strictly observed with respect to EU-structural aid. At least 25% of co-financing (in many cases 50%) is required by the EU from Lithuanian public sources, and in addition to that, private contributions are expected in case aid is directed to private enterprises. While private contributions to public investment initiatives may also be expected, they are very rare so far.

Some components of additionality have also recently been added to the various initiatives of the national government. For example, co-funding shall be required from the municipalities, the projects of which are included in the state investment program. Co-funding is also foreseen in the Municipal Infrastructure Development Program.

1.4 Transparency

It is recognized that the principle of transparency is generally observed in all major government investment programs. This may take various forms. The state budget and the state investment program are transparent *ex post*, i.e., full texts and quarterly (sometimes monthly) implementation reports are published on the Internet. Little transparency is observed at the draft stage—even central government institutions are not always able to obtain draft copies of these documents. The lack of *ex ante* transparency can be well justified and understandable, since the administrative burden on the Ministry of Finance is high and conflicts of interests at the stage of drafting would multiply if the ministry decided to expose the draft budget to open criticism.

The EU structural aid programs are *ex post* transparent, although most transparent is the SAPARD program—the SAPARD Plan is published on the Internet site of the Ministry of Agriculture, and much information on project profile and selection is provided. Less information is available on PHARE—although respective documents are also published on the Internet, the information is more fragmented. ISPA projects are the least transparent (although environmental projects are more transparent than the

transport projects). This is, at least partly, because ISPA transport projects are targeted at large national initiatives and are of less concern to potential beneficiaries (the Ministry of Transport can be considered the main or even the only beneficiary in some cases).

The publication also provides the general assessment of transparency in other (smaller) programs.

2. EVALUATION AND CONCLUSIONS

While regional disparities in Lithuania are widening, in reality the recognition of the necessity of regional policy is lip service rather than actual implementation. It is, however, doubtful whether such policy could be economically feasible.

The interconnection between various regional and national development documents is still weak or at the initial stages of strengthening. However, the coherence between various national investment programs has been considerably strengthened during the last couple of years.

The partnership arrangements are very strong for EU aid. Since these amounts are considerable, they may or already do have an impact on general investment planning and implementation practice in the country. However, partnership arrangements are usually weak in the state-funded programs. This may well be justified.

The principle of additionality is firmly applied to EU structural aid. In a few other programs it has been introduced very recently.

The transparency arrangements are strong enough both in state and municipal investment documents and in the documents for EU aid. In some cases, however, *ex post* transparency at the stage of implementation (rather than *ex ante* transparency at the stage of drafting) is preferred.

ENDNOTES

¹ Supra.

² The data in this passage is based on The Regions of the Baltic States (2000), Nordregio Report.

³ The data in this passage is based on supra.

⁴ The data in this passage is based on supra.

⁵ The data in this passage and the passages below is based on the Preliminary National Development Plan, 1999.

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ANNEX

Table A5.1
Evaluation Table

Investment Program	Approximate Amount (p.a.), [EUR]	Concentration	Programming	Partnership	Additionality	Transparency
State Budget	3,000,000,000	3	4	3	1	4
State Investment Program	300,000,000	3	4	3	2	4
ISPA	50,000,000	4	3	4	5	3
SAPARD	30,000,000	4	4	4	5	4
PHARE ESC	14,000,000	3	2	3	5	3
PHARE SPF	1,000,000	4	4	4	4	4
Municipal Business Support Funds	1,600,000	3	2	2	1	3

Grade 5—max. compliance

Grade 1—min. compliance

Amount p.a.—the amount foreseen in 2002 or the most recent data available.

Capital Investment Funding in Poland

Mieczysław Bak
Przemysław Kulawczuk
Anna Szczesniak

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Capital Investment Funding in Poland

Executive Summary

Mieczyslaw Bak, Przemyslaw Kulawczuk, Anna Szczesniak

INTRODUCTION

In 1990 Poland began the process of transformation towards a market economy. The process of decentralizing public finances accompanied the transformation of the economy and introduction of democracy. In 1990 the first level of self-government was established and local communities and municipalities began operating in Poland. The new territorial entities received concrete tasks and were equipped with different financial resources to supply needs identified by performance analysis. In 1999 the second phase of administrative reform was introduced. Two new levels, self-governing counties and regions, were introduced with new tasks and competencies. Poland now has relatively experienced local governments and two new levels of self-government that have begun to build their knowledge and skills to perform tasks previously undertaken by central state authorities.

The research conducted by the Institute for Private Enterprise and Democracy was aimed at the preparation of an inventory of capital investment funding mechanisms in Poland and evaluation of these mechanisms from the point of view of the five main principles of EU structural fund implementation: concentration, programming, partnership/subsidiarity, additionality and transparency. The full inventory is contained in the country report. The executive summary presented below focuses on how capital investment funding mechanisms fulfill EU principles and especially how they contribute to reducing regional disparities in a prospective member country. It is hoped that this will facilitate the future development of the use of structural funds in Poland.

1. CONCENTRATION

1.1 Regional Policy in Poland in the 1990s

The starting point for regional policy in the 1990s was a system of 49 medium-sized administrative regions and over 2,800 communes. In 1990 self-governing communities

and municipalities replaced administrative communes but 49 administrative regions remained. These regions were still fully dependent on the central government. As the result of the political change in the first part of the 1990s the central government economic policy focused on economic transformation. In the mid-1990s the awareness of regional issues increased with regard to expanding regional disparities. Large, inefficient state factories built in the 1950s and 1960s suffered problems connected with low competitiveness. The massive process of decommissioning the “old industries” began the process of de-industrialization of less developed regions. In the second half of the 1990s, economic development primarily centered on five or six metropolitan areas that boomed thanks to a strong inflow of intellectual capital and foreign investment. The disparities between urban and rural areas increased significantly.

At this time public debate took into consideration two types of administrative reforms that would better enable the running of regional policy in Poland. Model A suggested changing the 49 administrative regions into self-governing regions. Regional policy would thus be carried out through small regions. Model B proposed to resort to the model of counties and larger regions. The latter was victorious. The initial number of twelve large regions was changed to sixteen as the result of strong lobbying pressures. In the years 1997–1998 the strongest legislative effort was placed on the preparation of administrative reform and on listing the competencies and financing sources of the new self-government units.

1.2 Main Sources of Capital Investment Funding in Poland at Local Level

Different units effect capital investment at local and regional levels in Poland. The most important are local governments and infrastructure enterprises. In this chapter we have not presented any commercial capital investment except for infrastructure development. It means that the presented values are lower than in reality because various commercial expenditures were not taken into account.

The data presented in the report comes mostly from the year 2000. The situation concerning 2002 year is presented in a more detailed way. Dynamic data are presented in parallel and all data are given in current prices. To tackle the problem of inflation, data were re-counted in ECU or EUR on the basis of the exchange rate of the Polish zloty (PLN) on the last day of the given year. This simplification allows for the presentation of data comparative to those used in the European Union. Table 6.1 shows changes in capital expenditures of local governments and infrastructure companies within the period 1993–2000.

Table 6.1
**Capital Investment Domestic Expenditures of Local Governments
 and Infrastructure Companies in Million PLN and ECU/EUR (Current Prices)
 in the Period 1993–2000**

Capital Investment Expenditures	1993	1994	1995	1996	1997	1998	1999	2000
Local governments	2,435	3,364	4,658	7,056	9,680	8,176	12,562	13,532
ECU/EUR equivalent	1,018	1,131	1,473	1,983	2,496	1,991	3,013	3,497
Supply of electricity, gas, heat and hot water, water supply and purification	3,570	4,869	6,768	8,770	10,026	10,255	10,606	9,138
ECU/EUR equivalent	1,492	1,637	2,140	2,464	2,586	2,497	2,544	2,361
Post and telecommunications	1,482	1,723	2,590	3,938	6,474	8,402	9,446	10,320
ECU/EUR equivalent	619	579	819	1,107	1,670	2,046	2,266	2,667
TOTAL domestic in M PLN	7,487	9,956	14,016	19,764	26,180	26,833	32,614	32,990
ECU/EUR equivalent	3,129	3,347	4,432	5,554	6,752	6,534	7,823	8,525
Exchange rate PLN/EUR	2,393	2,974	3,162	3,558	3,877	4,107	4,169	3,870

SOURCE: Ministry of Finance, Main Statistic Office.

The data included in the above table show that within the period of 1993–2000 capital investment expenditures of local governments and infrastructure companies increased by 172.5% in EUR values. An especially rapid increase was observed in the capital expenditures of local governments (by 243.5%). The increase of capital investment in supplies of electricity, water, gas heat and sewage purification amounted to 58.2%. The increase of capital investment in post and telecommunications amounted to 330.9%. The presented data show that capital investment expenditures used for local and regional development increased significantly. For 2000, the total approved PHARE assistance for Poland amounted to 484 million EUR.¹ This assistance constitutes around 5.7% of total developmental expenditures at local levels in Poland. However, not all EU assistance had a regional character. The presented data show that local governments and infrastructure companies in Poland have significant financial potential for capital investment. Table 6.2 presents capital investment expenditures of local governments and the sources of their financing in 2000.

Table 6.2
**Capital Investment Expenditures of Local Governments
 and Estimates of Financing Sources in Poland in 2000**

Item	[Thousands PLN]	[%]
Capital Investment Expenditures	13,532,028	100.00
Sources of Financing	—	—
Own Revenues	4,421,580	32.65
General Subsidies	3,735,690	27.61
Allocations for Capital Investment*	2,717,510	20.10
Long-term Bank credits*	1,647,637	12.18
Long-term Loans*	502,868	3.72
Municipal Bonds*	227,494	1.68
Surplus from Previous Years	161,981	1.21
Other Incomes	107,144	0.79
Privatization Incomes	8,437	0.06
Sales of Securities	1,687	0.01
Total Sources of Financing	13,532,028	100.00

SOURCE: Ministry of Finance and own estimations.

* Incomes with dedicated direction of spending.

According to data included in the above table, the primary source of local governments' capital investment financing was their own revenues. On the basis of IPED estimates, own resources financed 32.65% of all capital investment. The second source of financing was general subsidies (coming from the central budget and supporting own revenues). This financed 27.61% of total local government capital investment in Poland in 2000. Both sources had non-dedicated directions of spending. Debt instruments accounted for 17.58% of capital investment financing in 2000. Of these, a critical role was played by bank credits. The other sources of capital investment financing were much less important. Table 6.3 shows the data on per capita capital investment expenditures.

The data presented in Table 6.3 show that communities (municipalities) in two regions have the highest average capital investment expenditures per capita. These are Mazovia (which includes Warsaw) and Lower Silesia (Wrocław). Other regions have expenditures below the average. The lowest per capita capital investment is observed in the rural Lubelski, Opolski and Warminsko-Mazurski regions and the heavily industrialized Silesia. Across the counties, the highest per capita expenditures are observed in Pomerania (57.3 PLN), Saint Cross (51.9 PLN) and the lowest in Kujawsko-Pomorski (19.9 PLN). The discrepancies between cities with county rights throughout the regions are not as significant. Of these, the highest per capita expenditures are observed

in Pomerania (476.8 PLN) and the lowest in the neighboring Warminsko-Mazurski Region (216.2 PLN).

Table 6.3
Capital Investment Expenditures of Local Governments per Capita
in Poland in 2000 [PLN]

Region (Capital)	Population	Communities/ Municipalities	Counties	Cities with County Rights	Regions
Lower Silesia (Wrocław)	2,975,074	317.5	37.6	442.6	38.2
Kujawsko-Pomorski (Toruń)	2,101,068	210.7	19.9	335.9	12.7
Lubelski (Lublin)	2,233,271	172.7	33.1	243.0	25.5
Lubuski (Zielona Góra)	1,023,829	232.4	26.5	474.0	37.0
Łódzki (Łódź)	2,647,783	205.2	33.0	253.5	6.6
Małopolski (Cracow)	3,226,611	201.9	34.1	408.5	27.0
Mazovia (Warsaw)	5,068,677	543.0	25.7	378.1	16.7
Opolski (Opole)	1,086,608	181.6	27.4	407.2	14.3
Podkarpacki (Rzeszów)	2,127,859	218.7	47.9	342.2	16.1
Podlaski (Białystok)	1,222,011	208.5	46.9	293.7	17.3
Pomerania (Gdansk)	2,194,628	247.0	57.3	476.8	24.0
Silesia (Katowice)	4,857,848	187.1	34.4	296.5	71.1
Saint Cross (Kielce)	1,323,719	217.2	51.9	300.1	75.6
Warminsko-Mazurski (Olsztyn)	1,466,248	190.6	41.5	216.2	11.0
Wielkopolski (Poznan)	3,357,541	259.0	28.2	339.5	19.6
West Pomerania (Szczecin)	1,733,446	269.3	37.7	388.8	13.9
TOTAL	38,646,201	277.6	34.8	342.8	28.5

SOURCE: Ministry of Finance.

Huge differences were observed in capital investment expenditures at the regional level of self-government. The highest per capita expenditures were observed in Saint Cross (75.6 PLN) and Silesia (71.1 PLN). The lowest expenditures were observed in the Łódzki Region (a mere 6.6 PLN per person). The massive differences among regions are mostly based on the fact that new regions were created only one year before the beginning of the analyzed period. The presented data show that differentiation in effecting capital investment among regions within particular groups of local governments is not so significant. However, it is necessary to realize that the analyzed data are average data. Real differences between communities, counties and cities are much higher.

1.3 Changes in Regional Disparities

In the first part of the 1990s central governments somewhat neglected regional policy issues and concentrated on more pressing issues of economic transformation. The only equalizing mechanisms in place were as follows:

- General subsidies mechanism;
- Local government borrowing;
- Capital investment in infrastructure companies;
- State agency donations, preferential loans and grants;
- Moderate foreign aid.

Any concrete or objective framework did generally not cover the functioning of these mechanisms and thus the results of their implementation were neither collated nor assessed. In reality, the extent to which each local community managed to use the last four mechanisms listed above depended mostly on the entrepreneurship and political connections of the community mayor. Commercial interests also hamstrung an important part of capital investment. Therefore the results of the functioning of the mentioned mechanisms are extremely diverse.

Changes in regional disparities were measured in four areas: regional incomes, infrastructure, environment quality and employment. Table 6.4 shows the changes as presented in relation to eleven variables and two statistical measures: GINI index and decile ratio.²

Table 6.4
Changes in Regional Disparities in Poland in 1990–1998

Analyzed Statistical Variable	GINI		Decile ratio	
	1990	1998	1990	1998
Total capital investment in 49 regions [in zlotys]	33.4	46.4	9.0	57.3
Average monthly wages in 49 regions [in zlotys]	3.3	5.1	1.3	1.7
Labor income in 49 regions [in zlotys]	31.0	34.6	7.2	19.5
Density of roads/per 100 sq. km	18.0	18.4	3.3	4.3
Stationary phone subscribers/1,000 inhabitants	15.0*	11.3*	2.7*	3.1*
Untreated waste water in hm ³	64.3*	49.0*	91.5*	96.5*
Reduction of air pollutants—particulates [%]	4.2*	3.5*	1.4*	1.3*
Reduction of air pollutants—gases [%]	72.7*	30.2*	531.0*	418.5*
Unemployment ratio [%]	16.0	18.2	3.1	7.9
Employment in particular regions [in thousands]	28.4	29.6	5.9	14.1
Employees/1,000 inhabitants	3.8	6.1	1.3	1.7

SOURCE: Own computations on the basis of data of the Main Statistic Office. * 1991.

The basis for the comparison was a group of 49 administrative regions. This group better illustrates regional disparities than the currently used twelve large regions.³ The selection of the categories for analysis was due to data availability. According to the conducted research it was possible to reach the following conclusions:

- 1) Distribution of capital investment throughout Polish regions was carried out in a way that increased disparities and inequality amongst regions.
- 2) Positive changes were observed in the areas of infrastructure that fell under the responsibility of local governments and commercial companies: water supply, water treatment and communications—in these areas regional disparities were reduced. With respect to roads, where state authority prevailed, disparities increased.
- 3) Positive changes were observed in reducing pollution and regional disparities decreased. This was mostly due to the reduction in “dirty production” and environmental investment by companies. The National Fund for Environmental Protection also had a positive effect.
- 4) Significant growth in regional disparities was observed in labor incomes and employment. Weak regions became weaker in both fields, leading to increased social problems. The position of the strongest regions became stronger with respect to wages and remained unchanged in terms of employment levels. As a result, economic disparities amongst Polish regions increased.

Surprisingly despite the general reduction of regional disparities in infrastructure, economic disparities amongst regions significantly increased. It is possible that infrastructure improvement was too weak a factor to attract commercial investment, business and employment to rural and less developed areas. The state became even more centralized (the government liquidated seven out of nine large regional commercial banks), and the headquarters of numerous important companies were moved to the capital. The headquarters of significant financial institutions can only be found in four regional capitals (Cracow, Katowice, Wrocław, Warsaw). Through the process of mergers and acquisitions, government action and market forces, the headquarters of regional banks moved to Warsaw from Szczecin, Gdańsk, Lublin and Poznań. Two of the aforementioned regional capitals were located in so-called problem regions.

The concentration of wealth in large metropolitan areas creates problems for provincial and rural areas as well as for metropolitan areas (mass transportation and traffic). The present regions do not constitute homogenous territories with prevailing similarities thus making regional policy, especially equalizing or reducing disparities, more difficult. It is therefore necessary to conduct sub-regional policy within regions. To achieve this the Main Statistics Office created a new category of 44 sub-regions. In reality these are merely a statistical convenience, although sub-regions may be used for conducting policy aimed at reducing regional disparities.

Equalizing mechanisms in capital investment funding in Poland allowed for significant improvement of infrastructure in rural and less developed areas; but the sectoral policies of the government through the 1990s, together with close relations between business and politics at the central levels, facilitated centralization of the economy, labor market and incomes.

1.4 Evaluation of the Principle of Concentration

The fulfillment of the concentration principle in regional policy can be understood either as development and implementation of regional or local development programs or the introduction of development initiatives through fragmented sectoral mechanisms. De-concentration of regional development can be understood as a preference for public investment in areas of economic growth or as increasing the incapacity of poorer areas to exploit the availability of investment funds to meet co-financing requirements.

Through nearly all of the 1990s, de-concentration mechanisms were stronger in the areas of income and employment distribution. Parallel to this, total capital investment disparities increased. However, capital investment funding mechanisms reduced infrastructure disparities amongst regions. This was especially visible in water supply, availability of telecommunications and the reduction of environmental pollutants. Capital investment funding mechanisms functioning in relation to infrastructure decreased disparities, but government economic policy, especially in the area of privatization, mergers and acquisitions moved business headquarters from the provinces to larger cities and from the larger cities to the capital. It is worth noting that foreign investors preferred the larger cities for the location of the company headquarters, despite the fact that labor costs were significantly higher. In general, business preferred to remain close to the political authorities and numerous firms and banks originally opened in the provinces were subsequently moved to the capital in order to be closer to contracting units. As a result, regional disparities in the distribution of income and employment opportunities increased.

2. PROGRAMMING

Regional policy in the first years of economic transformation was not the most important target of government policy. The only mechanisms reducing infrastructure disparities functioned at the level of communities and municipalities. The possibility of Poland's accession to the EU changed the approach of governments towards regional policy from spatial issues to the issue of equalizing economic levels and reducing regional disparities. Thus it can be said that the EU had a very positive impact on changing the approach

of Polish governments to regional policy. The educational role of current regional policies of EU countries removed the dominating naïve ideological point of view that any governmental intervention spoils market mechanisms and regional development ceased to be a subject for conflict amongst political parties.

The period 1997–1999 was devoted to administrative reform aimed at introducing two new levels of self-government. In accordance to the needs of the reform, new legislative acts, which described the tasks and competences of the new levels, were introduced. These acts stated that the regional policy of all entities responsible for regional policy should be carried on the basis of strategic development plans. After the implementation of administrative reform, two years were dedicated to the preparation of strategic development plans by the new self-governments and the national government.

At the national government level the first significant document concerning regional policy was prepared in May 2000. Parliament passed the Act on the Principles of Supporting Regional Development. The Act provides that supporting regional development is aimed at:

- 1) Development of different areas of the country, improvement of living standards and the level of need satisfaction of local communities,
- 2) Creating conditions to increase the competitiveness of local governments,
- 3) Equalizing differences in the level of development of particular areas of the country; equalizing the opportunities of citizens regardless of area of domicile and reducing the backwardness of less developed areas that have less favorable development conditions.

The Act also defines the main tasks in the running of regional policy. According to the Act the role of supporter is played by the central government and roles of beneficiaries by regional and local governments.

In November 2000 the National Strategy of Regional Development 2001–2006 was prepared. The preparation of the strategy was enforced by the requirements of EU integration. The strategy listed the following objectives:

- 1) Increase the average level of GNP per capita in relation to the EU average from 38% in 1999 to 47% in 2006. The regional minimum should amount to 33% of the EU average and regional maximum to 71%;
- 2) Acting against excessive increases in regional disparities through the reduction of unemployment and stimulating the potential of less developed areas;
- 3) Training of staff in central and regional administration in the effective implementation of regional policy, co-financed by the EU;
- 4) Utilization of administrative reform for increasing the pace of development. Increasing the value of own revenues of local governments and reducing public resources;

- 5) The strategic objective is to create conditions for increasing the competitiveness of regions and to act against the marginalization of less developed regions in order to support long-term economic development, social, economic and territorial cohesion and integration with the EU.

The strategy provided that the main activities that should be adopted for fulfilling the above objectives should focus on: the development of infrastructure, restructuring and diversification of the regional economic base, supporting human resources development in problem areas, providing cooperation between regions (cross-border, transnational).

It was provided in the strategy that the list of areas requiring support would be created in special support programs, which would be adjusted to the financial possibilities of the state. The National Strategy will be carried out in two phases: before accession to EU and after accession. The Council of Ministers provides the general coordination of the strategy but the Minister of Economy is responsible for strategy implementation. In tandem, Regional Steering Committees were created to coordinate the implementation of particular regional strategies. All regions prepared the regional development strategies that constitute the basis of state regional policy.

The implementation of regional policy described in the Act and National Strategy is in the initial stage. According to the Act, regional contracts were awarded to regions and in 2001 the first regional projects were started. However, the size of these projects and financial allocation for this purpose is still far ahead of regional development needs.

When analyzing the programming principle in the distribution of capital investment funds in the country, it is necessary to answer the following questions:

- 1) How far is public investment subject to territorial cross-sectoral development strategies?
- 2) How much impact have Regional Operating Programs and similar regional development plans had on actual public investment?

To answer these questions it is necessary to underline that regional self-governing units have been operating since 1999. They have very little experience in regional development. In spite of this fact, a significant part of developmental funds went through territorial units in the 1990s. It included the following areas:

- *Communal infrastructure*: water supply, sewage purification, roads (partly through territorial and partly sectoral approach; since 1999 the regional approach has increased);
- *Supply of gas, electricity and telecommunication services* through commercial infrastructure companies (partly privatized) which had regional character (electricity supply) and national entities (the remainder);

- *Labor market development funds*: up to 1998—sectoral approach, since 2000—regional approach;
- *Education*: regional approach up to 1998 primary education, since 1999 also secondary education;
- *Health*—basic services regional approach up to 1998, since 1999 all medical services;
- *Business development*: up to 1998—sectoral approach, since 1999 mixed sectoral and regional approach.

The above list indicates the increasing role of the regional/local approach in directing development processes in Poland. Unfortunately, the visible weakness of all levels of self-governments constitutes a shortage of operating programs that would follow the preparation of strategies. The advancement of the preparation of the regional/local operating programs (plans) backed by financial resources is very low. Most territorial units do not have detailed development plans but only general strategies. The only detailed plan they have to prepare is the local/regional budget act, which specifies incomes and expenditures of local/regional government. Sometimes they prepare a capital investment plan, but it is subordinated to the one-year budgetary bill. Polish law prohibits communities to plan budgetary income and expenditures for more than one year. Incomes of territorial units vary from year to year with regard to changing legislative regulations (they change every year), and it is very difficult to plan expenditures in the long run. Polish local and regional units have a vision of what they want to do, but they do not have operating programs to attain this vision. Planning and programming is a serious weakness of regional and local units.

Important steps were taken in 2001 when the first regional contracts were concluded for years 2002–2003. In these contracts the central government promised to finance regional development undertakings (including capital investment). However the shortage of budgetary funds caused plans to be extended to 2004. It means that yearly financial support was cut by a third. It also means that the pace of advancing regional development projects was significantly cut.

3. PARTNERSHIP/SUBSIDIARITY

The principle of partnership and subsidiarity in the area of capital investment process can be understood as involvement of regional or local institutions and stakeholders in the selection, design and execution of public investment programs. It often raises the following question:

To what extent are: (1) regional institutions, (2) local governments and (3) “socio-economic partners” associated by and with national governments in the selection, design and execution of public investments in:

- 1) local infrastructure,
- 2) income/employment promotion,
- 3) human resource development?

When answering this question it is possible to conclude that:

- 1) All capital investment executed by local governments met the principle of partnership with the exception of small allocations for capital investment which, to some extent, could be put down to political tensions and choices (especially roads and bridges). They are financed from the own revenues of the self-governments, local governments borrowing and only rarely by allocations from the central government (20.1% in 2000). Besides, receiving all possible types of allocations requires close cooperation and planning at the local level;
- 2) Sectoral donations of governmental agencies met the partnership principle especially in the area of funding environment improvement programs. Other governmental agencies distributed their resources directly to the beneficiaries with little input from local or regional governments;
- 3) Most of local infrastructure capital investment met the principle of partnership in full. The lowest level was in roads (especially national roads);
- 4) Service fees based infrastructure investments were executed on the basis of satisfying customers’ needs. This reflected in full the principle of partnership;
- 5) Employment promotion was transferred from central government to regional entities in 2000. However with regard to the increase of unemployment and the reduction of funds for employment promotion, the real possibilities to carry out policy in this area were reduced;

In Poland strategies for regional and local development are prepared by self-governments. Self-governments are created by elections. In most regions the winning parties create regional executives, and in all other regions executives are created by coalitions. In Poland strategic development principles take into consideration preferences of stakeholders, but in reality capital investment projects that receive financing are the result of political lobbying for executing particular projects. With regard to the poor condition of roads and bridges in Poland the highest preference is given to improvement in this area. However, such investments are extremely costly and the other objectives are satisfied by regional contracts at a very low level. To some extent regional authorities may decide to issue bonds but this process is in its infancy.

A different situation exists on the level of municipalities and communities. They have more functioning programs and can influence more effectively when and what should be

carried out in the area of capital investment. Spending of regional governments constituted about 5% of spending of total local and regional governments in 2000. The rest were local and county governments. Local governments are very active on the bond market and are able to design and plan more capital investment than regional authorities.

Considering the importance of local government spending on infrastructure investment one may say that funding mechanisms created by local self-governments tend to be efficient. Local governments budgets need to secure the funding for covering the costs of their tasks and later they may decide on the level of capital investment on the basis of local needs. A relatively small amount of capital investment funding is decided by the national administration in the form of donations for designated local investment projects.⁴ Local governments, especially those authorities that elaborated local development strategies are more familiar with local needs and preferences. Also, they tend to spend the funds more efficiently than national authorities and have more opportunities to build public-private partnerships to execute investment projects. All these factors contributed to greater efficiency in Poland's regional funding mechanism.

Changes related to implementation of the self-government counties and regions in 1999 increased the scope of funds distributed on a regional basis. Efficiency of regional funding mechanisms led to the transfer of part of the sectoral investment to regional level and regional contracts replaced partly central investment programs. Those changes allow for better adjustment of investment programs to local needs. Regions, with the participation of municipalities/communities, counties and social partners prepare local development strategies, which include the most important investment projects necessary for economic development. Regions, within the framework of regional contracts, obtain the funds to cover part of the cost of planned investment expenses that were previously distributed on a sectoral basis.

4. ADDITIONALITY

Co-financing contributions to public investment funds made by self-governments or final beneficiaries seem to be a very important issue. The ability of co-financing influences the possibilities to attract new capital and new donors. It requires an answer to the question: How far do investment programs funded by donor or national budgets require co-financing by: (1) regional governments, (2) municipal governments and (3) final beneficiaries?

In Poland there are different mechanisms to support infrastructure capital investment. They are mostly based on the assumption that capital investment expenditures are made mostly from the financial resources (or borrowing) of the beneficiary or local government and the role of governmental agencies is to support or subsidize these efforts. The repayment of loans should come from utility service fees. The role of governmental

agencies is to leverage individual efforts of local communities and other regional entities. The general rule in providing assistance funds is that interest-subsidized loan instruments are rather easily accessible while donations are rather more difficult to receive. The levels of support are very diversified in the same agencies in relation to particular instruments. For example the National Fund for Environmental Protection provides subsidized interest loans up to 70% of the value of the project, while donations cannot exceed 30%. Both instruments can of course be used in tandem. Under specified conditions 50% of loans could be redeemed (when a project is completed on time). The operation of the National Fund is an example of the logic of how additionality is provided in Poland.

Another issue is the problem of how differences in the revenue bases of regional and local governments affect their ability to co-finance and access public investment funds. Important considerations are: How far are such resource disparities ameliorated by: (1) general equalization systems or (2) differences in co-financing ratios and other requirements?

In Poland, mechanisms to equalize incomes for local and regional governments are provided through the general subsidies mechanism. General subsidies are direct transfers from the central budget to communities, counties and regions. (General subsidies are considered as an addition to the own revenues of local governments and can be used for all competences).⁵ In communities, general subsidies are counted separately for three divided sections: fundamental, educational and compensation. The fundamental part contains mechanisms aimed at equalizing the diverse tax power of different communities. Therefore fiscally weaker communities are supported. In counties and regions general subsidies consist of three parts: educational, highways and equalization.⁶ There are different percentage formulae used for counting general subsidies for each kind of unit; the most important factor is the number of citizens living in each unit.

- 1) Each community receives a general subsidy consisting of three independent sections: fundamental, educational and compensation;
- 2) The fundamental section forms 1% of total planned incomes of the central budget;
- 3) From the total sum of general subsidies 4% is subtracted as central reserve;
- 4) Each community with tax incomes less than 85% of the average tax incomes per person in the nation receives 90% of the difference between per capita amounts (given and the average);
- 5) The remaining amount is divided amongst all communities in relation to the number of citizens;
- 6) The educational part of the general subsidy is established as 12.8% of the total planned central budget incomes and divided according to rules established by the Minister of Education. These rules are based on complicated formulae including such factors as number of students and former expenditures;

- 7) Similar equalizing rules exist in relation to counties and regions;
- 8) Equalization in counties and regions is effected through the equalization section of the general subsidies.

In spite of the fact that the general subsidy is created using three different mechanisms, there is no detail on the purpose of transferred funds. Local governments are obliged to fulfill all their tasks (originated from the particular self-governance acts for each level of local government). However, it is not stipulated what part of general subsidies should be spent on current expenditures and what part for capital investment.

Low income local and regional entities are also provided for by low interest loans. The interest rates are determined in relation to the bill of exchange rediscount rate (Berr) announced by the National Bank of Poland. In the case of a loan granted to the Capital City of Warsaw and to Warsaw local communities, the interest rate of 0.5 Berr p.a. is applied; in the case of rural counties the interest rate is 0.2 Berr p.a.; whereas in cities with county rights it is between 0.1 and 0.5 Berr p.a. depending on the total budgetary income per inhabitant. The total income of the county and the municipality/community is calculated as the income in the budgetary year, two years previous to the year under consideration. The interest rates on loans granted to municipalities and communities is between 0.1 and 0.45 Berr p.a., depending on the total budgetary income per inhabitant generated in the budgetary year.

The main problems affecting capital investment from local governments incomes are low revenues compared to needs. Local authorities are obliged to cover current expenses related to the tasks described above, including salaries and other personnel costs. Besides the lack of sufficient funds, after covering current expenses some problems are created by the lack of development strategies and long-term investment programs. Strategies generally include the vision of the municipality, county or region for ten to twenty years. Elaboration of the strategy is not compulsory for the municipality and county and it is related to significant costs (10,000 USD and up).⁷ Therefore only certain local governments elaborated development strategies. Municipalities also have limited knowledge on how to prepare long-term (four to six years) investment programs, which should include identification of investment needs and a list of investment priorities together with estimated costs. Lack of development strategies and investment programs for all local government units results in lower interest in capital investment and in lower effectiveness of such investments.

It can be stated that local/regional governments use the EU Structural Funds principles to some extent. Their legal duties and the situation of the particular community, municipality or region determine their criteria, procedures and decisions for investment spending. The whole process is more transparent and conforms to programming and partnership principles if the regional strategy exists. As it was stated above, this was not obligatory for the local authority.

Local government borrowing is considered as one of the quickest growing sections of capital investment financing of local governments in Poland and is potentially a successful source of co-financing. Accordingly to IPED estimates 17.6% of total capital investment of local governments was financed through borrowing, amounting to 2,378 million PLN. This amount was split between 1,648 million PLN of bank credits, 503 million PLN of non-bank loans and 227 million PLN of municipal bonds. These sums were calculated on the basis of yearly increases in borrowing; new credits minus repayments of old credits, non-bank loans (mostly from public target funds) and municipal bonds (new issues minus repayment of old issues). Local government borrowing is one of the potential sources to increase opportunities to satisfy the principle of additionality and provide sources for backing EU funds.

The 1998 Public Finance Act defines local government borrowing in Poland. The Act provides that the deficit of local governments' budgets should be covered from: sales of securities issued by local government, bank credits from Polish banks, loans, privatization incomes and any surplus from previous years. The Act provides that the ratio of repayments of credits, loans and other similar sums should not exceed 15% of the planned annual incomes of the local government and 12% when total public debt is higher than 55% of PNB. Another provision of the Act is that the total debt of local government should not exceed 60% of the total planned budgetary incomes for the given year. Apart from these provisions there are no real obstacles to local government borrowing. At the end of 2000 the total debt of local governments constituted 12.9% of their incomes. It means that, according to the Act, there is significant potential for further indebtedness. The above-mentioned ratio differs according to the different units of self-governments. Cities with county rights have an average debt/income ratio of 17.3%, communities/municipalities 14.8%, counties 3% and regions 2.8%. Regions and counties were created only from January 1, 1999 and these low ratios are due to their short period of operation. With regard to the fact that cities with county rights took over some tasks from central government administration, it caused their incomes to increase significantly from 1999 onwards and thus increased their borrowing possibilities.

Notwithstanding that future obligations to provide own resources for development projects are undecided, there is little doubt that either through own resources or (more probably) through borrowing, local and regional governments will be able to fulfill the principle of additionality in accepting EU funds.

5. TRANSPARENCY

According to IPED estimates most funds for capital investment (above 90%) are distributed on the basis of criteria that are open, clearly defined and publicized. Most public fund applications/competitions are published on the Internet and information is freely

available to applicants and suppliers. Another issue is the execution of the competitions. Occasionally, participants complain about the actual execution of the competitions, but in general they are based on the Public Procurement Act of 1995 (revised).

The Law on Public Finances of November 1998 plays an important role in providing transparency in public spending. The law specifies the procedures for the budget construction. Projects of the regional/local budget should be prepared by the unit board and sent to the Regional Accounting Chamber, which supervises finances of regional/local authorities, no later than the end of November. The opinion of the Chamber should be presented to the local council, which accepts the budget in the form of a resolution. The whole procedure of passing the Budget Resolution should be completed by the end of the year; in some special cases this can be extended to the end of the following March. The local/regional council (*Rada* or *Sejmik*) has limited possibilities to implement amendments; it cannot introduce changes that decrease revenues or increase expenses without acceptance of the local government board.

The budget also specifies long-term investment programs, including details of all planned programs. A supplement to the Budget Resolution should describe the investment program, its objectives and tasks to be financed from the budget, name of the administrative unit responsible for the program, time schedule and total current cost of the program and its cost over the next two years. Budget resolutions in the following years should include the necessary financial resources for the programs' execution and timely accomplishment. Investment programs can be reduced or postponed by resolution of the local/regional parliament.

According to Polish law, investment spending, like all other spending, should be made efficiently—achieving the best results compared to expenditure and in a way that allows for the timely accomplishment of the investment program and fulfillment of its obligations.⁸ The last statement is especially important for companies involved in local authorities' investment programs. According to the law, investment programs should not begin if insufficient funds are available for its execution; in practice this has not always been the case.

In Poland investment expenditures by public units should be made on the basis of the Law on Public Procurement. According to the last amendments to the law only relatively low expenditures, up to 3,000 EUR, are excluded from the tender procedures. Companies executing larger investment contracts should be selected in open tenders. If the investment contracts do not exceed 30,000 EUR the contractor can be selected by "limited tender," where only a selected number of organizations are invited. This procedure can be also applied if the specific character of investment limits the potential number of interested and competent companies. If the open tender procedure fails, special two-phase tenders can be organized. During the first phase companies can provide the offer without price. During the second phase negotiations are conducted with a limited number of companies. In case of the tender being canceled due to the

lack of sufficient offers, tender procedure can be replaced with negotiations, assuring competitive conditions.⁹

Committees, composed of local administration representatives, assess the offers of the companies interested in participating in the public procurement process. In many cases, the lack of experience of its members creates problems with selection of the most appropriate offer, thus leading to lower effectiveness of public spending on investment at local and regional level. However, in general, all local, regional and central authorities obey procurement procedures both in fund distribution and in selecting companies to execute the orders. Respect for public procurement rules is considered as a matter of critical importance by both units submitting offers and the public.

A more difficult situation exists when the problem of allocations from central budget is concerned. Serious doubts appear when central government allocations are used for effecting capital investment, which is considered the task of local governments (they should be covered from general subsidies according to the general rules). The criteria included in the Act of Incomes of Local Governments states:

- Allocation may not exceed 50% of the total cost of capital investment (80% in education and 75% in high unemployment units);
- Unused allocations should be returned.

Unfortunately, apart from the above criteria, there are no provisions considering eligibility, maximum sizes of allocations, procedures of applying, selection criteria, etc. It means that criteria are discretionary and strongly dependent on the political will of parliament and the central government. Some authors maintain that allocations financing the “own-tasks” of local governments require political decisions.¹⁰ In this context such allocations could be considered as awards for electoral support. The only positive side of such target donations is the fact that they cannot be used for other purposes. The examples of such allocations are allocations from the central budget for building a new line of the Warsaw metro or allocations to build the bridge on the Vistula River in Gdansk. In spite of the fact that most of such allocations absolutely meet the rationale of public spending, without doubts these expenditures are strongly influenced by political pressures.

Ex post formal control on the fairness of capital investment spending is executed at all levels of governments. This control is performed internally (by local governments) or externally (by regional accounting offices and the Highest Chamber of Control). However, external control is performed rather sporadically.

Typically, monitoring and evaluation processes are seldom organized; local and regional authorities rarely use monitoring and evaluation as the instrument for introducing improvements in procedures or process and skills in this area are limited. Moreover, participatory monitoring and evaluation of capital investment are not performed.

6. EVALUATION

Table 6.5

Evaluation of Capital Investment Funding Instruments in Compliance
to Structural Funds Principles in 2000 for Local and Regional Development
and Estimation of the Value Ratio as a Percentage of GDP

Capital Investment (CI) Funding Instrument	Type of Principle-score					Value Ratio as % of GDP
	CON	PRO	PAR	ADD	TRA	
Infrastructure Companies Expenditures for Capital Investment	5	5	4	4	5	2.841
Own Revenues of Local or Regional Governments (LG) spent on CI	4	4	5	5	5	0.646
LG General Subsidies spent on CI	5	4	5	5	5	0.545
LG Allocations for Capital Investment from Public Funds (mostly Environmental)	4	5	5	5	5	0.397
LG Allocations for Capital Investment from the Central Budget for own Tasks of Local Governments	3	2	1	1	1	
LG Long-Term Bank Loans for CI	5	5	5	5	5	0.241
LG Long-Term Public Funds Loans for CI	5	5	5	5	5	0.077
LG Municipal Bonds for CI	5	5	5	5	5	0.033
Other Incomes of Local and Regional Governments spent on CI	4	3	3	3	5	0.040
PHARE Program 2000 (M 484 EUR) ¹¹	4	5	5	5	5	0.273
SAPARD Program 2000 (M 171.6 EUR) ¹²	4	5	5	5	4	0.097
ISPA Program 2000 (M 312 EUR) ¹³	4	5	5	5	3	0.176
Regional contracts (started in 2001)	4	4	5	3	5	0.390 ¹⁴
Sectoral allocations for CI from the State Budget	2	2	1	1	2	1.236

SOURCE: Team estimation on the basis of the report findings and statistic data. Explanation: CON—Concentration, PRO—Programming, PAR—Partnership, ADD—Additionality, TRA—Transparency. The value of GDP in 2000 = M 684,926 PLN (M 176,983 EUR).

SCORES: 5—very high performance, 4—high, 3—moderate, 2—limited, 1—poor.

ENDNOTES

- ¹ It does not mean that this amount was spent on local capital investment.
- ² GINI—value in points equal to measured area between the diagonal line of equality and the Lorenz curve, divided by the area of the triangle under the line of equality, multiplied by 100. Decile ratio—the share of labor income (and other similar categories) received by the richest tenth of the regions divided by the share received by the poorest tenth of the regions. In the report eleven variables were estimated.
- ³ To avoid problems in analyzing regional differences in the present twelve large regions, the Main Statistic Office divided Poland into 44 sub-regions in 2000.
- ⁴ In 2000 it was 91.5 million EUR.
- ⁵ In the executive summary regulations for 2000 are presented. Unfortunately methods of counting general subventions change very often.
- ⁶ The fundamental and educational parts of general subsidies are subordinated to real budgetary incomes. Because central budgetary incomes are fluctuating, it is necessary to change local budgets many times in the fiscal year.
- ⁷ It is however compulsory for regions.
- ⁸ Law on Public Finances, November 26, 1998 with further changes, §27 p.3, 2001.
- ⁹ Law on Public Procurement with changes dated June 22, 2001, Dz.Ust nr 76, 2001.
- ¹⁰ E.g., Zyta Gilowska.
- ¹¹ Appropriation.
- ¹² Appropriation.
- ¹³ Appropriation.
- ¹⁴ Estimation of 2001 ratio.

Capital Investment Funding in Romania

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Capital Investment Funding in Romania

Executive Summary

Afrodita Popa

INTRODUCTION

Purpose of the Analysis

Special importance is attached to regional development in the decentralization process that started in the countries of Central and Southeastern Europe after 1990; there are three main reasons for this:

- Allocation of funds for investments to poorly developed regions, for reducing regional disparities;
- Economic development involves a series of factors and measures, starting with infrastructure development, stimulation of the labor market, environmental protection, which are more easily treated at a regional level;
- Regional structures are the most likely to develop the measures of public private partnership necessary for economic development and growth in a market economy.

The study intends to make an analysis of the funds for financing capital investments in Romania aimed at contributing to regional development.

In the current study the capital investments have been divided into three main components:

- infrastructure,
- promotion of economic activity,
- development of human capital (funds for labor market development).

The funds for capital investment financing will be analyzed according to their source:

- The European Union,
- The state budget,
- Off-budget revenues,

- Local public administration revenues,
- Revenues from local administration loans.

Methodology

This analysis is based on the information supplied in the study “Funding of Capital Investments in Romania.”¹ The study makes a presentation of the current and potential development policies, with a detailed description of the role of the institutions involved in the process, and presents a list of the funds for funding capital investments in Romania according to the source of origin and destination.

The analysis makes a detailed evaluation of the funds for financing capital investments in Romania on the basis of the following criteria:

- Concentration (allocation of funds for alleviating regional disparities);
- Programming (compatibility and correlation with multi-sectoral development strategies);
- Partnership and subsidiarity (partnership between the levels of public administration and the private sector in identifying and establishing investment priorities);
- Additionality (co-financing of priority programs);
- Transparency (of the criteria and procedures of fund allocation).

The study also makes a comparative analysis of the funds for financing capital investments in Romania, according to the source and amount.

Limitations

This study does not intend to make a comparison regarding the allocation of funds for capital investments on a sectoral or regional basis, nor to analyze the efficiency of the various approaches to fund allocations.

Therefore, no comparative analysis will be made of the effects resulting from sectoral allocation versus regional allocation of funds for capital investment. The information included in this study can, however, be included in any such analysis.

Similarly, it is not the objective of this analysis to supply alternative solutions for a more efficient allocation of the capital investment funds or for the increase in their impact in the medium and long term.

1. CURRENT REGIONAL DEVELOPMENT IN ROMANIA

In the period 1998–1999, with PHARE assistance, a complex institutional framework was created. Its aim was to attain the regional development goals laid out in Law 151/1998 on regional development in Romania, with the observance of the principles and procedures according to which allocation and management of the Structural Funds are made in the EU member states, in particular the Regional Development European Fund.

In 1997 PHARE had a component of institutional development, which with technical assistance, contributed to the drafting of Law 151/1998 and laid the basis for capacity-building to prepare Romania to manage Structural Funds. As a result the following institutions were set up: The National Council for Regional Development (NCRD), the National Agency for Regional Development (NARD), the Regional Development Councils (RDC) and the Regional Development Agencies (RDA).²

At the end of 2000, NARD was incorporated into the new Ministry of Development and Prognosis.

With the introduction of regional structures in Romania eight regions of five to six counties were created (Figure 7.1).

The main goal of regional development policy, as formulated in Law 151/1998, is “narrowing of the existing regional disparities, in particular by stimulating balanced development and accelerating the recovery of those zones that are lagging behind in point of development due to historical, geographic, economic and political circumstances and the prevention of new disparities and regional imbalances.”

Not all the regions have the same level of development.³ Thus, Region 1 Northeast is facing the most serious problems, both from the social and economic viewpoint and as regards the level of unemployment and industrial decline.⁴ Regions 3 South and 4 Southwest face very serious problems also. The best situation, in socio-economic industrial terms, is found in Bucharest and Regions 7 Center and 5 West.

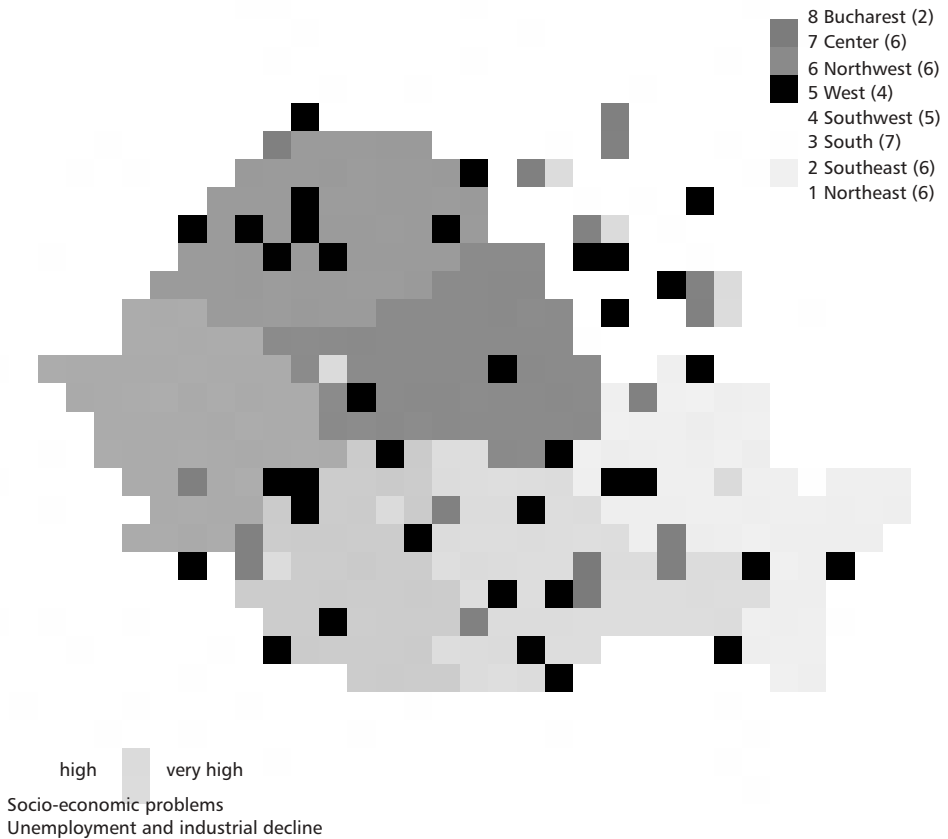
In spite of all this, the inter-regional gaps are not the biggest problem in Romania. The most important problem is that of intra-local disparities within the counties themselves.

Thus, the inter-county horizontal imbalance calculated as a ratio of total local budget revenue per capita is maximum 2:1. The intra-county imbalance is over 5:1 in the case of rich counties and about 2.5:1 in the case of poor counties.⁵

The municipalities that are county seats, which in most of the cases have fewer than 30% of the county population but utilize most of the financial capacity, often over 80%, explain the big intra-county imbalances. The main cause is that the services offered by the local public administrations, which through related taxes and fees generate these revenues, are not homogenous. The municipalities that are county seats and

the bigger towns offer a wider range of services than the small localities or the localities in rural areas.

Figure 7.1
Development Regions in Romania



2. THE FLOW OF CAPITAL INVESTMENT FUNDS

In this section the funds for capital investment in Romania will be analyzed according to the following criteria:

- Concentration,
- Programming,
- Partnership/Subsidiarity,
- Additionality,
- Transparency.

Concentration refers to the promotion, with priority, of public investments for the socio-economic development of under-developed areas.

In order to see whether capital investments observe the principle of concentration, the following elements will be considered:

- Does allocation of investment funds aim at reducing intra- or inter-regional discrepancies?
- Does the regional development policy have the same goal?
- Is the allocation of investment funds made on a regional or sectoral basis?

Programming refers to the inclusion of capital investments in multi-sectoral development strategies. An analysis will be made of the flows of capital investment from the angle of the regional or sectoral approach.

Partnership/Subsidiarity refers to the involvement of all stakeholders (at a central, regional and local level) in establishing the priorities of capital investment and their development. We shall analyze to what extent the stakeholders at a regional/local level are involved in capital investment decision-making.

Additionality refers to the co-financing of the capital investment programs funded through external and/or governmental funds by the local governments and/or final beneficiaries.

The following elements will be analyzed:

- To what extent do investment programs financed by external or governmental funds need local co-financing?
- To what extent do the differences in local financial capacity affect the possibility of accessing EU funds?

Transparency refers to the clarity and availability of all the information in the financing programs, the selection and evaluation criteria and the procedures of allocation of funds for capital investment.

2.1 Concentration

Seen in a wider European perspective, the disparities in the level of revenues (as an indicator of the level of development disparities) are a phenomenon with profound economic and social implications. Thus, as the average level of the GDP per capita in Romania is 22% of the European average, the Bucharest-Ilfov region (RDA 8) attains 38.5% of the European average (at purchasing power parity) while the Northeast region (RDA 1) reaches only 20% of the European average.

It is important to notice that besides the Bucharest-Ilfov and Northeast regions, which represent exceptions, all the other regions of Romania have similar average levels

of revenues, in the overall context of a slightly higher level of development in the western part of the country as compared to the east.⁶

In formulating regional development policies, two National Development Plans (NDP) were drawn up.⁷

- NDP 2000–2002, designed as an instrument through which to prepare the technical and financial procedures necessary for the use, as of 2000, of the PHARE pre-accession financial instruments, ISPA and SAPARD;
- NDP 2002–2005, in which are defined seven priority axes around which all the objectives, measures, programs and projects that will contribute to the achievement of these major priorities are articulated.

For NDP 2000–2002, in conformity with the Memorandum on Financing, the investment projects had two domains:

- The component for industrial restructuring and development of human resources (15.5 M EUR) with co-financing from the Romanian government (National Pre-Accession Fund of 3,875 M EUR).
- The component for rural development of 2.5 M EUR and co-financing of 0.625 M EUR that was developed in partnership with the former NARD and the Ministry of Agriculture, Food and Forests.

The investment projects in the component of Industrial Restructuring and Development of Human Resources were implemented in all the eight development regions, the initial allocation being equal. The projects had three goals: local initiatives, tourism development and human resources development.

The approach to drafting the NDP for 2002–2005 is similar in approach although the content and role of the NDP has evolved to encompass a deeper economic and social analysis made at sectoral and regional level.

The priority axes, as defined in NDP 2002–2005, are:

- *Axis 1.* The development of manufacturing and related services sector, strengthening of competitiveness of economic activities and promotion of the private sector;
- *Axis 2.* Improvement and development of infrastructure;
- *Axis 3.* Consolidation of human resources potential, of the capacity of the labor force to adjust to market requirements and improvement of the quality of social services;
- *Axis 4.* Support for agriculture and rural development;
- *Axis 5.* Protection and improvement of the quality of the environment;
- *Axis 6.* Stimulation of scientific research and technological development, innovation, communication, IT and the creation of the information society;
- *Axis 7.* Improvement of the economic structure of the regions, support for balanced and sustainable regional development.

The sectoral and regional financial programming was made in close connection with the drafting of the 2002 State Budget and the budget orientations for 2003–2005, so that it includes objectives, measures and programs that contribute to the achievement of national development priorities.

In order to concentrate activities and decrease inter-regional disparities, eleven priority targets or Industrial Restructuring Zones, were identified in seven of the eight Development Regions.

Table 7.1 shows the funds allotted for regional development (the three components that are the object of this study), according to their source. It should be mentioned that no accurate comparison could be made on the volume of funds according to the source, since the data refers to different years (2000 for local budget funds and 2000 and 2001 for EU funds, government and beneficiaries contribution). Furthermore, some of the funds (local budgets funds) have already been disbursed, others (EU, government and beneficiaries) only pledged.

The funds allocated for financing local public administration capital investments differ from one region to another. The main differences are the capacity of the local governments (LGs) to mobilize own resources for capital investment and the volume of funds allocated for this purpose from the state budget.

Thus, in 2002 the biggest volume of capital investments financed from LG sources belonged to RDA 2, and the smallest to RDA 1 (RDA 8—Bucharest will not be taken into consideration in this comparative analysis because it is a unique position and the results could be misconstrued).

Within these funds, the funds allocated from the state budget and from off-budget sources have been predominant in some RDAs, but not necessarily the poorest ones.⁸ Thus we can draw the conclusion that the funds transferred from the state budget to the LGs for financing capital investments and those coming from off-budget sources are not distributed according to the criterion of correcting intra-regional gaps.

A comparative analysis of 1999 and 2000 shows that in most cases the investment funds, regardless of their source, have risen in absolute value. In relative value, owing to inflation, these funds have diminished.

The line-item budget of LGs does not allow for the separation of investments into the three main components analyzed in this study; therefore the analysis of compliance with the principle of concentration by types of investments cannot be made, at least when referring to investments whose financing source is the local public administration.

As to the investment funds allocated through the pre-accession instruments the following can be mentioned:

- The EU funds for the Promotion of Economic Activities have been relatively fairly distributed across the eight development regions; the funds from the state budget were also regularly distributed (the funds allocated in 2000 and 2001), with a maximum for RDA 6 (poor region) and a minimum for RDA 3 (average

Table 7.1
Funds Allotted for Regional Development According to Their Source

Source of Funds	Population	Local Budgets (Disbursed 2000)		PHARE 2000, FNDR 2001 (Pledged)		State Budget (Pledged for PHARE 2000, FNDR 2001)		Own Contributions Beneficiaries (To be Disbursed for PHARE 2000, FNDR 2001)	
		Total [EUR]	EUR/Capita	Total [EUR]	EUR/Capita	Total [EUR]	EUR/Capita	Total [EUR]	EUR/Capita
Destination									
RDA 1 (NE)	3,786,066	40,345,588	10.66	23,086,250	6.10	9,309,418	2.46	95,000	0.03
RDA 2 (SE)	2,983,028	52,954,665	17.75	17,506,250	5.87	6,552,750	2.20	1,475,335	0.49
RDA 3 (S)	3,499,272	40,803,548	11.66	15,456,250	4.42	5,869,417	1.68	0	0.00
RDA 4 (SW)	2,423,059	27,314,324	11.27	2,493,750	1.03	1,548,584	0.64	0	0.00
RDA 5 (W)	2,068,149	26,688,946	12.90	7,343,750	3.55	3,165,251	1.53	0	0.00
RDA 6 (NW)	2,864,034	36,326,562	12.68	15,163,508	5.29	5,771,836	2.02	0	0.00
RDA 7 (C)	2,654,843	29,432,146	11.09	6,993,750	2.63	3,048,584	1.15	0	0.00
RDA 8 (B)	2,291,528	78,197,889	34.12	2,493,750	1.09	831,250	0.36	0	0.00
Total	22,569,979	332,063,667	14.71	90,537,258	4.01	36,097,093	1.60	1,570,335	0.07

region). Funds that will be allocated through PHARE 2000 and NFRD 2001 are distributed in a more balanced way.

- The funds destined for human capital development follow the same pattern: relatively regularly in 2000 and 2001, with a maximum much beyond the average at RDA 6; the funds that are to be allocated through PHARE 2000 and NFRD 2001 are distributed with priority for RDA 1, RDA 2, RDA 3 and RDA 6 (adequate for the poor regions).
- The funds destined for infrastructure investments, that appeared for the first time as a distinct component starting with PHARE 2000 are concentrated especially on the poor regions (RDA 1, RDA 2, RDA 3, RDA 6), regardless of their source (EU, state budget).

This analysis shows that as of 2000 the principle of concentration of funds is being applied.

Table 7.2 presents the volume of funds disbursed or pledged, as of 2000–2001, according to the source. The funds from EU (PHARE and ISPA) include also the contribution required from the Romanian government and/or final beneficiaries.

Table 7.2

The Volume of Funds Dispersed or Pledged, According to Source, 2000–2001

Local Budgets		PHARE 2000, FNDR 2001		ISPA 2000–2001	
Total [EUR]	EUR/Capita	Total [EUR]	EUR/Capita	Total [EUR]	EUR/Capita
332,063,667	14.71	128,204,686	5.68	1,210,977,498	53.65

Analyzing the volume of funds/capita, in Romania, it can be easily noticed that the biggest volume of funds is allotted on a sectoral approach (ISPA, components of environment and transport) as compared to the funds allotted on regional development criteria, i.e., through PHARE and local budgets (for the latter, the approach is more local).

2.2 Programming

In 1999–2000 the National Development Plan (NDP) was drafted and approved, including financial planning for the period 2000–2002. It includes the strategic priorities of development for the period 2000–2002, for which Romania requires financial assistance from the EU (achieved through the PHARE, ISPA and SAPARD instruments), as well as the priorities that, in addition to community assets, are to be financed from internal and other external resources.

This has been the first programming document drafted under the conditions of a market economy and achieved both on the basis of information from the field, by means of the Regional Development Plans drawn up by the Regional Development Agencies and the plans and strategies drawn up at a national level by the various ministries and institutions involved in regional development.

In the NDP 2000–2002, nine priorities were defined, out of which six are national priorities of regional development and three are national priorities of sectoral development.

No evaluation can yet be made of the amount of funds allocated for regional versus sectoral development, but according to the number of priority measures defined by the NDP, the approach was prevalingly regional.

In drafting the regional development plans that formed the basis of the NDP, a systematic and detailed analysis was made of the problems identified in every region. Thus, priority objectives were established for every region as well as measures aimed at tackling current problems.

However, drafting of the regional development plans was not carried out on the basis of priorities defined by local governments. This is because most LGs do not have concrete development or implementation priorities. The priorities are scattered, and the funds are insufficient to simultaneously carry out the necessary investments in infrastructure.

There was neither coherent strategy, at a regional level, for remedying intra-regional gaps nor any balanced strategy for all-sector development.

As for the drafting of the NDP 2002–2005, several stages of consultations have been covered, both with the ministries and with the Regional Development Councils, through their executive bodies—the Regional Development Agencies (RDA). For the first time meetings were organized between the ministries and the Regional Development Councils through the RDA.

Sectoral and regional financial programming was made in close connection to the drafting of the State Budget for 2002 and with the budget provisions for 2003–2005, so that it includes objectives, measures and programs that go hand in hand for the achievement of the national priority axis of development.

The NDP 2002–2005 specifies the financing sources of these priorities. Thus, the NDP 2002–2005 is not only a programmatic document that highlights the priorities and measures related to the accession to the European Union but also an instrument that underlines what types of financial resources (State Budget, PHARE, ISPA, SAPARD, other sources) will be used for the implementation of these measures.

There is no articulated multi-sectoral approach in programming capital investments. Major importance has been attached first to the sectors where the differences compared to the requirements regarding conformity with the EU directives are largest. Thus, a large amount of funds will be channeled to the environment and transport infrastructure programs, with ISPA co-financing.

In establishing the regional development priorities there is no consideration of the fiscal capacity of LGs, and there is no coherent policy and strategy for remedying intra-regional disparities. In this respect, a policy could be designed to differentiate the local contribution to programs with an impact at an economic and social level. Following a fiscal policy of diminishing the horizontal imbalances should aim to remedy intra-regional disparities in the long run.

All this leads to the conclusion that allocation of funds for capital investment is made in relation to the priorities defined in the NDP (regional or sectoral) and therefore in observance of the principles of programming, with the rider that priorities at a regional level do not take into account intra-regional disparities.

Moreover, although most of counties draw up development plans (according to the legal provisions in force), they are not always taken into consideration when drafting the regional development plans and are almost never implemented or correlated with the local budgets.

2.3 Partnership and Subsidiarity

An analysis of institutional relations regarding capital investment flow shows the following:

- The strategies, programs and priorities are defined at a central level; it is also at a central level that the implementation agencies and/or payment agencies for the programs financed through structural funds are to be found;
- The regional level is responsible for defining regional priorities (by consultation with the LG and the private sector in the region), for the selection of the projects financed through structural funds according to the priorities defined at a central and regional level and for their monitoring and evaluation;
- At a local level there are fund beneficiaries whose task is the implementation of the projects financed through structural funds; more often than not they are not consulted about the needs and priorities at the local level when drawing up regional strategies.

With the drawing up of the NDP, and especially of the NDP for 2002–2005, observance of the principle of partnership has been considered, at least between the central and regional level.

The planning activity in the NDP:

- Promotes interaction among ministries;
- Supports cooperation among ministries, regional bodies and local governments;
- Improves free access to information—as a part of the consolidation of the civil society and promotion of an “information society”;

- Leads to growing transparency in the process of drafting the development strategy and programs of Romania.

All the above are requirements of the European Union, particularly for accessing Structural Funds.

As regards the partnership between all the stakeholders interested in promoting a project, starting with the central level and ending with the local, often the partnership was a formal one and ineffectual, at least from the regional level down.

There is a partnership between the central administration and the regional level in identifying and establishing priorities. However, effective cooperation with local governments, and especially cooperation with the private sector, has not been considered or promoted. Conversely, the existing legislative framework restricts the connection between the public administration and the private sector to the issuing of licenses, permits and approvals. Furthermore, the local government does not generally take into consideration the needs of private investors in the process of drawing up local policies; there is little dialogue with the private sector regarding the necessities, priorities and lines of action for economic growth at a local level.

In conclusion, as regards partnership, partnership exists only between the levels of the public administration and the central/regional structures. Similarly, the principle of subsidiarity is observed up to the regional level, but these principles are not applied below the regional level.

As of 2002 the situation changed considerably, and special attention has been attached to the consultation and involvement of all the stakeholders interested in the decision-making process of establishing community priorities. Thus a wide process of consultations between the central and the local governments took place for the promotion of new pieces of legislation to settle the issue of local public finance in that year.

We can assume that, once started, this process will be expanded to the other domains as well, including the identification of priorities for capital investments.

The process will probably last several years, but the positive factor that we would like to mention here is that the foundations of a new culture of partnership are being laid in Romania, this time for real, not formally or imposed because of the requirements of certain programs with European funding.

2.4 Additionality

All the pre-accession instruments, which are actually the most important source of capital investment financing in Romania, require to a certain extent co-financing from the Romanian government and/or the final beneficiaries.

In the case of the bilateral agreements signed between the lending institutions and the final beneficiaries, the conditions and percentages of local co-financing vary from

one program to another; however, they are not a major source of financing capital investments in Romania.

Sectoral and regional financial planning was made in the NDP 2002–2005 by identifying the financing sources: the state budget, including loans guaranteed by the state and the EU pre-accession funds; the contribution of the private sector to the development programs of Romania is also estimated. In this way there is level of coherence between the PHARE, ISPA and SAPARD funds and the planning of national investments and other national economic policies.

The procedures on the release of the financing installments are very well defined, and for any type of program of funding from the European Union the existence (and more often than not the release) of the tranche of local co-financing (be it governmental or the contribution of the beneficiary) is a pre-condition for receiving the EU grants.

What should be noted is that all the existing pre-accession instruments in Romania require a big contribution by the final beneficiaries. This hinders access to such instruments by the local governments with low financial capacity. A paradox is being created here: although destined for a harmonious regional development, the EU funds are accessible only to the local governments with a healthy financial situation and not to those with the greatest need.

On the other hand, neither the Romanian government nor the regional institutions have designed any mechanism to support localities with a perilous financial situation to access the pre-accession funds (e.g., by local shares to various programs with European funding, subsidies for infrastructure investments, an effective equalization system, loans with low interest rates, etc).

The fact that most of the localities with big infrastructure problems cannot ensure from their own budgets or from loans the co-financing contribution necessary for any type of capital investment program will lead to bigger intra-regional gaps.

The solution would seem to be that an articulated strategy and an efficient system of horizontal balances will lead to a reduction in intra-regional infrastructure disparities over time.

2.5 Transparency

On the basis of the National Development Plan, the MDP draws up every year a project chart that, following negotiations with the Ministry of European Integration, is sent for approval to the European Union. The Financing Memorandum is concluded on the basis of the project charts and is signed by Romania's government and the European Union. This Memorandum establishes also the implementation arrangements, the financial procedures (by reference to the EU or national regulations) and the co-financing obligations.

The procedures regarding selection of projects, contracting, monitoring, reporting, payment and control have been drawn up in conformity with PHARE-ISPA-SAPARD, EU Regulation, Romanian legislation and were approved by the NFRD, the MPF and the European Commission.

The selection procedures are transparent; the calls for proposals for the projects are advertised in the press, the information package is available on the Internet and all the RDAs. The press periodically informed the public concerned about the number of projects and the value of the funds allotted. The criteria of allocation and the results of the calls for proposals were made public in every RDA.

The criteria that underlay the allocation of funds were established together by the MDP, RDAs, the line-ministries and with the consultation of the civil society sector. They were approved in the NCRD.

The criteria and procedures for the allocation of funds, for every component of capital investments, are also made public. The priorities established in the NDP are widely covered by the media.

The RDAs have the obligation to make public all the information on any available line of financing and to put at the disposal of the potential beneficiaries all the information necessary for taking part on an equal footing in the calls for proposals for the projects.

The process is wholly transparent. What is still questionable is the method of establishing the selection criteria for the projects, which, especially is influenced by political factors at a regional level.

Similarly, it is not clear what is happening when there are insufficient funds for financing all the eligible projects. As for the projects financed through ISPA, a sectoral allocation of funds was made, and it can be assumed that all the projects identified as priorities in the respective sectors will be financed (because the project identification was made in a phase prior to the negotiation of the amounts allotted to Romania through ISPA). In the case of PHARE and SAPARD it is not clear what influences criteria selection from the eligible projects in case the total amount of funds necessary exceeds the amount of funds allocated.

3. EVALUATION

In this section we will evaluate the funds for financing capital investments according to the source of origin and their amount, according to the five aforementioned criteria.

The analysis is made on the basis of the data of 2000. As to the volume of funds from various sources, we should mention that the funds from the European Union, through various financing instruments, are the ones allotted in 2000, whereas the local

funds (both those from the state budget and the own funds from the local budgets) are those effectively released and spent for capital investment.

For this reason the comparison is not relevant. The local sources for funding capital investments for co-financing of the European programs will be different in volume. Conversely, the low level of local sources in 2000 is closely connected to fiscal decentralization in Romania, within which new responsibilities were attributed annually to local governments, very often without allocation of the necessary financial resources, a fact that had an effect on the decrease in capital investment expenditures.

Therefore evaluation of funds for capital investment financing will be based primarily on the observance of the five criteria and only after that on the relation with the volume and importance of funds for every financing source.

In Table 7.3 we have given scores from one to five for each criterion, by financing source, with the following significance:

- 5—the criterion is fully fulfilled;
- 4—the criterion is fulfilled to the greatest extent;
- 3—the criterion is fulfilled to a sufficient extent;
- 2—there are several shortcomings in observing the criterion;
- 1—the criterion is not fulfilled.

Table 7.3
Assessment of Regional Funds in Romania

		Concentration	Programming	Partnership	Additionality	Transparency
EU	Phare	4	5	3	4	5
	ISPA	1	1	3	4	5
State Budget	Contribution to EU financed programs	4	5	3	5	4
	Transfers for investments to LGs	2	2	2	1	2
LG revenues	Own revenues for investments	3	3	1	1	4
	Off-budget revenues	2	1	1	1	2

It should be mentioned that for some of the financing sources, some criteria cannot be met (e.g., concentration for ISPA programs, owing to the fact that ISPA has a sectoral approach and the concentration criteria refers to a regional approach).

Additionality scored 4 points for EU-financed programs. As explained earlier in this document, the local resources required for co-financing these programs are in

some cases too large to allow equal access to all LGs. As for the funds committed by the state budget as co-financing to the EU-funded programs, these totally fulfilled the additionality criteria.

The investments funded out of LG revenues scored lower because revenues for investment are very unpredictable and highly dependent on the resources needed for financing the regular responsibilities of LGs, and also because there exists no clear criteria for allocation of the off-budget revenues.

ENDNOTES

- ¹ Report drawn up for the Local Government Initiative of the Open Society Institute (LGI), within the program Local Government Policy Partnership Fiscal Decentralization Initiative in 2002 by Afrodita Popa, Victor Giosan and Victoria Goldenberg Vaida.
- ² The development regions are only institutional structures. The local public administration in Romania is organized on two levels: the county councils (the first level) and the local councils (municipality, town or village). There is no subordination between the two levels of local public administration in Romania. More details on the system of local public administration in Romania and the regional structures are supplied in the study “Financing Capital Investment in Romania.”
- ³ See map.
- ⁴ The National Statistics Institute 1999 .
- ⁵ “Reduction of the discrepancies between the local budgets of various types of territorial administrative units by improvement of the transfers from the state budget to the local budgets” made by the FDI Technical Assistance project in the field of inter-administrative financial relations. The coordinators were Claudia Pamfil and Victor Giosan.
- ⁶ NDP 2002–2005.
- ⁷ More information on NDPs in Afrodita Popa, Victor Giosan and Victoria Goldenberg Vaida “Funding of Capital Investments in Romania,” report drawn up for the Local Government Initiative of the Open Society Institute (LGI), within the program Local Government Policy Partnership Fiscal Decentralization Initiative in 2002.
- ⁸ Ibid.

ANNEX 1

Table A7.1
Institutional Responsibilities in Regional Development in Romania

Institutional Responsibilities in Regional Development in Romania		
Level	Institution	Role in Regional Development
Central Level	Ministry of Development and Prognosis (MDP)	Ministry of synthesis whose role is to draw up analyses and prognoses on the development of Romanian economy, to implement the government strategy and programs, to promote economic and social development policies as well as the foreign investment in Romania.
	Ministry of Public Finance (MPF)	Ministry with a role of coordination and synthesis. The General Directorate of Public Finance and State Financial Control (GDPFSFC) represents MPF in every county.
	Ministry of Public Works, Transports and Housing (MPWTH)	MPWTH represents the state authority in the field of railway, road, inland rivers, air transportation, multi-modal and combined, constructions and lay out of territory, that it exercises directly or by means of the special technical bodies, subordinated public institutions or authorized commercial companies.
	National Administration of Roads (NAR)	NAR is operating under the coordination of MPWTH; a regie autonome that is responsible for the administration of national roads and bridges through 7 subordinated regional directorates.
	The Ministry of Public Administration (MPA)	NPA is a ministry that is implementing the government's policy in public administration, the strategy for the development of public services of local interest.
	The Ministry of Labour and Social Solidarity (MLSS)	MLSS has the role to provide and coordinate the application of the government's strategy and policies in the field of labour, protection and social solidarity.
	The Ministry of Tourism (MT)	MT drafts and applies, on the basis of the government's program, the policy in the field of tourism, as a domain of priority in the national economy.
	The National Council for Regional Development (NCRD)	NCRD is a deliberative body, without legal standing, whose main role is to promote regional development policy in Romania.

Table A7.1 (continued)
Institutional Responsibilities in Regional Development in Romania

Institutional Responsibilities in Regional Development in Romania		
Level	Institution	Role in Regional Development
Central Level <i>(continued)</i>	The Ministry of Agriculture, Food and Forests (MAAF)	MAAF is a ministry involved in regional development issues.
	The Ministry of SMEs and Cooperation (MSME)	MSME is a ministry involved in regional development issues.
	The Ministry of Economy and Resources (MER)	MER is a ministry involved in regional development issues.
	The Ministry of Waters and Environment Protection (MWEP)	MWEP is a ministry involved in regional development issues.
	The Ministry of European Integration (MEI)	MEI is a ministry involved in regional development issues.
Regional Level	The Regional Development Council (RDC)	RDC is a deliberative body whose role is to coordinate the activities and promote the objectives of the policy of regional development.
	The Regional Development Agency (RDA)	Each development region is led by a RDA, responsible for drafting and implementation of the regional development strategy and programs; RDAs are not territorial-administrative units.
Local Level	County councils (CC)	CCs are territorial-administrative units—tier 1 of local government in Romania.
	Local councils (LC)	LCs are territorial administrative units (municipalities, towns and communes)—tier 2 of local government in Romania.

Conclusions:
Decentralization and Regional
Development in Practice

Kenneth Davey

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Conclusions: Decentralization and Regional Development in Practice

Kenneth Davey

INTRODUCTION

In the run-up to accession to the EU the debate over reform and development in the candidate countries has had a strong but often confused regional dimension. This has been encouraged by the EU and has had three interlocking strands:

- *Regional government*: the possible creation or reform of an upper tier of self-government both to complete the reforms of public administration begun in 1990 and to stimulate socio-economic development;
- *Regional policy*: the desirability of directing public investment and encouraging private investment to reduce the growing territorial disparities in levels of income and employment;
- *Regional development planning*: basing increasing proportions of public investment on regionally conceived and focused strategies and priorities rather than nationwide sectoral programs and targets.

The impact of this debate on the reform of public administration has been analyzed in a parallel LGI study by Gerard Marcou (ed.), *Regionalization for Development and Accession to the European Union: A Comparative Perspective*, OSI/LGI 2002.

The purpose of this study is to see how far it has influenced the actual flows of public investment. This will serve as a basis for discussing the actual significance of the regional approach to development.

The six country studies, summarized in the previous chapters, have analyzed public investment and evaluated it according to the EU's own regional development criteria of concentration, programming, partnership and subsidiarity, additionality and transparency.

This chapter compares the findings of the six studies under each criterion and then attempts to reach some general conclusions.

1. CONCENTRATION

To what extent, and in what ways has the funding of capital investment in the six countries given priority to disadvantaged regions and localities?

1.1 Disparities

In the early 1990s all countries were preoccupied with the loss of previous markets for their goods, services and produce and the resulting collapse of existing bases of employment; measures to shore them up or replace them with new products suitable for new, largely western markets were sought by all levels of government.

By the mid-1990s growing disparities between levels of employment and income in different regions and localities were emerging in the six countries and the gaps have continued to widen. In Lithuania, for example, the difference in GDP per capita between the richest and poorest counties grew by 240% between 1996 and 1999.

The growth in disparity arose partly from differences in the decay of the previous economic base. The environmental backlash against brown coal particularly affected mining areas such as Northwest Bohemia; the loss of Eastern European and Soviet Union markets for manufacturing goods particularly affected areas such as Silesia (both Czech and Polish) and Miskolc. Loss of Soviet Union markets for food crops particularly affected the Baltic States. The disappearance of protected markets particularly affected factories whose original location reflected no natural advantage.

It arose also from differences in ability to attract fresh investment. Foreign investment in sectors such as electronics and automobiles favored areas closest to western European markets, greenfield sites rather than existing industrial locations and proximity to motorways (particularly important because so much modern manufacturing is organized around widely dispersed production of components). In Hungary 80% of all foreign direct investment has been west of the Danube, (65% in Budapest), and in Lithuania 61% has been in Vilnius. Differences in economic performance feed through public revenues into infrastructural support. Local government capital expenditure in Warsaw Region has been three times greater per capita than in Lublin.

Discussion of regional policy and regional development tends to focus on inter-regional disparity in incomes and employment. To some extent this has characterized the experience of the countries studied. There have been broad differences between west and east in both Hungary and Poland; unemployment in the eastern Hungarian counties has been twice the national average. The west/east divide is even more pronounced in neighboring Slovakia (which is not covered by the studies). The economies of North Moravia and Northwest Bohemia suffered disproportionately in the Czech Republic.

The country studies are unanimous, however, in arguing that disparities between incomes and employment *within* regions are far more significant than those between them. In Romania disparities between regions are not very substantial, once the capital is excluded, but are very significant between large cities, smaller towns and rural areas. Statistical deviations at NUTS IV level greatly exceed those at NUTS II. In Lithuania, for example, the favorable rankings of Vilnius, Kaunas and Klaipeda counties disappear once the cities are removed from the measurement.

Generally, settlement size rather than regional location explains more of the difference in performance. This is partly because the collapse of pre-1990 markets was generally most injurious to collective agriculture and to the medium-sized mono-industrial town so favored by Soviet-era planning. Commuting extended urban unemployment to rural hinterlands. Larger cities are more resilient because of their diversity, their human resources, their attractions to service industry and the business infrastructure such as banking which is crucial to private enterprise. In Poland, for example, the consolidation of commercial banking has contributed towards the concentration of investment in five to six metropolitan areas.

Two caveats emerge from the country reports. Firstly, while gaps in income and employment may have been widening during the late 1990s, the poorer localities have not necessarily been getting poorer in absolute rather than relative terms. Unemployment in eastern Hungary is still twice the national average but it has more than halved in size since its 1993 peak. Secondly, some other disparities have been significantly reduced, such as access to public services like telecommunications, gas and piped, treated water. While inter-regional disparities in average incomes grew by 50% in Poland between 1990 and 1998, differences in telephone subscribers and treated water fell by similar margins.

1.2 Regional Policy

In 1990 regional policy generally had a bad name in Eastern Europe. It was associated with a rigid socialist style of regional planning that bequeathed at least three unwelcome legacies. The first was the small village which had been deliberately deprived of new development and infrastructure; secondly, the mono-industrial town, totally dependent upon a single factory which had no competitive advantage such as access to raw materials or good communications; the third was an excessive network of service institutions that were insupportable in the new fiscal climate.

In varying degrees, regional policy has re-emerged during the late 1990s, though on very different lines. There are at least three reasons for this. The first is growing consciousness of the disparities discussed in the previous section and political pressure to mitigate them.

The second reason has been the influence of the European Union and the growing pressure to qualify for membership and access to pre-accession and, ultimately, Structural Funds. As explained in Chapter One, the European Union sees regional development as important to the maintenance of “cohesion” and much PHARE funding and technical assistance have promoted creation of an institutional and procedural framework for it. This has also become part of implicit or explicit conditionality for accession to the Union. Other donors have also supported the Union’s approach in a more random fashion, with pilot regional projects or associated training.

The third reason is neatly described in the Polish report, “the educational role of current regional policies of EU countries removed the dominating naïve ideological point of view that any governmental intervention spoils market mechanisms.”

The result, particularly of EU pressure, has been the creation of an institutional framework for planning and implementing regional development. Typical components have been the re-establishment of a ministry responsible for regional development (often a haven for the remnant of Socialist-era regional planners), demarcation of planning regions, legislation on support to regional development, and formulation of a national strategy for regional development and regional plans (usually called ROPs—Regional Operating Programs). The Czech Republic, for example, created a Ministry of Regional Development in 1996, and in 2000 passed an Act on Support to Regional Development and a Regional Development Strategy supported by eight ROPs.

The EU’s institutional model also includes a regional level of self-government capable of partnership in the design and execution of regional programs. This has added pressure to the establishment of supra-municipal tiers of self-government in the Czech Republic and Poland. However, only in Poland have these elected units fulfilled the EU’s own requirements for the size of a NUTS II region. As a result combinations of self-governing regions or counties have actually formulated ROPs in the Czech Republic, Hungary and Romania, whilst the concept of a sub-national NUTS II planning region has been abandoned by the EU in the Baltic States.

Concern for the development of disadvantaged regions has been neither consistent nor consensual, however. Governments have tended to change hands after every electoral term in Eastern Europe with consequent changes in preference for interventionist policies. Regional policy only emerged in the Czech Republic in 1996 after the defeat of the ideologically pro-market government of Vaclav Klaus. In Lithuania “it is noted that a clear preference of the government, even though it is not explicitly recognized, is to promote the development of ‘growth poles’ by introducing nationwide grant schemes or investing comparatively high shares of funds in their public infrastructure.” Growth versus equity is a live debate in Eastern Europe, and there are understandably people and parties who argue that inter-regional equity is an unaffordable luxury.

Moreover, EU policy has itself been ambivalent, particularly in the Baltic States. The decision to treat Estonia, Latvia and Lithuania as single NUTS II entities has been

interpreted as “replacing a policy of support to specific regions with support to market development in all regions (which was no real regional policy at all).”

1.3 Concentration in Practice

Insofar as public investment has given priority to disadvantaged areas, how has this been affected?

The institutional development described in the previous section would suggest that such preferences would be implemented largely through comprehensive regional plans and programs. There are some examples of this approach, though as yet relatively few. PHARE has funded pilot regional development projects in three northern and eastern Hungarian counties and in Northwest Bohemia and North Moravia in the Czech Republic. In Latvia a Regional Development Fund has been significant in employment creation through business support and labor retraining. The 2002–5 Romanian National Development Plan allocates substantial funding to multi-sectoral investment in nine Industrial Restructuring Zones, spread across seven planning regions.

Such regionalized investment programs may play a larger part in the future, depending in part on the balance still to be struck between EU contributions to regional and sectoral operating programs. However, the principle of concentration has been more observable so far in the application of a regional bias to allocation of *sectoral programs*. For example, in the Czech Republic allocation of funds for support of small and medium enterprises (SMEs) and human resource development have been weighted by unemployment levels; a similar bias has been given in Hungary to funds for labor market and human resource development. In most countries the EU’s SAPARD program is accessible to micro-regions with significant rural unemployment and agricultural market decline.

Finally, one traditional instrument of “concentration”—localized tax breaks—has been ruled out of court by EU accession requirements, based on single market, “level playing field” philosophy. Whether local tax exemptions do really promote sustained development is highly debatable, but the option is no longer open.

1.4 Impacts

The country studies have attempted to evaluate all capital investment flows according to their bias towards disadvantaged areas.

Clearly experience varies from country to country and over time. A few generalizations can be attempted:

- 1) Some concentration of investment in lower income/higher unemployment areas has been achieved by specifically regional programs, particularly the PHARE

pilot regional projects, and also by those sectoral business support and labor force development funds that are deliberately allocated for this purpose.

- 2) National programs in fields such as tourism, road development, business support, and industrial parks tend to have the opposite effect by favoring areas of faster economic growth; this is a function of their own internal logic.
- 3) A substantial proportion of all regionally located investment has been in environmental infrastructure—water supply, sewerage, waste management, etc.—funded by national environmental protection funds and by EU through ISPA. Distribution is normally based on the degree of inadequacy of existing provision plus local ability to meet co-financing requirements (which may include loan repayment). Allocation rarely has any specific relation to regional income and employment levels, and the co-financing requirements may even prejudice access by lower income localities. Nevertheless, such environmental investment does reduce gaps in the quality of life and may in the long term improve the economic attractions of the poorer localities.

2. PROGRAMMING

How far are the nature and location of public investment subject to territorial cross-sectoral strategies?

The EU's emphasis on programming stems from the conviction that regional deprivation can only be effectively tackled by a strategic approach that combines mutually supportive and interdependent actions. The quality of the infrastructure, the environment and the labor force will all be important to potential investors and to improve one without the others may be futile. Fragmented and uncoordinated programs may well be costly and inefficient.

2.1 Regional Programming

As mentioned in the Concentration section, the revival of regional policy and preparation for EU accession have led to substantial development of planning institutions and processes, particularly over the last three years.

This has happened at both national and regional levels. Romania's National Development Plan for 2000–2 is, for example, the country's first comprehensive strategy and includes integrated programs for certain priority zones. Poland adopted a National Strategy of Regional Development in 2000, backed up by the Act on Support to Regional Development.

Legislation in most countries has also required preparation of regional development plans. All Lithuanian counties and Czech, Hungarian and Polish regions have been

obliged by law to do so. Latvian municipalities voluntarily created five Planning Regions to carry out regional planning on the level of macro regions (NUTS III). Legislation in Latvia also requires preparation of development plans and spatial plans at both local government level and regional level (presently 26 districts and seven Republican cities are the official regional level in Latvia); regional planning on the level of macro-regions came as the initiative of local and district governments and afterwards were elaborated into the new Law on Regional Development)

Conceptually these regional plans were to be the basis of regional operating programs (ROPs), which would attract a combination of EU, national and regional/local investment funding. Realization of this aim has been distorted and confused, however, by changes in EU requirements and their mismatch with national systems of governance.

The main problem has been the EU stipulation that ROPs should cover NUTS II regions that should have a minimum population of one million. Only in Poland does the regional level of self-government (*województwa*) conform to this size. Elsewhere the pre-existing counties (Hungary, Lithuania, Romania) and newly created regions in the Czech Republic have been closer to a half million in average population. To meet the NUTS II requirement 19 Hungarian counties have had to be combined in seven development regions, fourteen Czech regions in eight, 41 Romanian counties in eight. Except in Poland ROPs have accordingly been framed by regional development councils or “monitoring committees” which are not directly elected bodies but nominated representatives of constituent self-governments, state agencies, employers, trades unions, etc.

Nor do these planning regions necessarily reflect some geographic identity or single socio-economic character. A major consideration in the wealthier countries such as Hungary has been eligibility for Objective I funding, potentially available from EU structural funds for NUTS II regions whose per capita GDP is less than 75% of the EU average. Boundaries have been drawn to ensure that no city or county above this level disqualifies the whole region, leading to somewhat artificial combinations of richer and poorer neighbors; such marriages of convenience are not celebrated for compatibility and harmony.

In the Baltic States the progress made in developing regional programs was effectively halted when the EU opted for single NUTS II region and ROPs, since it was generally assumed that they would have no impact on actual allocations.

2.2 Impacts on Investment

How much impact regional programming will have on investment funding in the future is unclear (except perhaps in Poland). It depends, firstly, on the balance to be struck between EU funding of regional and sectoral programs. This depends significantly on

national choice since the EU insists that structural funding is only supplementary to national investment. Currently the bulk of pre-accession funding is devoted to ISPA and SAPARD, which are essentially sectoral in nature and micro-regional in application.

Secondly, in the smaller countries such as Slovakia and the Baltic States, the EU has abandoned the ambition to fund regional development on a sub-national basis. Whole countries are to be treated as both NUTS I and NUTS II regions and regional development programs rolled into single national ROPs. The political and administrative difficulties of forming sub-national NUTS II regions and fear of bureaucratic overload at Brussels have both contributed to this retreat.

Nevertheless, regional programming is having an increasing impact on public investment in a number of ways. The first and most obvious effect is where comprehensive regional programs have been undertaken as in the pilot PHARE programs in two Czech regions and three Hungarian counties. The eleven Industrial Restructuring Zones selected for priority in the Romanian 2002–5 NDP are due to receive funding for a mix of environmental, infrastructural and human resource investments. The Romanian report refers to extensive consultation with regional development councils in compiling the NDP, a significant departure from previous practice.

Secondly, the recent second wave of devolution to regional or local self-governments in the Czech Republic and Poland (plus greater fiscal decentralization in Romania) has brought some additional objects of public investment within the scope of local choice and preference. In Poland, for example, this has involved the devolution of responsibility for secondary education, medical care, regional roads, business support and human resource development funds.

Thirdly, the formulation of regional strategies and the institutions engaged in this process (regional governments, regional development councils and agencies, etc.) should enhance local capacity to bid for allocations under sectoral programs. How far this results in reducing disparities does depend, however, on the equalization of regional/local fiscal capacity for co-financing, a point to which the following two sections will return.

How far sectoral programs are influenced by regional strategy varies between countries. In both the Czech Republic and Hungary allocations of funds for business, human resource and rural development have been increasingly “regionalized” in terms of geographical distribution. In Latvia, on the contrary, sectoral programming ignores the obligation to include a regional dimension, reflecting an implicit overall drive for growth. “The National Development Plan talks of balanced development but contains no targets or action plans to achieve it.” In Lithuania county regional development plans are not considered when the State Investment Program is drawn up, and they only influence the bids made by county governors for sectoral funding pertaining to their very limited competences.

A potentially important reconciliation between regional and sectoral approaches to investment is attempted by the planning contracts between the Polish state and its regional governments. Modeled on French practice, these are multi-year agreements

covering investments within a region whether funded by state, regional or local government programs. Lump sum allocations are made by the state budget governed by a formula, allocating 80% by population and 20% inverse to levels of GDP per capita and employment (10% each). Use of these funds is proposed by the regional government and agreed with national government in the person of the minister responsible for regional development. The laws define eligible sectors very broadly and impose a percentage breakdown between them (e.g., 12% for human resource development). Counties, municipalities and other agencies are partners to the contracts in respect of projects within their competence and contribute matching funds. Though the various agencies execute their own component projects, the contract does give participants opportunity to influence each other's project choices, locations, etc., improves consistency between investments and provides some medium-term perspective to the investment program. In fact, an early change of government and fiscal climate forced renegotiation of the contracts, but the framework remains in place.

Finally, the Lithuanian report introduces an underlying skepticism about the recent emphasis on programming. "The fact that most advanced countries do not have national development planning or acquired it only recently, as well as the fact that in many such countries regional development policy appeared only recently, is very telling."

3. PARTNERSHIP AND SUBSIDIARITY

How far are regional institutions, local governments and "socio-economic partners" involved in the selection, design and execution of public investment programs?

3.1 Municipal Government

In most of the countries studied the municipal tier of self-government has played a major role in investment over the last decade. In 2000 it accounted for 40% of public investment in the Czech Republic, 41% in Poland and 332 million EUR in Romania.

Most of this investment was undertaken in some form of partnership with national government, co-financing grants or accepting credit provided by the state budget, EU (mainly through ISPA, SAPARD and PHARE) and off-budget funds (mainly environmental and road funds). But, as discussed in respect of additionality, substantial cost shares have been borne by municipal revenues.

Experience in the Czech Republic is typical. Municipal participation has been high in investments in environmental infrastructure (water, sewerage, solid waste, heating), industrial parks, support to small and medium enterprises, rural "revitalization" and energy saving, but low in tourism, other forms of business support and (surprisingly) housing.

There are a number of reasons for the prominence of the municipal role. The first is the almost universal responsibility of municipalities for investment in environmental infrastructure. Major upgrading of sewage and solid waste treatment and disposal and conversion of coal-fired heating plants have been major priorities in every country. The “green” lobby generally enjoyed more license than other forms of vocal dissent in the Communist-era and was better prepared to press its case in 1989. This pressure has been substantially reinforced by EU accession requirements. They are also very costly and rank highly in overall volumes of expenditure. In countries such as Hungary and Poland substantial subsidies have been available from state budgets and environmental funds financed from penalties, and municipalities have also borrowed heavily for these purposes.

In the early 1990s municipal revenues in most countries left significant margins for capital expenditure. Only in Hungary did local government take immediate responsibility for those local services that entail large recurrent costs like payment of teachers’ salaries. The surplus of revenue over operating expenditure was reinforced by sales of the substantial real estate that passed in most countries from state to municipal ownership.

The importance of the municipal role needs a number of qualifications. Firstly, the municipal capacity for financing investment is generally in decline. National budget deficits have reduced the real value of intergovernmental transfers in relation to local responsibilities, while in countries like Poland and Romania social services like education with heavy current costs have been progressively devolved on local self-government. Repayment of credit is now a burden on many municipalities, in some cases crippling. In some cases access to fresh loan finance is constrained by statutory debt ceilings.

Secondly, this financial capacity varies considerably between municipalities, depending on their size and prosperity and the adequacy of equalizing mechanisms. The Romanian study comments that cities were far better placed than towns faced with a vicious circle, the high running costs of their housing, heating and public transport restricting the funds available for the replacements, repairs, insulation, etc., needed to reduce them.

Thirdly, municipal investment has contributed significantly to reducing disparities in infrastructure and environmental quality (demonstrated in the Hungarian and Polish studies), but only a small portion is directed specifically at increasing incomes and employment.

3.2 Regional and County Government

With the possible exception of Romania, regions and counties have played a far smaller part in public investment than municipalities.

Romanian counties have been significant investors because they own and control public utility companies (a situation common in the former Soviet Union, but not in

Central Europe). They also have a major role in the distribution of revenue shares and more current finance flexibility than central European counterparts.

There is an official upper tier of self-government in Latvia—these are 26 districts and seven Republican cities (NUTS IV level). Since these districts are not directly elected, the councils of districts consist of chairmen of lower level municipalities. As a gesture municipalities have voluntarily created Planning Regions on NUTS III level. Lithuanian counties have very limited competences; they are obliged to produce regional development plans but these have had little practical effect on public investment.

Hungarian counties were retained as tiers of self-government in 1990, but in a severely emasculated form. Their limited competences are largely in the social sphere, they have no taxing power and depend on transfers supplemented by highly discretionary deficit grants; county capitals are outside their jurisdiction. Their chairmen preside over county development councils comprising representatives of state agencies, municipalities and “socio-economic partners” that allocate state budget investment grants and subsidies. A similar role in allocating EU-funded programs has been given, however, to parallel development councils at the level of the seven NUTS II regions.

Czech regional governments only came into office in 2001. They have no taxing power and depend on revenue shares and grants which as yet cover no more than operating costs, leaving no margin for capital expenditure or debt service. They have responsibilities for the coordination of regional development but it is far from clear how these are going to be exercised; before they came into existence ROPs were formulated for larger NUTS II regions by “monitoring committees” with mixed state, municipal and non-governmental representation.

To some extent Poland parallels the Czech Republic. Its sixteen regional self-governments are also latecomers, created in 1998; they account for only 5% of local government expenditure, have no taxing power and depend on tax shares and equalization subsidies leaving little margin over operating costs. Nevertheless their role in the coordination of investment is more explicit and potentially important. This is enshrined in the formulation of regional development plans which are then the bases of the contracts with the government governing the use of both regional and sectoral development funds on a three-year rolling basis. Polish marshals (elected regional chief executives) have been successful in securing municipal participation in these contracts and thereby leveraging the greater volume of disposable funding at that level as counterparts to state funding.

3.3 The Non-governmental Sector

Non-governmental bodies are frequently “partners” in public investment programs as recipients/beneficiaries. Public utility companies, for example, receive loans and grants for building or renovating plants; SMEs receive loans and business advice or acquire plots on industrial estates.

Partnership in the design of development strategies and programs is far more limited, although there are examples. The conventional “socio-economic” partners—chambers of commerce, trades unions, etc.—are normally represented on the regional development councils, regional monitoring committees etc responsible for approving ROPs and often partners in creating regional development agencies. The latter have had varying roles and success but normally assist potential beneficiaries in preparing applications for investment funds. Nevertheless, the types of public/private partnerships incorporating private enterprise investment put together in EU member states to attract structural funds have yet to emerge.

4. ADDITIONALITY

How far do public investment programs require co-financing by local government and final beneficiaries?

4.1 Requirements

The country analyses show that EU-funded programs such as ISPA, SAPARD and PHARE, have strong co-financing requirements.

The practice with state budget programs is less uniform. Additionality may take the form of liability to repay loans; the Polish Environmental Protection Fund, for example, provides a mix of 30% grant and 70% subsidized credit. However, it is often possible to match one source of state assistance with another. Hungarian municipalities, for example, have been able to finance environmental infrastructure entirely with combinations of credit and grants from different national programs.

One outstanding uncertainty in most countries is the future location of responsibility for co-financing EU structural funds after accession. The probability is that this will be largely assumed by state budgets, a financial relief to sub-national government, but a reduction in its leverage over the use of the funds.

4.2 Impacts: Administrative Constraints

The previous section referred to the high volumes of municipal capital investment, most of it financed with some combination of state and municipal revenue. The Polish and Romanian studies also report the considerable extent of capital cost recovery through consumer charging by utility companies.

Additionality requirements obviously enhance resources for public investment, but they also impose substantial limitations on it. The first relates to bureaucratic constraints. In some cases single year budget cycles restrict the ability of either state or municipal governments to pledge funds to a co-financed project that will take longer to implement. Latvia has overcome this with the introduction of three-year rolling budgets, but in the absence of this many projects rely on annual partial funding agreements that often leave investments incomplete. A related constraint is the instability of intergovernmental financial relations, with local government grants and revenue shares often subject to annual formula changes.

Additionality is also increasingly constrained by statutory debt ceilings. The initial post-communist local government legislation of the early 1990s was extremely relaxed by international standards in its attitude to borrowing. National policies have changed both because of some municipal default on bond redemption (highly publicized but not in fact that widespread) and of the adoption of Maastricht Treaty restrictions on public sector indebtedness in pre-accession negotiations. Recent Polish legislation is typical in restricting annual debt service obligations to 15% of municipal revenue.

4.3 Impacts: Affordability

The biggest constraint, however, is affordability. This is as much a relative as an absolute limitation, distinguishing between the ability of different local revenue bases to match funds available from the state, EU or other external sources.

Differences in local fiscal capacity to match external funding obviously run counter to the amelioration of income disparities and the principle of concentration. They can be mitigated, either by: (i) general revenue equalization systems or (ii) variations in co-financing requirements.

The extent of revenue equalization varies between countries. Systems fall into two categories. In the first, intergovernmental transfers are “equalized” in themselves but do not attempt to even out disparities in municipal “own” revenues. Well over 50% of the overall revenue of Hungarian municipalities comes from state grants that are calculated normatively, but there are huge per capita disparities in the local and other revenues making up the balance. A similar situation exists in the Czech Republic. The largest revenue source for Czech municipalities is shares of state taxes; these shares have varied over the last decade, but from 2001 the allotted percentages of the shared tax yields are distributed strictly per capita with a weighting for population size.

In the second category are systems that seek to reduce differences in local revenue bases. A horizontal equalization system in Poland supplements municipalities with per capita revenues below 85% of the national average at the expense of those more than

150% above. Latvia has a system of horizontal equalization based on assessments of both revenue capacity and spending need. Its formula aims to bring the revenues of municipalities up to 90%, cities up to 95%, and of districts up to 100% of estimated expenditure need. A similar system operates in Lithuania. In Romania funds amounting to approximately 26% of Personal Income Tax are allocated for both vertical and horizontal equalisation, but their distribution between municipalities is at the discretion of county governments and has proved both unstable and regressive.

The other way of mitigating differences in ability to match external resources is to link the amount of co-financing to revenue capacity. This can be achieved by varying matching ratios or, in the case of loans, rates of interest. Only one example of such practice is revealed by the studies. In Poland interest on state investment loans is charged at rates between 10% and 50% of bank rate according to the type of local government and its per capita revenue.

The Romanian report particularly emphasizes the adverse impact of differing co-financing capacities on regional development and the need for compensating mechanisms.

5. TRANSPARENCY

How far are the criteria and procedures for distributing public investment funds clearly defined, publicized and executed at the stages of inviting applications, project selection and associated procurement? How adequate are the processes of *ex post* monitoring and evaluation?

The evaluations in the six country studies give a very mixed response to these questions. The highest ratings go predictably to donor funds (chiefly from the European Union and World Bank) since their uses are governed by very explicit agreements with national governments and compliance is open to severe scrutiny. Far lower scores for transparency are attached to state budget or off-budget fund capital grants to local governments, utility companies, etc. and to allocations from sectoral ministry budgets. Hungarian examples include national funding of labor force development, tourism and environmental infrastructure. There is much reference to the vagueness of rules and lack of publicity. In the Czech case much blame is attached to the multiplicity of relatively small and competing subsidy programs in fields such as SME development. Nevertheless there is a general sense that administration of non-donor resources is improving, partly under the general emphasis in pre-accession negotiation on the improvement of public accountability.

A number of reports stress that although the eligibility criteria are clear, there are no transparent procedures for comparing one eligible project with another when, as is common, applications exceed the funds available, no clear weights by which they can

be ranked. It is at this stage that political preference and patronage determine, or at least influence, access to funding.

Transparent allocation of funds is not the end of the story. Capital investment depends heavily on procurement of construction services and equipment, a fertile area for corruption in all countries. The risks of design failure, contract default and cost overruns can also be notoriously high. Interestingly, the Polish study suggests that media scrutiny generally ensures adherence to transparent procurement procedures. The Hungarian report takes a different line in criticizing the procurement of consultants for project design; frequent re-tendering allows politically favored firms illicit access to rival bids and opportunity to make their own more competitive. Other reports, particularly from the Czech Republic, Poland and Romania emphasize the weakness of machinery for *ex post* monitoring and evaluation of project execution and outcomes.

6. CONCLUSIONS

6.1 Regional Government

The role of regional self-government in the promotion of regional development is still unclear and unproven, although the Polish example may offer some clue to its future.

Communist rule generally left county government with a bad image. The first wave of public administration reform after 1989 either excluded the county level from the system of self-government as in Czechoslovakia and Poland or severely restricted its resources and responsibilities as in Hungary. It retained a far stronger role in Romania but acted more as a constraint on municipal freedom than as an agent of local democracy.

As a result subsequent reform of the upper level of sub-national administration has been slow and contentious. In practice, the argument for regional self-government in the Czech Republic and Poland (as also in Slovakia) has had more to do with removing power from a thoroughly unaccountable layer of state bureaucracy than with facilitating regional development. EU pressure has helped to turn the tide in favor of the reformers, though even this has been as much concerned with fulfilling the Copenhagen criteria of accountable government as with the channeling of structural funding.

In another sense the EU search for regional development partners has confused the public administration reform. NUTS II sizes have seemed to demand larger self-governing regions than politicians were willing to create. At its crudest minimum regional populations of one million threatened to deprive too many cities of regional capital status. Only in Poland do self-governing regions enjoy NUTS II status.

Municipal governments have been longer in the development/investment game for a variety of reasons. With the possible exception of Romania it is predominantly their functional responsibilities such as environmental infrastructure that are the focus of investment

and, unlike the regions and counties, they have real-estate and disposable tax incomes to contribute to development packages. Real-estate ownership, land-use planning and construction control are also pertinent municipal weapons in the attraction of inward investment.

The Polish case does, however, suggest that regional government over time can achieve a significant role in the coordination of regional development. Substantial sectoral responsibilities such as business and human resource development are now in its hands and the regional planning contracts, together with their supporting lump sum allocations of state budget funding, have given them a substantial voice in the allocation of investment finance. Poland is, of course, the largest of the countries under study with the greatest geographical reason for an intermediate level of coordination.

The Czech and Slovak regional governments could over time achieve a similar role despite their lack of NUTS II size. It will be extremely hard for any Hungarian authority to do so given the current division of power between regions with no geographical coherence or democratic legitimacy and the counties whose self-government role is so anemic.

6.2 Regional Policy

National concern about growing disparities in income and employment has strengthened in countries such as the Czech Republic and Hungary during the late 1990s. It has resulted in some comprehensive regional development programs in disadvantaged regions, mainly as PHARE pilot schemes. However, reports stress that disparities within regions are far more significant than those between regions. More common and, arguably, more relevant have been locally and sectorally targeted responses, e.g., business support, labor force development, rural revitalization, industrial restructuring aimed at towns or micro-regions affected by the collapse of localized industry or agriculture.

The reduction of disparities has never been a dominant concern, however, and it has been subject both to ideological opposition and fluctuating attention. Motorway development is an example. This has great impacts on the location of growth; transportation is of crucial importance, for example, to the production of manufacturing components, the development of new agricultural markets and the growth of service industries. Linkage to EU networks has been a far higher priority than access to deprived regions. The M3 is wending its way to Nyíregyháza very slowly and connections from Prague to Dresden and Nuremberg are constructed more urgently than to Ostrava. The Polish formula for regional development support contains a 20% weighting in favor of regions with below average income and employment, but such bias is frequently offset by the greater ability of richer localities to co-finance national funding. In any case,

public investment cannot by itself counteract the advantages of wealthier regions in attracting private investment.

6.3 Regional Development Planning

Great effort has gone into creating a legislative and institutional framework for regional development planning and numerous plans and “operating programs” have emerged. The question remains what impact they will have on actual public investment, most of which still flows through nationwide sectoral channels.

What difference does it make? Many decisions critical to local development are bound to remain at national level; motorway development has already been mentioned. The components of regional and sectoral programs are virtually the same. What differs is the right of self-government at regional or local government to allocate money between them and their discretion in adjusting implementation detail like location to local priorities. The Polish regional contracts illustrate a “half-way house” with regional governments making detailed choices in agreement with national government and within a framework of sectoral priorities.

Here, we come against the issue of efficiencies of public choice. Proponents of fiscal federalism and local public choice argue that the more local the choice, the more efficient. This is oversimplistic. The Polish study argues that regional programs are unduly weighted in favor of road schemes simply because their dispersal and visibility satisfies the demands of political horse-trading within regional executives. All expenditure involves a hierarchy of choice from the allocation of x million EUR to transportation to the siting of a culvert. Who knows best varies with the level of decision.

If substantial structural funds are allocated to ROPs, regional development plans may govern equivalent volumes of public investment. If not, their main utility may lie in providing a coordinated and rational basis for bidding for and deploying funds available under nationwide sectoral programs.

In such a process regional governments have a potentially valuable role simply because of political clout. They may have few resources to contribute but a Polish Marshall or a Czech *Hejtman* is a significant political figure whose inquiries and demands cannot be easily ignored. Their ability to impose some developmental and geographical coherence on otherwise fragmented funding decisions can be important, a skill as much political as technocratic.

Ultimately, regional development is a competitive game rather than an economic science. Strategies are important, (and EU influence has obviously helped to develop them at both national and regional level), but what finally matters is the opportunistic eye for the often unanticipated and unplanned chance to give them practical substance.

Country Reports

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