Local Innovations for Growth in Central and Eastern Europe

Edited by Sylvain Giguère



OECD

Local Economic and Employment Development

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Foreword

Policy recommendations are helpful, even more so when they can be adapted to the context in which they are to be applied. This is one of the concerns which led to the creation of the OECD LEED Trento Centre for Local Development in 2003. The Centre, which is part of the Local Economic and Employment Development (LEED) Programme of the OECD, has enhanced the mission of the Organisation with a brand new task – capacity building. In a knowledge-based economy, skilled practitioners can make a difference to whether a locality seizes or shies away from the opportunities offered by globalisation. Capacity for local economic and employment development has been identified by many observers as an area for improvement in Central and Eastern Europe, where local actors, overwhelmed by a wave of reforms since 1989, are struggling to absorb the new concepts and methods introduced in recent years.

Central and Eastern European countries have had a wide experience of the OECD peer review process. Some countries joined the OECD as early as the mid-1990s (Czech Republic, Hungary, Poland, Slovakia), while others are scheduled to join soon (Estonia, Slovenia). Latvia, Lithuania, Romania and Slovenia have gained additional OECD experience since becoming full members of the LEED Directing Committee in the early 2000s, and other countries, such as Russia and Ukraine, have enjoyed special collaboration with LEED. The Baltic states and Russia recently participated in a special project, which culminated in an OECD publication in 2007 (Baltic Partnerships: Integration, Growth and Local Governance in the Baltic Sea Region).

The creation of the Trento Centre has allowed the establishment of a systematic mechanism for collaboration between the OECD and the countries of Central and Eastern Europe. It has facilitated the exchange of experience between policy-makers and practitioners across the region through capacity building seminars, thematic conferences and dissemination of policy material. It has created a network of experts devoted to the same goal as that pursued by OECD LEED: adapting policy recommendations to the local context, developing new expertise, enforcing peer review, stimulating change. The Centre also provides a vehicle for collaboration with other international organisations, such as the UNDP Bratislava Regional Centre for Europe and the CIS, a key partner of OECD LEED in the region and for this publication.

This volume is the first output from this collaboration mechanism. It presents the result of the work undertaken by a group of selected experts in the region, focused on the issue of local development and governance in Central and Eastern Europe. It is part

of the policy research agenda on employment and local governance launched in 1998 with the publication on Local Management: For More Effective Employment Policies *and is the latest in a series of reports, each providing a building block of expertise towards the realisation of a more integrated and cohesive approach to policy making. Subjects addressed by previous volumes include partnerships, decentralisation, the drivers of growth, skills upgrading, and the integration of immigrants. The findings from each of these pieces of research are inputs into the analysis which has generated the present publication.*

This volume provides lessons for both policymakers and practitioners on how to stimulate the emergence and success of local innovations for growth in Central and Eastern Europe. I hope that its lessons will be applied throughout the region, and be useful beyond.



Sergio Arzeni

Director, Centre for Entrepreneurship, SMEs and Local Development

Head, OECD LEED Programme

Acknowledgements

Sylvain Giguère, Deputy Head, Local Economic and Employment Development (LEED), prepared and edited this publication. Special assistance was received throughout the publication process by Andrea-Rosalinde Hofer, Policy Analyst at the OECD LEED Trento Centre for Local Development, who also played a major role in the organisation of the conference on Local Governance and Development in Central and Eastern Europe, to which this volume is a follow-up. Ekaterina Travkina, Responsible for Non-member Countries in the LEED Programme, at the OECD Headquarters, and Elisa Campestrin, Assistant at the Trento Centre, provided central contributions to make this project a success. Debbie Binks, Lucy Clarke, Sheelagh Delf, Francesca Froy, Kay Olbison and Bevan Stein provided essential assistance in the implementation of the project and the preparation of this publication.

Special thanks are extended to the contributors to this publication: Irena Đokic, David J.A. Douglas, Vladan Jeremić, Dubravka Jurlina Alibegović, Irina Kolesnikova, Haralambos Kondonis, Zdenka Kovač, Holger Kuhle, Kalyan Pandey, Jelena Šišinački, Željko Šević, Nenad Starc, Marijana Sumpor, Ivana Rašić Bakarić, David Smallbone, Desislava Stoilova and Paul Stubbs.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Executive Summary

Central and Eastern Europe has been swept by a wave of reforms since 1989 and is still in a state of profound transformation. While the region is today one of the fastest growing in the world, it is facing some tremendous challenges. The extensive restructuring of the economy has created large scale unemployment in some regions while in others, the emerging private sector lacks the labour and skills it needs to grow. Many of those who have lost their jobs have been unable to qualify for the new employment being created and are affected by financial hardship and the erosion of public support.

This difficult situation has led to important movements of labour, as many have left their countries of origin in search of a better life. Migration, combined with a declining fertility rate and a rising mortality rate, has been an important phenomenon since the beginning of transition, with a number of countries losing significant shares of their population. This has led to soaring wages in some areas. Conversely, in areas in which private sector investment is slow, skilled workers are performing jobs that do not reflect their levels of education. Labour is thus used inefficiently and skills are becoming obsolete. Internal labour mobility could be expected to offset such problems, but it is often hampered by an underdeveloped housing market and an ill-adapted transport infrastructure. These factors have contributed to a worsening situation for large swathes of the population and the widening of regional disparities.

A more sustainable track

These conditions explain why the countries of Central and Eastern Europe have for some time been seeking to put economic development on a more self-sustaining track, counting more on their local assets than on foreign capital to stimulate local growth. Policies are increasingly being formulated so as to encourage the effective implementation of integrated development strategies which take into account the economic, labour market, social and environmental dimensions of development. These strategies are designed to build on local assets and competitive advantage, to take a long-term perspective and to make use of resources and expertise from all sectors of society (government, the private sector, civil society) and at all levels (local,

regional and national). They promote the drivers of growth on which local stakeholders can have an impact: skills, innovation, entrepreneurship and social cohesion.

Many such initiatives have been performing well by all standards. They have succeeded in fostering the development of SMEs, contributed to specialising or diversifying their industrial base, recycled the skills of laid-off workers, promoted social inclusion to share more evenly the benefits of growth and tackled market failures in the financing of small scale economic development initiatives, thereby leveraging economic activities locally.

These achievements have had to overcome significant obstacles, which are not necessarily different from those encountered in advanced economies: lack of financial resources, lack of capacity and leadership, reluctance to work in partnership, centralisation and compartmentalisation of policies, lack of disaggregated data to guide decisions, lack of evaluation to avoid repeating failures, and several other practical problems in the implementation phases of local development strategies. The region has been a formidable laboratory for economic development since the beginning of transition. Other emerging economies – in Latin America, Africa and Asia – as well as advanced economies can benefit from this experience.

Nearly 20 years after the fall of the Berlin Wall, it is timely to learn the lessons from the experience of Central and Eastern Europe in local economic and employment development. How do successful initiatives overcome the current challenges that local development faces in Central and Eastern Europe? What can government do to facilitate the process by which localities respond to the challenges of globalisation and seize the opportunities it offers?

Establishing local development structures and mechanisms

The book first looks at the governance structures that have been set up to foster local economic and employment development. It examines the experience of selected countries (Croatia, Poland, Serbia and Slovenia) in restructuring their institutional framework and compares this with similar initiatives in Canada, Finland and Ireland. The analysis shows that the regional and sub-regional institutional landscape is marked by considerable diversity throughout Central and Eastern Europe, especially in terms of administrative arrangements.

Self-governing units, at regional or sub-regional level, can act as a catalyst for economic and social development. To play this role fully they need to work towards building a consensual development strategy that can give orientation

to central government policy as well as to local actions. The size of such administrative units may influence this capacity. As the situation in both Croatia and Slovenia indicates, overly small areas lack the critical mass needed to have any influence on national policies and local action. The size of administrative structures should ideally reflect the interdependencies between cities and rural areas and the need to link them. This would help to determine the specialisation of regions and stimulate their capacity for innovation.

The problem of size and the comparison with advanced economies suggest that much can be done by introducing new forms of governance, such as partnerships or regional strategic platforms. The partnership structures that have been set up in rural counties and broad urban agglomerations have made it possible to reinforce the complementarities between urban centres and their surrounding areas and to overcome the difficulty introduced by administrative boundaries. Partnerships have also been active in these countries in building capacity for local economic and employment development.

The examination of many countries in the region signals that the potential benefits from establishing multi-sector partnerships are considerable. They can provide solutions to burning development issues in local communities while also bringing about welcome transformations within and across sectors by expanding access to resources, encouraging service-focused leadership, building participatory and inclusive decision-making practices, and achieving results that build on synergies.

Building trust and capacities

Partnership development in Central and Eastern Europe is constrained by a low level of trust between stakeholders of different sectors (public, private and civil society) that also inhibits collaboration across policy areas. Bridging the various organisations and linking the various stakeholders is a central subject of concern in the region and specific action needs to be undertaken to develop participatory democracy. There is an overall lack of resources and expertise in local development in Central and Eastern Europe, and a contribution from each sector of society is required to ensure success. In particular, an active civil society can put forward its own initiatives to complement or modify existing ones. This appears to be particularly important in poor communities in rural areas, which face multiple disadvantages.

Analysis shows that recognition that local and regional authorities are a vital element in a sound democratic state structure conditions the development of participatory democracy in Central and Eastern Europe. Local government can

provide guidance to the community, create an enabling environment and facilitate fund raising and institutional support. Also, the studies show that mobilisation works best if it is institutionalised within local government.

Local government officials can usually play this role effectively provided that their capacities are enhanced to the required level. Training should be targeted towards the staff involved in planning and decision making on local development initiatives, and should include advice on accounting procedures. It should aim to strengthen transparency and accountability, better define the responsibilities of each stakeholder, increase the capacity and the professionalism of local authority officials, provide training on how to communicate effectively with citizens and take their initiatives into account, and promote the core values of citizens' participation in local community affairs.

The need to build capacities locally and to provide a link between government and stakeholders from the private sector and civil society in the determination of strategic objectives are key aspects of successful local initiatives for growth. Partnerships are a standard feature of modern governance in advanced economies and their establishment is generally conducive to better outcomes if implemented with care. However, as the experience of advanced economies suggests, partnership and new forms of governance are only part of a broader picture.

Adjusting the national policy framework

The analysis indicates that not all can be achieved by local initiatives. National governments have a strong role to play in making things happen locally. This involvement mainly concerns national policy coherence and flexibility in the management of programmes. Not much can be expected from partnership development at a local level if a similar partnership approach is not taken at the national level. To open up possibilities locally, national government departments and social partners should, as in Ireland, first agree on what they expect from joint action at local level, and establish a joint strategic framework for these activities. Instead of fuelling the proliferation of fragmented local initiatives in various policy areas, making an integrated approach almost impossible, they should allow for the development of consistent initiatives associated with long-term strategic priorities. This can be achieved by the adoption of more flexible policy frameworks enabling policies to be adapted to local conditions. The analysis also suggests that the establishment of integrated regional government departments, as in Finland, can make a positive contribution to the promotion of the regional consistency of policy initiatives.

Overall it is well worthwhile to devote significant attention to reducing the complexity of the institutional landscape, avoiding the proliferation of new statutory or governance structures. Participatory democracy should not be seen as a tool to change power relations, as this risks diverting the focus away from the implementation of strategies with the consequent loss, of credibility and accountability. A more realistic goal is to set up a process through which diverse interest groups reveal problems, various experts propose potential measures, and administrators implement policies in the most effective manner, possibly with the support of elected officials and within a transparent framework.

Fostering entrepreneurship is a useful case study for understanding better what the respective role of central government and local initiatives should be in promoting local economic and employment development. Given the critical local dimension of entrepreneurship, policies must, to be effective, take into account various location-specific factors and tailor business assistance schemes to local conditions. Local and regional governments, business organisations, training service providers and economic development organisations are useful partners for governments in this endeavour.

The challenges associated with the governance of entrepreneurship have been particularly wide-ranging in the case of Central and Eastern Europe. One of the key roles for the state has been to develop a well co-ordinated relationship between the various actors involved in promoting and regulating enterprise creation and development at the national, regional and local levels. Analysis shows that more remains to be done on these aspects.

Setting the local finances right

More specifically, government should undertake action to provide local administrative units with the capacity to support economic development strategies financially when they are appraised positively and judged relevant. Local government can do much to finance entrepreneurship and SME development, notably in partnership with the private sector and financial institutions, as well as drawing on the non-profit sector fully to tackle market failures. This does not imply further subsidising local projects or enhancing government transfers. It rather consists in providing a clear and transparent framework for raising and allocating funds, supporting a broad strategic development process that can provide clear guidelines for the support of local development projects, and providing financial guarantees where needed. As case studies in Poland, Hungary and the Eastern *Länder* of Germany reveal, this would facilitate the establishment of public-private partnerships to finance SME development and the involvement of the non-profit sector in tackling market failures for small loans.

This in turn calls for greater autonomy in local financing so that local authorities can play an effective role in supporting local development. The analysis of the experience of Croatia, Belarus and Bulgaria shows that local and regional governments everywhere face the same problem of inadequate financing. The main revenue source for financing local development projects is locally raised budgets, and the funding sources for capital investment are limited. This reveals a problem of capacity as it is the responsibility of local authorities to identify and analyse technical and financial options and show investors that they have adequate and reliable revenues to meet their debt service obligations. Municipalities should also be able to define strategic orientations for economic development, which can in turn provide a rationale for the joint funding of relevant projects that meet strategic objectives.

Fiscal decentralisation can enhance the capacity of local governments in financing local development. In many countries of Central and Eastern Europe, there is a mismatch between the responsibility of local authorities in terms of service provision and the share of local budgets in the state budget. Fiscal decentralisation can contribute to the development of a favourable investment climate and foster sustainable development. A gradual devolution of taxation power to local authorities as well as the development and adoption of a stable legal framework for the principles and mechanisms of the intergovernmental transfer system would contribute to greater financial independence of municipalities.

ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 1

Local Innovations for Growth in Central and Eastern Europe: Policy and Governance Issues

by
Sylvain Giguère

Designing and implementing local development strategies is of critical importance if prosperity and living standards are to be raised. They are the means by which localities can respond to the challenges presented by globalisation and seize new opportunities as they occur. Yet this is a much more difficult exercise than is sometimes thought. The challenges are even more acute in Central and Eastern Europe, with its ongoing ambitious reforms, profound economic restructuring and extensive learning phase. The success of local development strategies in the region depends on the ability of governments and their partners to accelerate change in both the policy and governance aspects of economic and social development. These include wide-ranging issues such as enhancing flexibility in the management of policies and programmes, establishing a consistent overarching strategic framework for local development, reviewing local government finance and setting up mechanisms to raise capacities. There is much government can do to influence the development of local innovations for growth in Central and Eastern Europe and enhance their impact on the economy and society.

Introduction

Central and Eastern Europe is in a state of profound transformation. Countries from the Baltics to the Balkans, from the Visegrad group to the Russian Federation, have been swept by a wave of reforms since 1989 which have touched upon all aspects of economic and social life[1]. The old communist institutions were dismantled rapidly, with the aim of liberalising prices, freeing up a space for the market economy, and reaping as many benefits as possible from an increasingly globalised economy. While the transition began with a major fall in economic output, followed by slow recovery in many regions, today Central and Eastern Europe is one of the fastest growing regions of the world.

The mobility of capital and the mobility of labour are two of the forces most responsible for shaping today's region. Attractive to investors due to its low production costs, the region has benefited from substantial flows of foreign direct investment. New firms have replaced state enterprises which have reduced their activities or been closed down. In this process, jobs have been destroyed and others created, though at differing speeds. The extensive restructuring of the economy has had an immense impact, creating large scale unemployment, while the emergence of private sector employment, with its promise of increasing prosperity for various segments of the labour force, has been relatively slow.

Those who have lost their jobs have not always been able to qualify for the new jobs created. Many of them, also affected by material hardship, non-payment of salaries or the erosion of public support, have left their countries of origin in search of a better life. Indeed the transition has provided one of the greatest opportunities in recent times for the population of Central and Eastern Europe to work and live abroad. This possibility has been enhanced by the accession of twelve of these countries to the European Union in two waves since 2004. Migration, combined with a declining fertility rate and rising mortality has been an important phenomenon since the beginning of transition, with a number of countries losing significant shares of their population. Bulgaria, Estonia and Latvia, for example, have lost approximately one tenth of their population since 1989.

The forces of change are sometimes conflicting. Foreign capital has flown into a country, but labour and skills have departed, sending wages soaring and threatening competitiveness in some regions. Conversely, in areas where

private sector investment is low, skilled workers are performing jobs that do not reflect their levels of education. Labour is thus used inefficiently and skills are becoming obsolete. Internal labour mobility could be expected to offset such problems, but it is often impeded by an underdeveloped housing market and an ill-adapted transport infrastructure. Vocational training is also inadequate to meet demand, having institutions that are typically under-resourced and constantly challenged to meet rapidly changing business needs.

Widening regional disparities are the result, with investment flowing mainly to large agglomerations where infrastructures are better developed and the skilled labour force is concentrated, while other regions are increasingly depressed. When the young leave and entrepreneurship is weak, municipalities find it increasingly difficult to ensure the delivery of basic services. In this context, an ageing population often turns to a subsistence economy based on agriculture. In Albania, 90% of the poor live in rural areas, with 60% of the heads of poor households self-employed in agriculture (IFAD, 2002). The rural situation has deteriorated throughout the region, and inequality between rural and urban areas has greatly increased. Poverty is growing rapidly, and economic insecurity has dented social cohesion. Central and Eastern countries also face new challenges associated with in-migration. Labour shortages in some sectors are being filled by migrants from Asia, Africa and other countries from the region, and this requires the implementation of measures to facilitate the integration of the newcomers and their families.

New orientations for policies and institutions

The countries of Central and Eastern Europe are now seeking to put economic development on a more self-sustaining track. Obviously, foreign direct investment will continue to be a major source of growth, but reliance on low production costs to attract capital is considered unsustainable given the more competitive situation of China and the South-East Asian economies. There is recognition that what matters more in the long run, both in the search for capital and the promotion of indigenous investment, is the skills base. What brings enterprises to a region and encourages them to stay is largely the availability of a pool of skilled labour. Enhancing the quality of local human resources also helps to harmonise goals of economic competitiveness and social cohesion. A further area of consensus is the need to stimulate the internal market. The capacity to generate innovations and new economic activities is central to the development of mature economies. This is reflected by the strong growth in recent years which is attributed to the latest reforms aimed at the development of SMEs and the stimulation of domestic consumption through facilitated access to credit (Svejnar, 2006).

Such reforms have set the stage for the renewed efforts currently being devoted to endogenous development in Central and Eastern Europe. Policies are increasingly formulated so as to encourage the effective implementation of integrated development strategies, which take into account the economic, labour market, social and environmental dimensions of development. Strategies are designed to build on local assets and competitive advantages, to take a long-term perspective and to make use of resources and expertise from all sectors of society (government, private sector, civil society) and all levels (local, regional and national). Such strategies must give direction to national policies at the same time as they co-ordinate actions by local and regional governments.

Local strategies are not new in the region. Back in the early 1990s, an array of international and donor organisations, such as the World Bank, UNDP, the ILO, the European Union, the EBRD and USAID began to finance local economic development strategies and to distribute guidelines on how to devise them. Thanks to these organisations there is today a significant degree of expertise in the region on local economic and employment development. Many lessons have been learnt and capacities built in a short period of time through this international involvement.

The obstacles to be overcome have been steep. At national level, priority has been given to the major tasks of transition: macro-economic stabilisation, privatisation, enforcement of a legislative environment adapted to a market economy, development of a banking system, new labour market regulations. At local level, priority has been given to attracting new investors as state enterprises closed down. In times of economic collapse, there is little patience for learning and applying new concepts, especially when the economic regime is new and few people know how to handle it.

What local strategies try to achieve

All strategies for local economic development are unique. They are based on the conditions and characteristics of an area; they build on local assets and address strengths and weaknesses. They are often subject to a vision for long-term development, which in turn depends on the views and goals expressed by various stakeholders and on the trade-offs negotiated between them.

Nevertheless, most area-based strategies will, at least to some extent, aim to stimulate a number of the key drivers for growth and competitiveness at local and regional levels, including (but not only): skills, innovation, entrepreneurship and social cohesion.

Skills. There are a number of channels through which skills lead to growth. Firstly, skills are a core element of economic development – where pools of skilled labour are available, there is greater opportunity for enterprise

creation, business development and inward investment. Secondly, diverse and specialised skills are prerequisites for technological progress and higher productivity. Talent is a key driver of innovation. Finally, opportunities to develop skills are essential if the benefits of prosperity are to be spread to all segments of the population.

Innovation. Innovation can take various forms, from a new product design to a new production process. Normally innovation is itself the result of a process, consisting of three distinct phases: the generation of knowledge; the sharing and distribution of that knowledge among potential users; and the application of the new knowledge to product development, whereby it translates into a new business activity or, what is more likely, the renovation of an existing one. Modern growth theory sees innovation as endogenous, with firms forging a continuing market advantage by being the first to create compelling new products. There are technology spillovers among firms in the R&D process as each new innovation contributes to knowledge overall. This provides a rationale to support research activities and innovation.

Entrepreneurship. A spirit of entrepreneurship is vital for growth. Entrepreneurship is one of the most direct ways to create jobs, increase incomes, facilitate adjustment to economic change and underpin economic competitiveness in a given area. New firm formation is also a key vector for innovation. In the most distressed areas of cities and regions, entrepreneurship has an additional social benefit, because as well as supporting job creation and local economic competitiveness in general, it is also a key mechanism to help disadvantaged groups leave unemployment and poverty. Entrepreneurship can foster the emergence of the third sector/non-profit economy, and can contribute to retaining young talent in disadvantaged regions and emerging economies.

Social cohesion. Each of the growth drivers above has a social dimension that can be captured using the terms social cohesion, social inclusion or social capital. The overarching concept of social cohesion is a critical aspect of quality of life, which is in turn conducive to a good business climate that attracts capital and talents. Social cohesion can be viewed as the sum of the degree of social inclusion and social capital present in a region. Social inclusion relates to integrating disadvantaged individuals and minority groups into the labour market and helping them to take part in the development of a prosperous society. Social capital is characterised by networks and shared values, which play an important role in supporting business development.

Where national policies exist to fuel such drivers of growth, local area-based strategies can orient them better to meet local needs. This may involve setting up complementary projects, and mobilising support from different

levels of government and from other stakeholders. Local strategies rely on broad support to come to fruition, requiring a direct involvement from the business community as well as civil society groups. As some of the drivers are interrelated, there is also much to be gained from bringing different policies together, thereby maximising synergies, and avoiding duplication or conflicts. Strong co-ordination is required to harmonise the various actions undertaken at different levels around shared goals. Thus, the pursuit of endogenous development strategies calls for an appreciation of key governance principles: policy co-ordination, adaptation of policies to local conditions and participation of other stakeholders, including business and civil society, in the shaping of measures. In this respect, *governance* as such can also be considered as a driver of growth (Giguère 2005).

Obstacles

Pursuing endogenous development strategies in Central and Eastern Europe thus requires promoting some or all of the above drivers of growth in a way that takes into account local conditions; while simultaneously working on the establishment of a suitable governance framework that facilitates co-ordination, adaptation and participation. In practice such exercises have encountered a number of obstacles. Many of them lie within the field of governance, as we shall see below.

From design to implementation. One of the main problems facing strategies designed locally or regionally in Central and Eastern Europe has been the move from the design phase to the implementation phase. The manifold activities of the donor organisations involved in the region have sometimes led to the development of a plethora of strategies, superposed in the same territory or with large overlapping areas. This has made it difficult for government agencies and other organisations to understand where and how they should focus their actions, and has contributed to such strategies being on a rather low scale and with a low critical mass.

Lack of financial resources. Donor organisations have also sometimes been less willing to fund the implementation phase of their strategies, thus leaving projects designed locally short of resources to support their development. Government agencies and public services are often not in a position to support local projects or to modify the implementation of programmes because resources are absorbed by central government priorities. In some areas of Russia, for example, local offices of the Federal Employment Service have recognised the importance of supporting skills development strategies that could fuel the development of SMEs, but have been unable to translate this into concrete participation as their budget is pre-allocated to income support measures. Likewise municipalities are often ill-prepared to appraise local

development projects and face budget conditions that limit their room for manoeuvre.

Lack of capacity and leadership. If the capacities of local development managers have been enhanced rapidly thanks to the activities of the donor organisations in the region, this improvement has mainly benefited a small group of people, who have become a form of "elite" of local development. The gap between the understanding and awareness of these agents (who have often had opportunities to travel and participate in international meetings and exchanges of experience) and other local stakeholders has been wide and difficult to close. These practitioners have naturally been seen as possible leaders, but other stakeholders, possibly more informed about local development possibilities and obstacles, might have been better qualified to drive collective actions locally.

Reluctance to work in partnership. Working in partnership has its own difficulties and challenges in terms of sharing information, participating in a collective process, and maintaining support from one's organisation's own hierarchy. It takes time to become familiar with the methods of operation associated with partnership working and use them efficiently. Such methods have only recently been mastered by stakeholders in more advanced countries, where partnerships have been part of the institutional landscape for more than two decades. In Central and Eastern Europe, where the methods of a planned economy and its associated structure of committees are still fresh in the mind, and where people have only recently learnt to adopt a more individualistic behaviour in their economic and professional life, many people have low expectations of partnerships.

Centralisation. The role of central government in promoting endogenous development is critical. Governments increasingly manage policies to promote entrepreneurship, innovation, skills development and social cohesion. Each of these policy areas has a strong local dimension. For example, the rate of enterprise creation in one region can be six times that in another due to local characteristics (*e.g.,* education profiles, skills, demographics); any policy must take such characteristics into account to be successful. However, policies are often centrally managed, and the various programmes and instruments are difficult to adapt to local conditions. The local antennas of public services are often responsible only for the delivery of programmes and have little if any say on the strategic orientation of their implementation.

Compartmentalisation. All drivers of growth require involvement of more than one policy area. For example, skills development involves labour market policy, vocational training policy and also economic development. These policy areas are often managed in "silos", with only weak communication and co-ordination between them, even at the local level. Getting the policy managers

of the various sectors to work together is complicated due to the vertical structure of each organisation and the internal objectives each policy area has to meet. Sometimes barriers of culture and style of language are a further obstacle. What is more, in some cases, individual policy areas are themselves also fragmented in various sub-policy areas, with completely separate agencies managing the different programmes. Labour market policy is sometimes run by an agency responsible for active labour market programmes while another deals with unemployment benefits. Economic development is often split between foreign direct investment and endogenous development.

Lack of data. To inform decisions and strategies at local level, it is important for local stakeholders to use reliable data. This is especially critical when it comes to convincing government agencies and public services to change their course of action or to support a new project. Data must be gathered on economic conditions (enterprises, sectors, markets, clusters) and on the labour market (skills shortages, gaps and deficiencies, qualifications, education attainments, disadvantaged groups) while developing strategies for economic and employment development. However, such data is often missing because of a lack of resources from the public services responsible at local level, combined with insufficient analytical capacities. Data gathered at the national level are often too aggregated to be helpful in the design of strategies at local level.

Lack of evaluation. To ensure that resources are used in the most efficient way possible in the implementation of programmes and the management of institutions, performance must be monitored and assessed. Results need to examined to understand whether objectives have been met or not, and if an alternative action would have been preferable. More importantly, there must be a systematic use of performance evaluation results, and the policy development process should provide a clear place for learning from such results. All too often, evaluation results are used only when they can justify a decision (to continue or cease an activity) that has already been taken by policymakers. In many countries a lack of an evaluation culture nurtures inefficiency and leads to failure. This is often accompanied by ignorance of user-friendly evaluation techniques.

Thus local innovations for growth face important challenges, and these are all the more acute in Central and Eastern Europe. How can they be overcome? What are local best practices? What should government change to facilitate the process by which localities respond to the challenges of globalisation and seize the opportunities it offers? It is the objective of this book to respond to these questions. It will address them by exploring four themes of high importance for local economic and employment development: *i)* the governance structures of local development; *ii)* participatory democracy; *iii)* the local governance of entrepreneurship; and *iv)* local development financing.

Figure 1.1. **Central and Eastern Europe**



Source: United Nations, Map No. 3877 Rev. 6, 2007.

The governance structures of local development

The first part of the book will examine the results of a range of international efforts to deploy forms of governance that can best support local economic development. David Douglas in Chapter 2 looks at the rural context and compares the situation of economic development of Poland with that of advanced economies, Canada and Ireland. All three countries share some important institutional features, such as a weakness within local government

and a high degree of own-revenue dependence, which restricts action on local development. However, the regional and sub-regional institutional landscape is marked by considerable diversity across the three countries, with a wide variety of different governance arrangements having a major impact on local development outcomes.

The three countries analysed by Douglas present different combinations of modes of organisation which yield different outcomes. In terms of public organisations, Poland has recently introduced 16 regional administrations which prepare regional development plans and provide a link with national policies, in addition to sub-regional structures less involved in local development. In Ireland, the sub-regional level has had a relatively strong operational involvement, with counties having a traditional role in dealing with economic development in rural areas. By comparison, the Canadian province examined, Ontario, is poorly organised at regional level.

Yet the existence of statutory bodies may not be a necessary condition for the design and implementation of local development strategies, as the analysis shows. In Ireland, the establishment in 2000 of non-statutory county development boards (and city development boards in urban centres) has been an important factor in the design of integrated development strategies (covering economic, social and cultural policy areas). In Canada, local governments can request the establishment of a Community Future Development Corporation (CFDC); in addition there is a culture of partnership and an activist civil society that local government can tap into when the situation requires it. As a result, capacities in strategic and participatory planning are not a problem in either of these countries. In Poland however, a deficit in capacity has been identified, and is particularly apparent in relation to the absorption of European Union Structural Funds. This is a difficulty that is common to other countries of Central and Eastern Europe that have joined the European Union in recent years.

The need to build capacities locally and to provide a link between local government and stakeholders from the private sector and civil society in the determination of strategic objectives raises the issue of the establishment of effective partnerships. As noted above, partnerships are a standard feature of modern governance in advanced economies but are still a learning subject in Central and Eastern European countries. Progress is being made in Poland, with several ongoing experiments in establishing partnerships for local economic development.

However, partnerships are only one part of a broader story. As Douglas shows, building consensus and commitment around shared goals should go hand in hand with reinforcing local authorities and other existing institutions, building capacity, reducing the complexity of the institutional landscape, and supporting local economic development with an overarching strategy.

The role and size of administrative units

Some of these lines of action are directly supported by analysis of the case of Croatia. In Chapter 3, Ivana Rašić Bakarić, Marijana Sumpor and Jelena Šišinački are struck by the low critical mass of the counties, the units of self-government responsible for local economic development in Croatia. Only the bigger cities succeed in attracting population and economic activity. The chapter enquires as to whether the existing administrative setup and the functions of these counties, as set out in legislation, correspond to the needs of economic growth and development at the local level. It reviews concepts that derive from regional economic theory, trade theory, location theory and economic geography to gain insights into spatial considerations of economic activities and conclude that local economic governance structures are inadequate to foster economic development in their country.

One of the main problems identified is the fact that the legislation ignores the role of urban centres in the economic development of the regions surrounding them, while the role of counties in this context remains only vaguely defined. The authors argue that interdependencies between cities and counties should be reflected in the governance structure for economic development. In the absence of revised legislation, new forms of governance may fill the gap, thereby increasing the critical mass of local development initiatives and serving as a platform for bringing together government, business and civil society. In addition, the analysis of the Croat case highlights the need to strengthen analytical capabilities locally and to ensure that adequate regional and local statistics are available to allow for the monitoring of local government and economic development performance.

Building partnerships: a central role for national governments

Zdenka Kovač in Chapter 4 concentrates on the process of building new forms of governance. She examines the case of Slovenia, where reforms have established regional development partnership structures, and compares it with the cases of Finland and Ireland. The analysis also confirms the need, identified in the Croatian case in Chapter 3, for governance structures to link urban centres and the rural regions surrounding them. This would help to determine the specialisation of regions and stimulate their capacity for innovation. Also, as in Croatia, more clarity of the role of local governments in socio-economic policy areas and greater economic autonomy would help to stimulate greater participation in area-based strategic planning exercises. Local capacities appear to be a strong determinant of local successes; lack of capacities covers not only shortfalls in technical and planning skills but also embraces consensus building and bargaining skills.

The Slovenian analysis points to the roles and responsibilities of national governments. Not much in the way of successful outcomes can be expected from partnership development at local level if a similar partnership approach is not taken at national level. To open up possibilities locally, national government departments and social partners should, as in Ireland, first agree on what they expect from joint action at local level, and establish a joint strategic framework for these activities. Instead of fuelling the proliferation of fragmented local initiatives in various policy areas, making an integrated approach almost impossible, they should allow for the development of consistent initiatives associated with long-term strategic priorities. The Slovenian case underpins recommendations already made by the OECD in this regard, which suggest that this would require the adoption of more flexible policy frameworks enabling policies to be adapted to local conditions (Giguère, 2004). Kovač suggests that the establishment of integrated regional government departments, as in Finland could also promote regional consistency of policy initiatives.

Building partnerships: bringing NGOs on board

Another essential determinant of effective partnerships lies in the capacity of civil society to provide a meaningful contribution. Vladan Jeremič and Željko Šević in Chapter 5 see enormous potential benefits for Serbia from establishing multi-sector partnerships: they could provide solutions for burning development issues in local communities while bringing about welcome transformations within and across sectors through their impact on increased access to resources, service-focused leadership, participatory and inclusive decision making practices, and the benefits to be derived from synergies. Partnership development is hampered, however, by a number of legal and administrative barriers that constrain the emergence of NGOs and their participation in civic life. A low degree of trust within the country, poor communications between stakeholders and weak levels of organisation in local communities make this situation all the more difficult.

The authors argue that the Serbian government has to learn to communicate effectively with citizens and take their initiatives into account, whilst NGOs have to be more aware of their social responsibility and not only emphasise the responsibility of the other two sectors, namely government and the private sector. Enhanced interrelations and synergies between municipalities and NGOs are required to change the current situation. In particular, more experienced and well-established actors should play a more pro-active leadership role and combine their resources and skills to undertake joint actions, giving impulses to local strategic planning exercises embracing fund-raising, wider consultation of stakeholders locally, and the initiation of broad co-operation with the private sector and trade unions.

From representative to participatory democracy

Bringing civil society and NGOs on board in the furtherance of local development is an important governance issue which deserves further attention. The emergence of participatory democracy has been a lengthy process in advanced economies, but it still faces a number of obstacles, such as mistrust between stakeholders of different sectors. Since the fall of the Berlin wall, participatory democracy has appeared to many Central and Eastern Europeans as synonymous with the promise of greater efficiency in decision making and, accordingly, has nurtured high expectations. With the transformation of the role and tasks of all levels of government, and the need to develop new skills and perform new functions, it has been deemed necessary to have non-public stakeholders contribute to the design and implementation of local policies to ensure that the decisions made are consistent with both the aspirations of the population and the aims of long-term strategies. As Haralambos Kondonis explains in Chapter 6, much remains to be done on this issue – and work should start with the institutions that co-ordinate much of this broader participation – local and regional authorities.

The chapter surveys the development of participatory democracy in South-East Europe, recognising that local and regional authorities are a vital element in a sound democratic state structure and arguing for increased capacity building for these institutions, notably through administrative and fiscal decentralisation. Yet, the experience of several South-East European countries shows that unprepared and un-consensual decentralisation can undermine state stability and the effectiveness of local governance. Illustrations are provided by cross-border co-operation initiatives, which are so critical to nurturing a spirit of co-operation and trust throughout the region. Most of these initiatives are currently led by local authorities, without consultation with civil society; they are lacking in substance, fail to take a sufficiently long-term planning perspective, and therefore generate little impact. Enforcing the active participation of civil society in decision making and policy implementation and nurturing greater communication and co-operation between central and local government are key elements of a strategy to improve governance in the region and enhance policy effectiveness.

Such a strategy should aim to strengthen transparency and accountability, better define the responsibilities of each stakeholder, increase the capacity and the professionalism of local authority officials, and promote the core values of citizens' participation in local community affairs. Responsibility lies with national and local governments for initiating programmes, and partnering with NGOs on projects to promote citizens' access and equitable economic

sustainable development. Training programmes for local authorities should provide mechanisms for encouraging participation of the local community and specific social groups. They should include staff and interested individuals representing the local community.

Participatory development: from rhetoric to reality

Nevertheless, greater participation does not automatically imply more effective action. In Chapter 7, Irena Đokic, Nenad Starc and Paul Stubbs take a closer look at the practice of participatory development in Croatia and reveal the existence of a considerable gap between theory and practice. They recall that, as in many other countries of the region, new legislation has called for intensive programming efforts in social and economic fields, and required the preparation of documents labelled "strategic programmes", "strategies", or "long term plans", at all levels of government. However, very few of these documents, prepared in consultation with civil society, have been implemented in practice.

The authors examine three case studies and argue that participatory democracy is a sophisticated process. Different types of participation are required at different stages of a participatory process and for different groups of stakeholders (*e.g.*, preparation, adoption, and implementation of a given programme). Participation is more than the mere opening of workshops to the public. It means the introduction of a rigorous, triangulated, multi-faceted, methodology including interviews, surveys, focus groups, and continuous dialogue and reflection at each stage. Overall, effective participation requires the understanding of power as a set of complex social, political and economic relations. Without this, participatory development programmes can reinforce the status quo and reward the most articulate groups and municipalities that are already developed and highly skilled. Participatory democracy should not be seen as a tool to change power relations, as this risks non-implementation and a loss of credibility expose accountability. A more realistic goal is to set up a process through which diverse interest groups reveal problems, various experts define potential measures, administrators implement policies in the most effective manner possible, and politicians take an active part in implementation and bear political consequences.

Mobilising the population for maximum impact

A critical element of success in participatory development processes is the degree of mobilisation of the local population. This is particularly important in the case of strategies, programmes or projects that target the population itself. The participation of the population at various stages in the development of a policy initiative can ensure that the delivery mechanisms function properly and fulfil their objectives. An active civil society can also

take a bolder role and propose its own initiatives to complement or modify existing ones. This appears to be particularly important in poor communities in rural areas, which face multiple disadvantages. It has been widely accepted internationally that in order to promote sustainable rural development communities, the involvement of the local population is essential in all phases of the planning, design, implementation and benefit sharing of the programme. Organised groups of people can be involved in their own capacity development leading to self-empowerment. However, mobilising civil society in a disadvantaged community and in a deprived environment is a difficult challenge.

In Chapter 8, Kalyan Pandey analyses the results of an initiative launched by the United Nations Development Programme (UNDP) in Albania to mobilise local people to promote their development through their own resources and to participate in the decision-making process actively. The project is based on the fact that a participatory approach in community development requires responsible, well-informed and proactive people. The results show that mobilisation works best if it is institutionalised within local government, and if the latter has developed a role of catalyst, providing guidance to the community, creating an enabling environment, facilitating fund raising and institutional support. Local government officials can usually play this role effectively provided that their capacities are enhanced to the required level. Training should be targeted towards the staff involved in planning and decision making on local development initiatives, and should include advice on accounting procedures.

The governance of entrepreneurship and economic development

Among the policy areas embraced by local development, entrepreneurship is the area where the local "filtering" and adaptation of national programming perhaps matters most. The local dimension of entrepreneurship is critical. The nature of entrepreneurial activity varies across local areas owing to differences in demography, wealth, education and occupation profiles, among others. Particularly enterprising areas may enjoy important competitive advantages. Thus to be effective, policies must take into account the various location-specific factors and tailor business assistance schemes to local conditions. Local and regional governments, business organisations, training service providers and economic development organisations are useful partners for governments in this endeavour. They have access to privileged information which can help adjust government programmes and have a clear influence on the business environment. Strong linkages between higher education, business and public services fuel the innovation process locally.

The challenges associated with the governance of entrepreneurship have been particularly wide-ranging in the case of Central and Eastern Europe. As David Smallbone recalls in Chapter 9, the dynamic growth of entrepreneurship after 1990 generated considerable demand for institutional change, including the establishment of a suitable legal framework, the creation of commodity, capital and labour markets and the provision of a business support infrastructure conducive to the creation and development of new and small enterprises. Today, governance challenges remain acute: one of the key roles for the state is to develop a well co-ordinated relationship between the various actors involved in promoting and regulating enterprise creation and development at the national, regional and local levels. In this regard, the coherence of the policies, actions and behaviour of institutions at different levels is an important element in the institutional framework.

The author reviews progress made throughout Central and Eastern Europe and states that the importance of institutional development and capacity building and the development of a market-oriented system of governance should not be under-estimated. In some countries an appropriate and effective institutionalisation of small business policy is still one of the main preconditions that need to be fulfilled before productive and sustained private sector development can become embedded. In others, more should be done to unleash the potential role of regional and local authorities, both in promoting entrepreneurship and in facilitating its development, in view of the fact that it is at the local level that policy and institutions touch entrepreneurs most directly. Innovation should be stimulated less by supply-side initiatives (such as innovation centres or science parks) and more by a greater involvement of higher education institutions in developing links with the business sector in order to increase the supply of entrepreneurs.

Public-private partnerships and the governance of entrepreneurship financing

What are the most appropriate governance mechanisms to finance entrepreneurship locally? Holger Kuhle in Chapter 10 examines the experience of Poland and Eastern Germany in setting up public-private partnerships (PPP) to finance small business development. The PPPs are grounded in local environments and, in various combinations, bring together local authorities, the financial sector and non-profit organisations. The author finds that risk sharing between public and private sectors in a partnership between banks and SME development institutions is an efficient way of alleviating finance problems facing SMEs. PPPs provide support mechanisms that are both simple and accessible. Businesses have little time to apply to specific programmes that involve heavy bureaucratic procedures. The

simplicity of dealing with their customary bank is a net advantage. The support provided by PPPs is also flexible, adapting schemes to the specific cases (*e.g*, financing second chance entrepreneurship and transfers of businesses). Partnership with the private sector thus provides considerable leverage.

For the public sector, PPPs allow more efficient use of limited public funds, essentially matching micro lending for entrepreneurs, mainstream SMEs and entrepreneurial growth companies with guarantees. The public sector further contributes through improving the legal framework to facilitate fundraising and lending by micro credit institutions. However, PPPs are a governance tool that requires strong local leadership from the public sector. The problems of local development and entrepreneurship financing are to a large extent structural and require long-term participation. The experience reviewed shows that the role of the local public sector should be seen first of all as a facilitator and catalyst, in order to invite the rating-driven banks to exercise more openness and communication. The public sector should set the overall strategic objectives for finance provisioning and supervision at that level, while the management of the financial tools should be on a commercial basis.

Involving the non-profit sector in entrepreneurship financing

The non-profit sector can also play an important role in financing entrepreneurship. Chapter 11 by Željko Šević examines different models of the provision of financial support to aspiring new entrepreneurs, and uses as case studies Hungary's experience with foundation-supported development and Poland's experience with micro-finance. The chapter argues that non-government assistance programmes seem particularly suitable to the situation of transition economies, due to their capacity to support the development of efficient markets and the building of social capital. As the experience of advanced European economies and the United States suggests, the development of community development banking institutions could contribute to both entrepreneurship development and social inclusion in Central and Eastern European countries.

According to existing models, a publicly-sponsored network of non-profit development banking institutions would promote small business development, assist in the development of entrepreneurial skills, and provide special assistance to disadvantaged areas. It would help in making small business finance simultaneously more accessible and associated with the provision of necessary advice and assistance. Those institutions would be publicly capitalised, but run locally by non-profit organisations in collaboration with local governments and the private sector. Direct involvement of banks is required to supervise performance. While community development banking cannot solve all the problems of initial

entrepreneurial finance, it can help in narrowing the gap and tackling market failures.

Local development financing and fiscal autonomy

Whatever option is deemed best to finance entrepreneurship, local authorities are called on to play a major role in supporting local development initiatives financially. This is a difficult task as local authorities also face the challenge of delivering services (*e.g.*, education, health, transport, social services, housing), which may be seen as higher priorities and for which funding is also an issue. Therefore it seems appropriate to look more closely at the issue of the financing of local authorities and examine what the options are to contribute to financing local development most effectively.

As Dubravka Jurlina Alibegović explains in Chapter 12, local and regional governments everywhere share the problem of inadequate financing. Local budgets are the main source of revenue for financing local development projects, and the sources of funds for capital investment are limited. The solution for local and regional government is to find additional revenue sources for development projects. Most sub-national authorities are not prepared or unable to take on increased responsibilities for fund raising directed towards economic development.

In order to tackle this challenge, municipalities must acquire the skills and information to budget for current and future years; the ability to understand the impact of borrowing for infrastructure development (both annual debt service and annual operational and maintenance expenditures); and the ability to identify, prioritise and plan capital investment. Municipalities and cities facing a lack of investment capital must be able to identify and analyse technical and financial options and show investors that they have adequate and reliable revenues to meet their debt service obligations. Another central consideration is the involvement of municipalities in the definition of strategic orientations for economic development. A major obstacle to local development financing is the misuse or the absence of a clear strategy for regional and local development. The strategy has a major duty to explain the roles of the various actors involved in regional and local development. It thereby provides a rationale for the joint funding of relevant projects that can meet strategic objectives.

Greater fiscal decentralisation to enhance capacity

Fiscal decentralisation can play an important role in the capacity of local governments to finance local development. In Chapter 13, Desislava Stoilova looks at the issue of the ability of local authorities to raise their own revenue as a determinant of their contribution to the financing of local development.

She examines the case of Bulgaria and argues that the local authorities do not enjoy enough autonomy. During the last fifteen years, Bulgaria has, like in many other countries of the region, undergone a process of gradual political, administrative and financial decentralisation, which has resulted in developing local self-governance and the devolution of increasing responsibility to the municipalities. Local authorities in Bulgaria are assigned mandates in the fields of education, health care and social assistance. They are partially responsible for services in such areas as culture (local libraries, museums and theatres), environment protection, housing construction supervision and some economic activities. And they are fully responsible for the local utilities such as water supply, sewerage, heating, gas supply, construction of local roads and streets, urban development and infrastructure. Bulgarian municipalities currently provide up to 30% of public sector services in the country. At the same time, the share of local budgets in the state budget has been constantly declining over the past decade or so.

To a large extent, this mismatch is due to the fact that, although local authorities have been assigned various responsibilities, state transfer flows towards municipal budgets have not increased in the same proportion. Moreover, by virtue of the current legislation, the influence of municipalities on local revenues is restricted. As the author argues, only real local financial independence and fiscal decentralisation can contribute to the development of a favourable investment climate and foster sustainable development. A gradual delegation of taxation power to local authorities as well as the development and adoption of a stable legal framework for the principles and mechanisms of the intergovernmental transfer system would contribute to greater financial independence of municipalities.

Financial autonomy provides crucial incentives

Fiscal decentralisation, however desirable, may not be sufficient to enhance local capacities to finance local development. The structure of revenue sharing between the various layers of government impacts on the public sector's incentives for providing infrastructure for private business development, as Irina Kolesnikova demonstrates in Chapter 14. The recent experience of Belarus has been that any change in local government's own revenues is almost entirely offset by changes in shared revenues. Local governments are unable to benefit from an increase in the local tax base and, therefore do not see any interest in expanding it. The chapter also shows that systems with weak local fiscal incentives are accompanied by stricter business regulation and lower growth compared with a system offering greater fiscal incentives. The fiscal dependence of local governments on the central and regional governments also has a negative effect on the efficient provision of local public goods.

A reform of the existing financial system for local governments is required to provide some degree of autonomy for local self-government. Such reform should seek to ensure stable revenues for local budgets by restricting the authority of central and regional administrations to address the revenue sources assigned to them, so placing the fiscal status of local government on a more stable base. Decentralisation can make governments more accountable, allowing a better matching of resources to preferences. However, shifts in expenditures towards higher decentralisation will not achieve the expected benefits without a concurrent shift in favour of greater control by localities over how much revenue local governments can collect.

Main lessons and conclusions

Designing and implementing local development strategies is critical to lifting prosperity and living standards. It helps localities to respond to the challenges presented by globalisation, and to seize the new opportunities offered. Yet it is a much more difficult exercise than is sometimes anticipated. An effective strategy not only requires the involvement of local government or the local economic development agency but the integration of local strategies in a knowledge-based economy and the incorporation of skills, innovation, entrepreneurship and social inclusion objectives. These call on the direct participation of a great number of stakeholders from the public, private and civil society sectors, and require adjustments of policy and governance frameworks. The analysis contained in this publication yields a number of lessons for Central and Eastern European countries, which are in many instances also applicable to other parts of the world.

The main lessons of this volume concern central government, responsible for the most part for designing the policy and governance framework. Though local initiatives can successfully tackle problems, most of them are not enough on their own to bring prosperity locally or change trends radically without support from national policy makers. It should also be recognised that there are some disadvantages involved in the proliferation of local initiatives, which can dilute accountability, undermine effective monitoring and evaluation, and reduce overall policy coherence. In many cases, more might be achieved by mainstream policies and programmes that are adapted to local conditions, and that are implemented in a manner consistent with strategic objectives determined locally. This however requires a degree of flexibility in the management of programmes that is sometimes not available. Policies concerned here include labour market policy, vocational training and regional development policy, depending on the strategies defined and emerging local issues.

As previous work has shown, decentralisation of policy can sometimes help make the policy framework more easily adaptable to local conditions, but

sometimes not, due to priorities associated with ensuring accountability and efficiency in service delivery that limit the freedom with which local agencies can develop and utilise government programmes in the field. Mechanisms do exist however to make the management structure for policies more flexible while maintaining a full degree of accountability and efficiency in service delivery. This can be done notably through the performance management framework and the target setting process, which can be enlarged to include further consultations with local stakeholders before final approval by government (Giguère, 2003).

Central government is also responsible for setting up an administrative structure that facilitates the strategic planning and financial support for local development across the country, be it at regional, sub-regional or local level. The existence of a level of government with an intermediation function that can perform an official role in co-ordinating actions and proposing a broad strategic framework for its area is an asset. Previous work has shown how the creation of self-governing regions in the Czech Republic, endowed with little power or a small budget, has stimulated some regions to adopt the role of catalyst for the development of their region. They work towards building a consensual development strategy that can give orientation to central government policy as well as co-ordinate local actions (OECD, 2004). The size of such administrative units may also matter for the development of coherent strategies as some of the analysis within this volume shows, although any difficulties can sometimes be overcome by the building of sound and encompassing governance structures, such as area-based partnerships or regional strategic platforms.

The second area of responsibility concerns local government finance. Government has responsibility for providing local administrative units with the capacity to provide financial support for economic development strategies that are appraised positively and judged relevant. There is much that local government can do to finance entrepreneurship and SME development, as this volume shows, notably in partnership with the private sector and financial institutions, as well as drawing on the non-profit sector fully to tackle market failures. This does not imply further subsidising local projects or enhancing government transfers but rather consists in providing a clear and transparent framework for raising and allocating funds, supporting a broad strategic development process that can underpin it, and providing financial guarantees when needed.

However, the role that local government can play in local development goes beyond financing issues. Local authorities are in general more comfortable with the delivery of specific tasks of municipal concern, such as housing and transport, than with providing socio-economic orientations for their area. Their economic development activities are often limited to spatial

planning and ensuring an attractive environment for inwards investment. As a result, local strategic initiatives are often carried out without, or despite, local authorities. This makes little sense, given the legitimacy of local authorities and their knowledge and potential role of catalyst, which could be put to use in local strategic efforts.

What is missing for this to happen, most of the time, is capacities and skills in the various fields of local economic and employment development. City officials overall have limited knowledge of the labour market dimension of investment and business development. Political pressures make it difficult to extend the timeframe of strategic decisions. For many years now international organisations and donor organisations have spent time building capacity for local government officials, technicians and other practitioners. The strategy seems now to be bearing fruit, as reflected by the number of successful local initiatives for growth in the region. Certainly these capacity building efforts should be continued and expanded, and extended to other groups of stakeholders such as civil servants responsible for sectoral policies, and representatives of trade unions and business organisations, in order to broaden perspectives and build support around locally-defined objectives.

As was mentioned above, the establishment of partnerships associating government, business and civil society can help overcome a number of obstacles. Such partnerships can compensate for rigidity in policy management by stimulating civil servants to take risks; they can help raise resources and compensate for constraints on local government financing; they can overcome the difficulties offered by overly small jurisdictions and segmentation between rural and urban areas; they can identify gaps in the skills in local communities and among local stakeholders. They can underpin a capacity building programme; they can add a more sustainable dimension to local decisions and build a longer term perspective. This explains why partnerships are widely resorted to today, not only within the framework of the implementation of Structural Funds in the EU member states and pre-accession programmes in others, though these policy initiatives have certainly provided a useful stimulus, but more broadly in most local efforts deployed to improve local social and economic conditions.

Partnerships are an unavoidable feature of local governance, in transition economies as in more advanced economies. Partnerships should be seen as a complement, a second best or a facilitator: they will never remove the need to get the policy and governance frameworks right, however effective they are. But it would be ill-advised to ignore them or the benefits they can bring to policy.

As previous work has shown (OECD, 2001, 2004), to release their potential, partnerships should concentrate on their strategic role and try to help their

partners to do a better job, rather than act as a substitute for them, which would limit the scope of synergies and co-operation. The strategies defined must be compatible with those designed at higher levels. Rules of accountability between partners, between delegates and their organisation, and between partnerships and the wider public must be strictly observed. More important, the success of a partnership approach depends on the behaviour of their partner organisations, which means identifying clearly the remit of the partnership as well as the limits to its action. The success of a partnership will also depend on how much flexibility the partners from government have available to them in the management of relevant programmes, and on their capacity to tackle at national level the problems of conflicting policy goals.

The success of local development strategies in Central and Eastern Europe depends on the capacity of governments and their partners to accelerate change in both the policy and governance aspects of economic and social development. Nearly two decades after the fall of the Berlin Wall, it is time to evaluate the progress made and to identify what needs to be done now to speed up improvements. Local innovations and initiatives may seem particularly vulnerable as they strive towards growth in a rapidly changing world, but there is much government can do to influence their development and enhance their impact on the economy and society.

Note

1. The author would like to thank Francesca Froy for her comments on this chapter.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 2

Local Governance for Economic Development: A Comparative Analysis of Canadian and Irish Conditions and its Lessons for Poland

by
David J.A. Douglas

Poland faces many exciting and challenging times today and tomorrow in its quest for an expanded and diversified national economy and the sustainable development of its regions, and their constituent communities. The comparative review of some Canadian and Irish experience suggests a number of issues that might productively be part of the ongoing refinement of Poland's local development policies and strategies. Notably, the existence of regional economic development structures should not obfuscate a lack of an overarching development strategy, which can detract from the local development agendas and leave a vacuum between regional and local development initiatives. Moreover, the emergence of governance systems does not replace strong, well resourced local government. The question of capacity in local economic development is a central consideration.

Introduction

What is achieved at the local level eventually and in sum determines what is achieved at the district, regional and national levels.[1] Yet local development is inextricably intertwined with policy, programme and sometimes project priorities and initiatives at these other levels, and indeed beyond them. Local development emanates from a number of sources, ranging from the household to supranational initiatives (*e.g.*, Friedmann, 1992; Hettne, 1995). It is well recognised nowadays that locally based factors are of fundamental importance (Nozick, 1992) and the literature is replete with the testimony of courageous and inspiring initiatives and episodes of community mobilisation, charismatic leadership and indigenous creativity (*e.g.,* Whyte and Whyte, 1991; MacLeod, 1986, 1997; Neil and Tykkyläinen, 1998; Brooks *et al.*, 1985). Increasingly, innovative approaches for economic, social, cultural and political development and environmental management at the local level draw upon the lessons from other contexts (*e.g.,* Giguère, 2004; Nolan, 2003). In an increasingly interdependent world this is both a fact of life, and a desirable practice. However, this horizontal transfer of innovation and development "technology" must be matched with a critical understanding of the policy and programme frameworks within which locally based development takes place. Just as there are layered top-down/bottom-up interdependencies in individual contexts (*e.g.,* Eastern Ontario, the Mid-West Region in Ireland, Moravia in the Czech Republic), so the nature of transferables from context to context are themselves layered, and must be conditioned by a critical appreciation of the micro-to-macro dynamics in each context.

This chapter will draw upon a recent intensive three-year critical appraisal of local economic development in Canada, focusing on the rural Ontario context (Douglas, 2003a), and a parallel critique of the local government restructuring process that also took place in this part of Canada (Douglas, 2005), and relate the findings and conclusions with some of the issues and challenges in Ireland and in Poland today.

Some important findings and conclusions on key aspects of local development capacity (*e.g.,* personnel, budgets, partnerships, skills) will be presented, and issues around the appropriate locus of responsibility for designing and implementing development strategies, in the Canadian context, will be explored. A number of policy recommendations emanating from the analysis will be presented. From there the process of local

government restructuring will be addressed and the links between effective rural development and local government development highlighted. The chapter will then address some of the local development challenges in a successful and rapidly developing context such as Ireland. The critical role of the counties will be contrasted with the remit of the Regional Development Authorities, and the variety of parastatal organisations currently active in local development here. Issues around local government development, community governance, local economic development and other matters will be critically explored. These contrasting contexts will then be posed against some of the issues and opportunities in the Polish context. The challenges of assigning the most appropriate roles and functions to the most appropriate levels of government, while at the same time fostering subsidiarity and effective community-based governance and encouraging regional development, will be addressed, drawing on some of the relevant lessons from the Canadian and Irish contexts.

Local development in rural Ontario: deficits and challenges

Ontario contains 12.5 million of Canada's approximately 33 million people, accounts for about 40% of Canadian GDP, is still the primary focus of international immigration, and while highly dependent on and integrated with the adjoining American market (94% of exports), has a fairly diverse economy (*e.g.,* automobiles, automotive parts, communications technologies, primary metals, forestry, agriculture, food and beverages). While, like most of Canada, it is a highly urbanised province, if we define rural communities as places with populations up to 25,000, approximately 30% of the province is rural (Douglas, 2001). Even though Ontario has one of the higher material standards of living in the world, a relatively low rate of unemployment (6%) and a fairly consistent competitive performance among Canada's ten provinces and three territories, this part of Canada is characterised by very significant polarities in its regional economies in terms of diversity, vulnerability, size and notably the performance of their rural economies (Douglas, 2001). While the Province does not have a regional development policy, as such, unlike the European Union, and does not overtly subscribe to a policy of "balanced development" the issue of glaring interregional disparities has been a concern for decades (Bryant and Douglas, 1995). Local development, especially local economic development is, therefore, of great concern across rural communities in most parts of Ontario.

Local development in Canada is pursued by a great diversity and a changing roster of organisations (Douglas, 1989, 1994; MacLeod, 1986; Galaway and Hudson, 1994; Pierce and Dale, 1999). In Ontario local government, specifically the municipality is a major player. Under Ontario legislation the economic development function is discretionary for the municipality, unlike

land use planning, transportation infrastructure, water and sewage services and other functions. Most municipalities are concerned with the growth and development of their local economies, if for no other reason (*e.g.,* political prestige, community pressures) than they have increasingly become almost totally dependent on the local economy for the larger proportion of their revenues (see below). Other important participants are the private sector, usually through a local chamber of commerce, and the Federal government through its successful Communities Futures Programme (started in 1986). The latter currently funds 60 Community Futures Development Corporations (CFDC) throughout most of rural Ontario (Douglas, 2003b).

Examining the condition of local economic development in Ontario through the rural municipality reveals that notwithstanding the political importance of this issue, in 2001 only 38% of rural municipalities actually had a development plan in place (Douglas and Chadwick, 2001). There is, therefore, some distance between local political rhetoric and espoused priorities and action. This is especially the case in the smallest communities (*i.e.,* less than 3,000 residents). In 2001 only 5% of rural municipalities had a formally designated local government official charged with planning for and facilitating local economic development (*e.g.,* an Economic Development Officer or EDO). This is in contrast to the presence of a Clerk-Treasurer, or a CAO or Municipal Manager who will be present in all municipalities, or a Director of Public Works or equivalent who will also be found in all municipalities. However, it also contrasts with the presence of designated senior officials to be found in most rural municipalities who have responsibilities for parks and recreation facilities and services, oftentimes land use planning and building services, and also for fire services and police. An additional 28% of rural municipalities had the equivalent of an economic development officer, usually through assigning this function to someone on a part-time basis, assigning it as part of another senior official's job, or otherwise. However, no less than 57% of Ontario's rural municipalities did not have any full-time staff for this function. Approximately 47% did not even have part-time staff here. In terms of a visible presence within the municipal organisation, it is estimated that only 8% of rural municipalities had an economic development department, or equivalent (Douglas and Chadwick, 2001). Budgets are usually very modest. They were non-existent in the smallest and in most of the smaller communities (*i.e.,* below populations of 3,000 and below 6,000 respectively). Budgets of no more than $20-25 000 (CAD) are not unusual. Indeed, less than two out of three rural municipalities who are actually active in this field reported having a budget in place.

There are some size/function correlates, though the pattern is by no means regular and consistent. Generally as one goes up the size spectrum the greater the likelihood of a designated Economic Development Officer, the

larger the budget, and the greater the likelihood of a development plan or strategy. The presence of an EDO is usually accompanied by a more substantial budget, a formal development plan, a greater focus on strategies concentrating on endogenous development, in contrast to external investment recruitment, and evidence of recent shifts in the mode and focus of the practice in the recent past. Besides the differences evident along the community size spectrum there are significant differences in resource allocation and the mode and focus of development practice across Ontario's six rural regions (Douglas and Chadwick, 2001).

While the dominant impression is one that suggests a dearth of development practice, especially among the smaller rural communities, as well as a system-wide deficit in plans, personnel and financial resources, the development challenge is compounded by the presence of a general deficit in development wherewithal. This is reported by rural development practitioners themselves, who indicate that less than one third of Ontario's rural communities have the capacity within the community to undertake local economic development. This is further compounded by a reported deficit within local government itself, of equal proportions! These shortfalls are in basic know-how relating to undertaking local economic development (*e.g.,* planning, analysis, marketing), a clear policy and sense of direction, and in the basic resources to finance the local development enterprise.

The institutional infrastructure

Given the centrality of local government in terms of leadership and agency in local economic development, recent developments in Ontario provide some important lessons. Ontario, like many other jurisdictions around the world (*e.g.,* New Zealand, Britain) has been subjected to a significant ideological shift in several political arenas. A neoconservative government held power in Ontario from 1994 through to 2003. A central feature of its initiatives was to down-size government and accelerate the privatisation of a range of public services through a massive, top-down and rapid restructuring of local government, notably school boards and municipalities (Tindal and Tindal, 2004; Downey and Williams, 1998). The number of municipalities in Ontario was reduced from 815 in 1996 to 445 in 2004, a reduction of some 45%. The number of local elected officials on municipal councils was reduced by 39%. This radical restructuring was largely accomplished by Provincial fiat and through amalgamations. There are some parallels with similar developments in parts of Australia.

This restructuring of local government is Ontario, especially as it applies to rural Ontario has been severely criticised and in effect interpreted as a process of rural *underdevelopment* (Douglas, 2005). The increase in the average

size of rural municipalities, both in terms of their territorial extent and their population, has all sorts of repercussions for local development. This is especially the case given the absence of transfers from the Province commensurate with the increase in municipal responsibilities associated with the restructuring (Tindal, 2004). Rural municipalities now have an increase in the diversity of communities within their expanded territories, have inherited an expanded set of responsibilities for physical infrastructure and services, have far fewer staff and fewer elected officials per resident, and are otherwise extended, as the Province incrementally withdraws as a fiscal partner (Kitchen, 2000). The challenges of increased complexity in the local economic development function have been exacerbated, therefore, with the realities of fewer available resources.

Toward a policy and programme response

Combining these political and public administrative developments with the capacity deficit alluded to previously serves to raise some very serious questions. For Ontario's rural municipalities and their communities there is a daunting development challenge brought about by the two-part capacity deficit (*i.e.,* community and municipal), the processes of globalisation (*e.g.,* more open, small economies in the context of instantaneously mobile capital and fierce competition), the incremental withdrawal of the Province as a fiscal partner (Kitchen, 2000), and the consequent dependency on own-source revenues for the viability of the municipality itself (Douglas, 2003a, Marshall and Douglas, 1997). A number of these development challenges have been addressed in a set of policy and programme recommendations made to the Provincial government, and other key players in local economic development in this part of the world (Douglas, 2003a). Key among these is the urgent need to collaboratively invest in human resources development, specifically in knowledge and skills in local economic development practice. Among the mechanisms identified to achieve the enhancement of capacity here was the funding and sponsoring of professional internships (Douglas, 2003a; pp. 4-6). This would be accomplished by a *Rural Local Economic Development Internship Programme*. Other related recommended initiatives included formalised training courses from the municipal association (Association of Municipalities of Ontario), the professional organisation of local economic development practitioners (Economic Developers Council of Ontario), and from universities and community colleges. The recommended roles of the Federal and Provincial governments here were primarily as financial partners.

Second is the need to foster inter-municipal collaborative development practice. The lack of financial resources for professional practitioners (*i.e.,* an EDO), and/or the reluctance of smaller municipalities in invest to this extent

in local economic development, especially after the fiscal trauma associated with the restructuring process, has meant that sharing the costs of upgrading local capacity might prove a feasible alternative here. Multi-municipal Rural Economic Development Consortia (REDC) have been recommended. Where a Community Futures Development Corporation (CFDC) was active in the area, and is clearly committed to longer term strategic planning for area economic development (as against shorter term enterprise facilitation and funding), this was identified as a viable alternative to the new REDCs. In part this latter recommendation would compensate for the continuing lack of a regional development policy in Ontario, and Canada, and especially the lack of a spatially specified rural development policy and programmes. However, it runs the risk of defining multi-municipal "regions" on the basis of limited criteria (*e.g.,* common shortfalls in fiscal resources, common interests in sectoral development priorities, adjacency), that may not be appropriate for integrated rural development planning and management.

Third, it was recommended that both the Federal and the Provincial governments address organisational change, specifically to ensure that rural communities and local governments had a "one stop" and secure access to public policy formulation and programmes and services. Fourth, it was recommended that the Provincial government clarify the nature of its "rural development policy", especially as it relates to a spatially selective and/or performance-based or potentials-based approach to funding and other support, as against a universally available minimum level of local development support, or support that is purposefully focused on localities undergoing significant stress (*e.g.,* longer term high unemployment).

Fifth, it was recommended that municipalities acknowledge the changing nature of local development practice (*e.g.,* away from zero-sum external investment recruitment, toward collaborative competition, and internal investment retention and expansion), and act on this in terms of recruiting and (re)training personnel, in terms of its design and choice of organisational arrangements, in terms of strategic planning and management, the recruitment, management and development of volunteers, and other initiatives.

While there were many other recommendations, the key points of relevance here are:

- solutions for the problem and challenges are to be found at *all levels* (*e.g.* at the local community and municipal level, at the Provincial and Federal government levels),
- solutions are to found at different *spatial scales* (*e.g,.* within a single restructured municipality, across a number of municipalities in new collaborative arrangements),

- solutions emanate from several *sectors* (*e.g.,* the often neglected direct role of the private sector in LED initiatives, the education sector),
- not unlike the growing record in other OECD countries, the centrality of *partnerships* and networks was identified as pivotal to the change process, redolent of current conceptions of governance systems,
- development initiatives sometimes require explicit *policy changes* as well as *programme adjustments* and fine tuning,
- there are appropriate *leadership* roles evident in existing formal organisations that have both the responsibility to take action and provide direction, but also the legitimacy to do so and effectively bring about change (*e.g.,* in this instance the Association of Municipalities of Ontario), and
- *integration* is central to any longer term solutions (*i.e.,* vertically through different jurisdictions and portfolios, horizontally between municipalities and local partners, and diagonally through these) and must reflect the multifaceted nature of solutions (*e.g.,* addressing perceptions, risk aversion, skills deficits, the dichotomy of espoused local political enunciations versus action, the complexities of increasingly open local economies in a globalising world, the absence of a coercive statutory basis for local economic development).

Some contextual challenges

These policy and programme challenges and recommendation must be understood in the Canadian and Ontario contexts. Canada is a society that is often characterised as being located midway between an American system with an enunciated ideology of freewheeling private enterprise and a social democratic ideology, more akin to most European contexts. In many respects it is a special case. Its mixed market economy reflects this; a vibrant market economy with many parastatal enterprises (*e.g.,* in energy provision, liquor sales distribution, transportation, gambling, agricultural supply management), and a fairly robust co-operative sector (especially credit unions), set within an advanced welfare state. Within this setting rural development has attained something of an iconic status, generally uncontested as self-evidently desirable, and underpinned by a host of considerations relating to cultural heritage, social equity, and environmental concerns (*e.g.,* urban sprawl). Its political stature, while perhaps waning, has long outlasted its importance in terms of direct economic contributions (*e.g.,* via agriculture, forestry, mining).

Notwithstanding the above, Canada in general and Ontario as an example here, are characterised by a lack of a coherent rural development policy. This has been evident for some time (*e.g.,* Cummings, 1989; Douglas, 1994). In lieu of a rural development policy at the Federal level have been on

the one hand a parade of sectoral development policies, with strong rural relevance (*e.g.,* agriculture, labour market development, fisheries, telecommunications), and on the other, a now lapsed half-century of very active regional development policies and programmes, mostly driven by economic and infrastructural agendas (Weaver and Gunton, 1982; Savoie, 1986; Douglas, 1994; Fairbairn, 1998; Blake, 2003), now replaced by regionally-based pools of development finance, essentially given over to small business development (*e.g.,* Western Diversification Canada, Atlantic Canada Opportunities Agency). Notwithstanding this mixed record there is some evidence over the last decade of an emerging if tentative body of policy, with some degree of integration, at the Federal level (*e.g.,* Rural Secretariat, 2003). It is very much issues/sector oriented, focusing funds and other initiatives into (for example) enhancing the communications and interaction between the Federal government and rural communities and interests (the *Rural Dialogue*), labour force (re)training, telecommunications infrastructure (*e.g.,* Internet access, Broadband), value-added agriculturally related production, rural youth issues, community development training relating to capacity development, special programmes for Aboriginal and more remote rural communities, pilot projects and models for innovative development practice and transfer, and SME development. There is a commitment to develop, in collaboration with the ten Provinces and the three Territories, a *National Rural Policy Framework*. However, there is neither a comprehensive integrated rural development policy in place, nor a set of integrated rural development programmes.

Incongruously, at least from a constitutional standpoint, the Province of Ontario does not have even the elements of an integrated rural development policy. The absence of the Province in local economic development, as a telling case in point, is evident (Douglas and Chadwick, 2001). The Provincial presence is essentially confined to agricultural production policies and incentives (mostly from the Ministry of Agriculture and Food, now recently re-named with a returned "Rural Affairs" appended), value added and small business development, a modest commitment to local community/private sector development partnerships (essentially enterprise development through the *Ontario Small Town and Rural Development Initiative*), advisory and related support and facilitation services from the Rural Development Division of the Ministry (*e.g.,* through the *REDDI* web-based analytical support), and other initiatives. Even though the Province is responsible for all natural resources, local government and land use planning, there is not a spatial strategy in place for Ontario's rural regions. There is some semblance of such a strategy emerging for the Greater Toronto Area (GTA) where with over 40% of the province's population, massive development pressures, traffic gridlock and significant infrastructure pressures are demanding action (Ministry of Public Infrastructure Renewal, 2005). A "Greenbelt" has been designated and

legislation passed to reserve an area of over 72,000 square kilometres for non-urban uses (Ministry of Municipal Affairs and Housing, 2005). It is, however, essentially a metropolitan growth management initiative, not unlike those evident in other metropolitan contexts, such as Copenhagen, the Randstad, London and elsewhere.

So, the local development challenges evident in rural Ontario have to be interpreted through the lenses of the Federal presence and the Provincial lack of presence here. The Federal presence, while not yet evident in a comprehensive or integrated rural development policy, is emerging in a more and more tangible manner, and is concretely evident in the Community Futures Programme, with some 60 CFDCs active across most of rural Ontario, and in selected major regional development investments (*e.g.,* the recently announced Eastern Ontario Development Fund). And it is evident in a multiplicity of sectoral projects (*e.g.,* community telecommunications access centres). The local/Federal partnership potentials are significant, if somewhat awkward in Canada's tri-level constitutional arrangements. They may increasingly prove difficult given that individual local governments, and even extended inter-municipal partnerships (as recommended), will have to negotiate many facets of implementation through individual Provincial ministries and agencies (*e.g.,* Ministry of Natural Resources, Ministry of Transportation). This jurisdictional layering is not unique to Canada, and indeed is one of the more persistent concerns in an evolving European Union. However, it is one important facet of the rural local economic development challenge here.

Ireland: progress and challenges relating to local development

Ireland's many successes in the development of its national economy are by now well known. The roots of the so-called "Celtic Tiger" phenomenon are of course diverse and deep, and go well beyond Ireland's entry to the European Union in 1973. They extend back to a radical transformation in Irish society from the rather insular, introverted economy of the 1950s to a much more extroverted and entrepreneurial economy driven by a very active, interventionist State. A key facet of this redirection was the introduction of national development planning which flourished in an unsophisticated manner in the 1960s, was significantly attenuated in the late 1970s and 1980s and was reintroduced after 1989 in large part at the behest of the EU in order to avail of Structural Funds. This continues to this day (Government of Ireland, 1999). The process has become more sophisticated, and now involves ground-breaking collaborative processes through the concept of "social partners" (NESC, 2003; Wagle and Shah, 2003). These complex consultative and mediation processes operate at the national and local levels, with considerable success.

One of the distinguishing characteristics of the Irish story is the evolving if uneven integration of (a) sectoral and spatial planning, (b) economic and social (as well as cultural and environmental) development perspectives and agendas, and (c) national and regional/local development planning. The approach to development policies, plans and programmes has therefore matured over time to a more holistic conception of the development problem and interventions for solutions (Walsh, 2000; McDonagh, 2001). There is, therefore, a radical difference between the original economic, which later became economic and social, five year national development programmes of the 1960s and those of the recent past (*e.g.,* Government of Ireland, 1999 versus Government of Ireland, 1969; the strategic advisory report of the NESC, 2003). Parallel to this evolution, and in varying degrees of synchronicity, has been the diversification of development institutions and organisations. These have multiplied from the original industrial (*i.e.,* manufacturing industry) investment recruitment of the early Industrial Development Authority (IDA) to a variety of labour force training organisations (*e.g.,* FÁS), specialised indigenous SME development agencies (*e.g.,* Enterprise Ireland, County Enterprise Boards), tourism development organisations (Bord Fáilte), and a variety of others. The successor to the IDA itself now focuses solely on foreign direct investment. Several organisations have been introduced as a direct response to EU policies and practices, such as Pobal (formerly known as Area Development Management Ltd., ADM) to administer the distribution of targeted EU Structural Funds for the support of the operations of area-based partnerships.

Alongside this institutional and organisation development has been the emergence and sophistication of development planning activities at various levels of government, in many non-governmental organisations (NGO), and at the regional level. The regional dimension of development in Ireland was formally examined as early as 1968 (Buchanan and Partners, 1968) and a series of regional configurations have been attempted since then (Horner, 2000). The latest are regional authorities, of which there are eight (including the Greater Dublin area), that have, in the main, a co-ordinating role among their constituent local governments. In practice this has been problematic and for the most part ineffectual.

However, Ireland has been very active at the local level in all three generations of the LEADER programme, and these have encouraged area-wide, multi-community approaches to development planning. Following a very successful LEADER 1 programme between 1990 and 1994 (Kearney, Boyle and Walsh, 1995) local area-based multi-sectoral rural development programmes have been supported throughout all parts of rural Ireland. Local small scale enterprise development has also been supported since the early 1990s by County Enterprise Boards (Meldon *et al*., 2004; Walsh, 2004a).

In addition, Ireland has launched a comprehensive approach to integrated planning at the county level. Detailed ten year development strategies addressing economic, social, cultural, environmental, land use, infrastructure and other facets of rural and urban communities have been prepared by each of the 36 City and County Development Boards (CDBs). The CDBs are particularly diverse in their make-up, having a cross-section of cultural, social provision, poverty related, labour force development, housing, as well as economic development interests at the table, from the community, county as well as the State levels.

Recently, for the slower growing regions with particular unemployment, out-migration, sectoral vulnerability and other problems, two overarching, overlapping and different multi-regional development agencies have also been brought into place. They are the Western Development Commission (WDC) established in 1997 and the Border, Midlands and Western Regional Assembly (BMW) which was set up in 1999. The WDC focuses on advocacy, policy analysis and promotion, fostering regional development initiatives, managing the Western Investment Fund, a revolving development fund of 32 million euros, and providing risk capital (via loans and equity) to businesses and projects. It is a semi-State body focusing on the seven western counties from Donegal to Clare. The WDC also fosters research and analysis, small town economic diversification, regional and local tourism, special projects (*e.g.,* organic agriculture) and other initiatives. The central purpose of the BMW is to act as a development forum for its three regional authorities, through the elected representatives of 13 Counties in these three regions, to manage development funds from the State (and through it, from the EU), to monitor the progress of the National Development Plan (NDP) in the area and the Community Support Framework, and to promote the co-ordination of public services in the far flung territory. This part of Ireland currently operates under the EU Objective 1 inasmuch as per capita levels of GDP in the region in 1999 were under 75% of the EU average. Both of these multi-regional organisations and the other regional authorities elsewhere in Ireland are actively engaged in the State's regional development objectives relating to "balanced development" and decentralisation.

The most recent advancement in Ireland's development thrust was the adoption of the National Spatial Strategy (NSS) in 2002 (Department of the Environment and Local Government, 2002). This integrates the country's urban and communications systems with the National Development Plan. It recognises the different development challenges and agendas for the different regions, such as small business development and the growth and diversification priorities for much of the Border Region, versus the growth management priorities for the burgeoning Greater Dublin area. The imperative of decentralising and deflecting growth from much of the east

toward other regions remains a central concern. Maintaining the momentum of infrastructure investments and renewal is also centre stage. Using the urban functional hierarchy the NSS identifies a series of "gateways" (*e.g.,* Dublin, Cork) and "hubs" (*e.g.,* Kilkenny, Tuam, Cavan). Strategic functions are assigned to these centres and their catchment areas, depending on their location (*e.g.,* Dublin and Dundalk as "consolidating" foci, Killarney and Tralee as "revitalising" hubs). Within each region a spatial strategy is articulated specifying inter-urban interaction, directions of development, key transportation and other linkages, the roles of all components in the settlement systems (*e.g.,* county), the major thrusts of development (*e.g.,* "rural diversification") and the location of key public investments (*e.g.,* airports, fishing ports; for further information see Walsh, 2004b, 2004c).

Beyond ongoing refinements to the development process and organisations, and other challenges associated with globalisation and a changing EU, there is and will be at least one major item remaining to be attended to in the Irish development case. That is the local government sector. Ireland is a highly centralised state (Callanan and Keogan, 2004). Even though the counties play a significant role in enterprise development, statutory land use planning and physical development, and in a number of other fields, the efficacy of an essentially 19th century local public administrative and representative system for the 21st century development remains a burning and contentious question (Walsh, 1991; Dillon, 1991; Barrington, 1991; Breathnach, 2002).

But what is evident in the Irish case is that a combination of national vision and commitment to development planning, and an increasingly integrated mode of development planning, has contributed significantly to success. The regional approach to development planning is in place, even if the role and relevance of the regional authorities remains in question. There has developed over the last four decades a considerable professional and lay capacity to design and manage development. The overall process is still highly centralised, though the innovative "social partners" process and the encouragement of area-based partnerships and increased popular participation, serve to offset some of the persisting "top-down" characteristics of development planning in Ireland. Notwithstanding the many successes the central issues of interregional disparities, both in income and opportunities, remain a contentious concern. The proof of interregional convergence on key indicators (*e.g.,* household income, GDP/capita, GVA/capita) is wanting. Not unrelated to this, and notwithstanding the government's recent commitment to substantial relocation of civil servants, the question of effective decentralisation and reining in the dominance of Dublin's growth and its associated appetite for national investment, remains to be resolved.

Local governance in the Polish context: some challenges and transferables

Poland today continues in the process of rapid and at times daunting change and associated challenges (Rapacki and Blazyca, 2001). And these changes have and continue to permeate every facet of Polish society from foreign affairs, urban development, the large agricultural sector, heavy manufacturing and the environment, to local government, education and social services. Local initiatives in the political, economic and cultural spheres have been both the source of much change and the recipients of change. The evolution of local development and governance in Poland, and its strategic directions have to be understood within the complex threads and tension of transition that persist as the country continues its post-socialist stage of dramatic restructuring, while at the same time it now evolves as a full Member of the European Union.

What, if any, relevance might the Canadian and Irish cases have for local development and governance in Poland? One of the common threads across these three contexts is the connection between local government development and local economic development. In Ireland the county is a central player, politically, in local economic development, especially in the more rural parts of the country (Walsh, 2002; McDonagh, 2001). But amid the inter-organisational complexity that characterises the Irish context, and the continuing high degree of centralisation in development policy and practice, local government is relatively weak, both in terms of its constitutional mandate and its resource base (especially in own-source revenues). Beside this the role of the regional authorities, as already mentioned, is problematic. This will become even more so as much of Ireland is excluded from Objective 1 coverage in the EU, after 2006. In the Ontario context, as a Canadian example, local government in the form of municipalities are constitutionally dependent on the will and whims of the Provincial government, and rural development here has suffered a significant setback as a result of this vulnerability (Douglas, 2005). And as has been documented rural and smaller municipalities have significant capacity deficits as agents in local economic development.

Poland, on the other hand has witnessed a very important decade and more of local government development (Regulski, 2003). Recently (1998-99) this has served to formalise the role and functions of the *powiats* (both urban and urban-rural) and, no less important, introduce a layer of 16 voivodeships (*województwa*) or regional governments. Learning from other European, North American, Australian and other experiences there has been a cumulative process of refinement and development, both at the elected political levels (*e.g.,* direct election of Mayors in the *gminy*) and in the administrations

(*e.g.,* more formal financial planning and control systems). The regions have emerged as the foci for local economic development, even though many of the *gminy* are also active here (Swianiewicz, 2002). All regions have now prepared economic development strategies. Not unlike other contexts, the degree to which these formal strategies are in fact active agendas for concrete action and represent real commitment for change is at times in question. The regions have an interesting direct link to national development policies and priorities. This is achieved through the presence of the voivod (*wojewód*), the governor, as representative of the national government and his/her regional administration, and a revenue base that is largely made up of grants, in contrast to own-source revenues. This national-regional arrangement is paralleled by the regional elected assembly itself, which is the unit of local self-government, with its own regional administration. Neither Ontario nor Ireland has these formal linkages, or regional authorities. An east-to-west transfer might be efficacious here.

There are some parallels between Ontario's municipalities and the *gminy* in Poland, as both are very dependent on own-source revenues for development. The latter have seen several years of surpluses in current operations, and may therefore have increasing discretion in assigning some of these resources for local economic development purposes. This is not the case in Ontario. An additional advantage for the *gminy* is a legislated share of locally generated income taxes, even though recent developments have suggested a trend away from these and other sources, toward grant formulae developed by the national government (Swianiewicz, 2002). This inevitably raises questions about the health and vibrancy of local democracy, self-reliance and self-determination. Neither Poland, Ontario or Ireland are free from the universal tensions in local government relating to the balance between the democratic representative role of local government and its services provision role (Marshall and Douglas, 1997; Douglas, 2005).

While local economic development is discretionary in all cases, the health and future of the local economy is an espoused political priority across the board. In Poland the regional level is, however, the more formally active in this field. Ontario is lacking any formalised regional structure for economic development (outside of a small number of regional municipalities). This is somewhat ironic given Canada's lengthy record in regional economic development spanning most of the second half of the 20th century (Savoie, 1986; Coffey and Polese, 1984; Douglas, 1994). In contrast, Poland has built upon a very rich tradition of regional economic analysis and regional science and retained the region as a formal territorial unit for development (Gorzelak, 1996). Therefore, in the Ontario case a local government has to seek out collaborative opportunities on its own through, for example participation on Community Futures Development Corporations, under a Federal government programme, or customise inter-municipal collaborations between

neighbouring local governments, or adopt some other collaborative arrangement such as those suggested in the recommendations alluded to earlier (Douglas, 2003a). As already noted Ireland has put in place two overlapping super-regional bodies (*i.e.,* the BMW and the WDC). Both have very circumscribed mandates and may in part seem to have some custodial functions in fiscal arrangements. But they do not function with any degree of independence as integrated rural development agencies. The counties have fairly advanced integrated development strategies in place, as of the last five years. But the counties are not functional regions, and do not have the regional breadth or rationale analogous to the voivodeship in the Polish context. They do, however, have considerable political legitimacy with ancient cultural, heritage and symbolic value (*e.g.,* through Gaelic sports). In short, they have a potent constituency and sense of place. The latter is increasingly recognised as an important factor in area economic development, for a whole variety of reasons (Davis, 1995). How to extend this toward a rational spatial construct, a development region scale, is a challenge. It must be addressed to respond to the limitations of the county as a spatial development unit, and the relatively impotent regional authorities that are currently in place, as amalgams of counties.

While there are likely some significant differences in the overall level of administrative capacity in local government in Poland, in contrast to Canada and Ireland, both Poland and Ontario (as a case in point in Canada) exhibit substantial capacity deficits in local economic development (Swianiewicz, 2002; Douglas and Chadwick, 2001). Local economic development is a central plank in the overall development of Poland's national economy. The development of local know-how in strategic planning and management, knowledge and skills in project identification, appraisal and design, in marketing, in skills in micro-finance and credit, and other dimensions of local development have been identified as priorities on the development agenda (Struyk and Cooley, 2000). Towns and smaller cities are likely to be the drivers of a diversifying, value-added, new manufacturing, higher productivity, services oriented and increasingly information-based Polish economy (Tacoli, 1998). However, "they lack the capacity to prepare comprehensive investment plans, local economic development strategies" (Struyk and Cooley, 2000; 2). Particularly critical to the development of Poland's rural communities, towns and smaller cities is the development of "absorptive capacity" at the local level. This is so critical that the appropriate management skills are in place to avail of the opportunities from the EU Structural Funds and other development avenues, and maximise their impact in terms of efficiencies, productivity, wealth creation and local income generation. Ireland had a ten year lead time going from and learning from pilot projects in integrated rural development a full decade before local communities had to engage in

collaborative area development initiatives through the EU's LEADER 1. It may make most sense for this capacity investment to be centred in the voivodeship, as the multi-*powiat* co-ordinating agent, in order to gain some economies of scale and critical mass so as to retain the professional personnel required. But based on the recent research conducted in Ontario, it would appear that this must be a development priority for both the Polish government and the sixteen regional assemblies. It should be an integral component of the local development package that includes the usual investments in physical infrastructure (*e.g.*, water and sewage, roads, telecommunications), education, health and social services, debt and equity finance and other items.

There is much talk today about the evolution from government or more correctly governing, to governance (Rhodes, 1996; Stoker, 1998; Marsden and Murdoch, 1998). "Governance is ultimately concerned with creating the conditions for ordered rule and collective action" (Stoker, 1998; 17). Distinguishing features of governance systems and episodes include shared power contexts involving various combinations of actors and organisations from government, the private sector, non-governmental organisations and other elements in civil society in fluid, horizontal relationships. These arrangements are usually very instrumental, involve blurred boundaries in responsibility and authority and are more like customised collaborative networks than formal hierarchically defined structures (Rhodes, 1996). They may be seen to largely replace the conventional formalised and often bureaucratic government-based arrangements. These reflected earlier conditions with relatively unquestioned sets of power relationships, based on authority, sanctions and exclusive access to strategic resources. In governance systems the emphasis shifts from "power over", towards collaborative "power with" and on to the pragmatics of "power to"; novel, fluid and at times unconventional partnerships and coalitions are formed to facilitate agency.

The uneven movement toward governance modalities has been associated with the rise of neo-liberalism, the ascendancy of the market as the optimal institution for the most efficient and therefore efficacious allocation of public resources; all of this taken as symptomatic of the demise of the welfare state in advanced capitalism. The corollary here is that governance is a process through which government can find a way to exercise some power, as its quota of power and legitimacy diminishes, while at the same time sharing some powers and accessing others as it engages civil society and private interests through various forms of participatory process. Through these more fluid, contextually responsive arrangements compliance is negotiated, locally autonomy is incorporated in the process and outcomes, and operating codes are learned and crafted through the process itself. And in the recognition of pervasive uncertainty, more opportunistic, flexible and

adaptable strategies are formulated and implemented. Governance as a concept and an organising framework, within "a new topography of political relations" is seen to have considerable purchase in rural development (*e.g.,* Marsden and Murdoch, 1998; Giguère, 2004). It should be said, of course, that this emerging concept has its critics and sceptics amid a somewhat disjointed and far flung discourse. Its application is neither accepted as universal or unquestioned (Graham *et al.*, 1998; Murdoch and Abram, 1998; Douglas, 2005).

Not unrelated to this is the question of partnerships (Esparcia *et al.*, 2000, Westholm, *et al.*, 1999). Ireland has pioneered many of the more recent innovations in area-based partnerships (Moseley 2003; Sabel and LEED Programme, 1996; Geddes, 1998). The process of designing participatory processes that facilitate the engagement and full involvement of civil society, the private sector, and others in the development process has been a centrepiece of local development planning over the last decade. Much of this is associated with issues around social justice, inclusion, marginalised elements in society being left behind in the economic transformation, and ongoing pressures for enhanced local democracy and subsidiarity. It has also been fuelled by the provisions of the EU Structural Funds, and the high level of activity in Ireland associated with the LEADER+ programme. There is much less evidence of participatory process in the rural Ontario context (Douglas and Chadwick, 2001). Notwithstanding the presence of quite extensive inter-municipal collaborative networks (*e.g.,* for water, waste management, ambulance services), the participatory process in local economic development here has been characterised as "passive" and conventional (*ibid.*, 2001). In some contrast the Federal government-supported CFDCs were designed from the start to be socially, culturally and otherwise inclusive. The degree to which they have achieved this, via local and area-based strategic planning for long term development is mixed (Douglas, 2003b). The lessons here suggest that the *ex ante* designing of collaborative structures and networks, while very important, is only one factor in their relevance and success. Ongoing monitoring, investment, adjustments and adaptive evolution, and management are critical, especially if the intent is really to move Polish collaborative systems toward *bona fide* governance systems.

Swianiewicz (2002) is optimistic here. "Most of Polish local governments are clearly attracted by the wider sense of 'governance' in the sense that they are concerned with the overall wellbeing of community, not just with services they are responsible for" (Swianiewicz, 2002). And there is indeed growing evidence of private sector collaboration with local governments in Poland, and experimentation with different forms of service delivery (*e.g.,* Krakow). Likewise, there is some evidence of a growing presence of non-governmental organisations (NGO) as active partners with local governments in Poland.

There are transferables from the rich Irish experience (*e.g.*, the costs of partnership maintenance, liability/responsibility issues). There are few but some regional lessons from the Ontario context (*e.g.*, Ontario East Economic Development Commission) that could be relevant to the collaborative processes promoted by the voivodeship.

Conclusions

Poland faces many exciting and challenging times today and tomorrow in its quest for an expanded and diversified national economy and the sustainable development of its regions, and their constituent communities. The country has not only an inspiring history of resilience and solidarity to fuel this development, but it has a rich legacy combining regional economic analysis and regional administrative structures. It has, in many respects, significant advantages that were not available to other countries in their development trajectory. And it now has a variety of challenges and opportunities afforded by its full participation in an expanded European Union.

This selected review of some Canadian and Irish experience suggests a number of issues that might productively be part of the ongoing refinement of Poland's local development policies and strategies. The importance of the overall political and macroeconomic policy overlay cannot be exaggerated. While there are regional economic development agencies in most provinces in Canada, and while there are Community Futures Development Corporations active in most rural regions, the lack of an overarching development strategy detracts from the local development agendas and leaves a vacuum between regional and local development initiatives. The Ontario case is clearly one that is without direction. The Irish case, by no means a model of perfection, at least provides a clear, articulated "roadmap" for the regional authorities and the counties to situate their development agendas.

It might be thought that the emergence of governance systems obviates the need for local government development. This is not the case. Indeed the increased complexity associated with governance systems, and the fluid uncertain mapping of relationships and resources entitlements, calls for a strong, well resourced local government. Episodes and practices that involve complex negotiated relationships between community groups, the private sector, quasi-autonomous nongovernmental organisations (Quangos), regional and national government agencies, and others will call for highly skilled, confident and respected elected and appointed officials in local government. Increased demands around issues such as transparency, accountability, liability and related matters will call for significant capacity in local government. While there is clearly much success and much to be learned

from the Irish area-based partnerships, and the over-arching "social partners" mediated approach to collaborative development, there is little to suggest that Poland should adopt *mutatis mutandis* the area-based partnership models developed and applied in the Irish context. It is to be recalled that Ireland had the time and space to move from pilot IRD projects into the LEADER sequence, over a decade, and has evolved a culture of negotiated development agendas at the national level over nearly half a century that has provided a legitimated foundation for all sub-national development initiatives. Poland has a significant record of development policies and planning at the regional level, with by all accounts greater legitimacy than Ireland's regional authorities. Context appropriate area-based partnership models might be fashioned here to avail of the regional government infrastructure already in place, and the reformed *powiat* system, while at the same time responding to significant differences in regional economies and development challenges (*e.g.,* Podlaskie versus Ślaskie).

The question of capacity in local economic development is a central consideration. The deficit in rural Ontario, as a Canadian case study, presents very serious vulnerabilities for rural communities and area economies. Ireland does not have the same deficits, in part due to the national development agenda and its pervasive effect, and in part due to concerted area development planning programmes such as LEADER. Deficits have been identified in the Polish context. While active participation in the EU's development programmes will address these deficiencies, a proactive investment in development training (*i.e.,* knowledge, skills, internships) will not only complement local participation in LEADER+ (and follow-up programmes), but will contribute to ensuring that localities are effectively represented in these collaborative arrangements.

In all contexts examined here, however superficially, the question of organisational and sometimes even institutional complexity comes to the fore. A plethora of agencies accumulates, reflecting a growing maze of policies, regulations and other initiatives. This is exacerbated by an almost inexorable layering of jurisdictions (*e.g.,* local, regional, national, supra-national), and the concomitant contesting of territories and portfolios. None of this helps communities. We know this, but we are not very effective in avoiding it. This is very evident in Ireland and in Canada's more disadvantaged regions. The development agenda is not only discredited, but the energies, trust, patience and solidarity of local communities can be adversely affected. Complexity can be a significant disinvestment, not just a necessary negative externality that must go with the development initiative. It can be and should be minimised, by design.

Governance has a certain cachet nowadays, either as a concept explaining the reconfiguration in decision-making process, notably involving governments,

or as a prescription for progressive and appropriate process here. The norms of subsidiarity and social inclusion that inform the allocation and management of the EU Structural Funds, and other EU initiatives, would seem to promote and otherwise reinforce the concept of governance. It will be important for Poland's regional and local development leaders to address the efficacy of this "no one's in charge" decision-making culture. Is it appropriate? Are there other ways of addressing the plurality of interests and potential agents in the local development process? A critical reflection on governance from some of the newer participants in the EU local development process, would be timely. And experimentation and place-particular adaptations in participatory process is a time honoured development tradition (Decoster, 2002).

Note

1. Part of the research for this chapter was completed while the author was a Visiting Professor at the National Institute for Regional and Spatial Analysis (NIRSA), National University of Ireland, Maynooth in 2004. The researcher expresses his gratitude to the Institute for its support and particularly to Dr. Jim Walsh for his valued insights on the Irish development context.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 3

Governance and Local Economic Development: In Search of an Appropriate Governance Structure for Croatia

by
Ivana Rašić Bakarić, Marijana Sumpor and Jelena Šišinački

Fostering local economic development in Croatia is primarily an administrative task of the 21 counties, the current units of regional self-government. However, the big cities alone succeed in attracting population and economic activity, and have therefore more strength and capacity to support economic development than other counties. Also, counties are small regions by European standards. The analysis shows that the existing administrative-territorial setup and functions that derive from the relevant legislation in Croatia do not match the needs of economic growth and development at the local level. The situation could be improved by a clarification in the responsibilities of the counties, the establishment of sound governance mechanisms, a local statistics base and the recognition of the development role of the urban centres.

Introduction

Croatian counties are responsible for fostering economic development at the local level. At the same time, even though this is not formally stated in any of the fundamental legal documents, most cities (towns) and many other municipalities are very active in promoting local economic development. Naturally, the stronger cities and towns are the driving forces in local economic development in Croatia, which raises the question of the competence of the counties in this domain. In practice, governance problems are apparent and make themselves felt in the form of conflicts, competitive behaviour based on local politics and shortfalls in communication and co-operation. The consequences are waste of scarce resources, inadequate support, duplication and neglect of those who really need support.

The thesis of this chapter rests on the assumption that the existing administrative-territorial setup and functions that derive from the relevant legislation in Croatia do not correspond to the needs of economic growth and development at the local level. The main goal of the chapter is to find quantitative and qualitative justification for a governance structure that can appropriately foster local economic development in Croatia. This analysis, which aims to investigate current local governance problems, focuses on the relations between the larger cities and counties as a mechanism for promoting local economic development.

Regional development theories such as trade theory, location theory and the new economic geography can give some insight into spatial aspects of economic activities. There are also the more contemporary approaches to polycentric development that are currently being discussed among experts and academics in the European Union (EC, 2004). As well as the focus on the economic factors of development such as the promotion of growth and competitiveness, the crucial contribution of institutional structures and modes of governance to development is now widely recognised.

The theoretical overview is presented in the first section of this chapter. The second section is devoted to the institutional analysis of the existing administrative-territorial setup, functions and competences of the local governments in Croatia. This is the basis for identifying shortcomings in the current governance structures for local economic development. The analysis of economic activity at the local level is presented in the third section in

which, however, lack of data for local self-governments has made it necessary to base the analysis on data for counties. According to theory as well as in practice, some units of local self-government, particularly the bigger cities, attract population and economic activity and have therefore more strength and capacity to support economic development than counties. This is mostly evident through fiscal data, which exists for all local governments. The fourth section is therefore devoted to the analysis of fiscal capacity for local economic development. By examining three counties and their respective county centres (economic and/or administrative), namely Sisak-Moslavina County (central Croatia); Šibenik-Knin County (southern Croatia); and Virovitica-Podravina County (eastern Croatia). The last section contains conclusions on the local economic governance structures in the Croatian counties and their internal economic development relations with the county centres, based on the insights gained from the analytical review in the earlier discussion of the current situation.

Theoretical basis for local and regional economic development

Location in regional development theory

Relations between economic centres and their region are the central consideration of the extensive range of local and regional economic theories. These theories evolved primarily during the 20th century, embedded in trade theory, location theory and economic geography. Although criticised and at times in the 1900s even considered as inadequate, a certain revival of the basic concepts is occurring, particularly in Europe. They are now viewed through a new lens in the context of a spatially oriented economic development policy that focuses on competitiveness, networking and collaboration. In addition, their revival can be recognised in the concepts of territorial cohesion and polycentric development which are put forward by European planning and regional development experts and scientists.[1]

One of the most famous development theories is Myrdal's (1957) *cumulative causation theory*, according to which some markets and places or nodes attract capital and a skilled labour force, accumulating competitive advantages compared with other locations. Myrdal also stresses that less-developed regions can derive advantage from growth in developed regions through spread effects as innovations are diffused to lagging regions and export markets expand for products from these lagging regions. However, there is a tendency for the benefits to be offset by backwash effects that occur because of movements of capital and labour from the lagging regions towards the more prosperous regions. Dawkins (2003) draws on this point to argue that free trade among regions actually reinforces the process of cumulative causation, in that growth is further catalysed in the more developed regions at

the expense of the lagging regions. Another famous theory is Perroux's (1950) *growth pole theory* based on his perception of the spatial distribution of firms and industries as a web linked by centripetal forces. According to growth pole theory, economic development strategies should concentrate investments on a certain growth pole or sector, in order to initiate development. Perroux also suggested that with appropriate policies, urban centres in a multi-regional context can become growth poles. Growth pole theory was criticised *inter alia* because of unbalanced benefits yielded by the implementation of such strategies, as benefits initially accrue to the growth pole, but at the relative expense of other parts of the economy. Consequently, groups in other sectors or parts of the region or national economy become resentful: it takes time for the benefits to trickle down to them. Dawkins (2003) notes that the application of growth pole strategies was abandoned during the 1980s because of their failure to fulfil the promised initiation of new growth in lagging regions. The emphasis on the process of structural change over time within growth poles fell away. Nevertheless, growth pole considerations still provide arguments for development strategies and many strategies target sectoral or regional poles.

A further significant contribution by Hirschman (1958) focused on *backward and forward linkages* between firms. He examined how *polarised development* could benefit a growing region and its environment and advanced the view that growth in a developed region produces favourable *trickle-down effects* in lagging regions because developed regions buy their products and employ their labour force. A further often-mentioned model is Friedmann's (1966) *centre-periphery model*. This author referred to the traditional export base theory of economic growth and stressed the important role of local politics and the local economy and leadership as well as the impact of the development history of the region. According to Friedmann, big urban areas start ahead of the game in competing for new growth because of the advantages conferred on them by lower urbanisation costs. According to this theory, all factors are in favour of the growth of central regions; regions outside the centre differ according to the relative autonomy of their economy.

Location theory, which was initially introduced by Alfred Weber in 1929 and later developed in the 1960s by Walter Isard, examines, primarily through mathematical models, why economic activity is not evenly spatially distributed and looks at factors that firms consider when selecting a geographic location. According to this theory firms locate in whatever way maximises profits by minimising costs, and optimises opportunities to reach markets. Stimson, Stough and Roberts (2002) added that significant attention is paid to transport costs, labour costs and other production costs, the scale of operation and agglomeration economies. These factors are still important, but over time, the attractiveness of a site, the business climate and networking possibilities have also become recognised as important elements in firms'

decisions on where to locate. A further important theory is *agglomeration theory or external economies of scale*. Armstrong and Taylor (2000) explain that agglomeration economies emerge on the basis of economic association of a large set of economic activities that do not necessarily need to be within the same industry. Concentrations of a large number of firms are created that together serve various industries, including for example urban transport and communications, well organised labour markets, social and public services, cultural and recreational activities, firms organised in *clusters* and *geographic concentration of innovative activities*. All this contributes to the attractiveness of existing centres or growth poles creating a cumulative process of growth. These authors recognise that this can have a negative impact on the less developed regions through backwash effects (*e.g.,* skilled labour migrating to more prosperous regions), causing negative cumulative causation effects. In addition, polarisation and fast growth can result in external diseconomies (or negative externalities) such as congestion, pollution, rising factor costs and higher living expenses.

An older often quoted theory is Christaller's *central place theory*[2] published in 1933, which rests on the notion that centralisation is a natural principle of order and that human settlements follow it. He suggested that there are laws determining the number, size and distribution of towns. This theory relies on two concepts, *i.e.,* every good or service will have a range (the maximum distance consumers are prepared to travel to acquire goods) and a threshold (the minimum size of market needed for a particular good or service to be offered for sale). According to Christaller, urban settlements are ordered according to a hierarchical structure of central places of various sizes and functional complexity, and in every larger region there exists a systematic spatial order of central places (urban settlements). The functions which these central places offer reflect the variety of economic activity that serves the surrounding population. The main criticism of this theory is that it is based on the assumption of isotropic places in which population density, purchasing power and consumer preferences are homogeneous. In reality, density and the socio-economic characteristics of consumers differ significantly over space. One of the newer models is Krugman's (1991) *core-periphery model* embedded in a new economic geography which is also linked to newer trade theories. Krugman stresses that the regional clustering of economic activities results from a combination of centrifugal (immobile factors, land rent/commuting, congestion and other pure diseconomies) and centripetal forces (linkages, dense markets, knowledge spillovers and other pure external economies). The pattern of core and periphery is defined in such a way that manufacturing industry will be totally located in the core, while agricultural production will be located at the periphery. This is sustainable with big internal economies of

scale, low transport costs, and a high share of regional population employed in manufacturing.

The theoretical overview that has been briefly presented above constitutes the fundamental basis of contemporary regional development theory, whose current focus has shifted more towards the complex relations of competitiveness, cohesion and sustainability. For the purpose of this chapter the main theoretical points brought to bear are concentration and agglomeration, as well as the importance of institutions and structural considerations while recognising the economic importance of certain locations (regions) and their developmental effects (positive as well as negative) on the surrounding territory. The next section is devoted to the second but crucial aspect of local and regional economic development, namely the theoretical background of the popular concept of governance.

Governance and good local governance defined

Though there are numerous definitions of governance today, depending also on the context, an often quoted definition is the one put forward by UNDP according to which *governance* can be defined *as* "*the exercise of political, economic and administrative authority to manage a society's affairs*" (UNDP, 1997). While the economic, political and administrative aspects of governance are often the focus, recognition of the need for a more holistic concept is growing. Accordingly, governance embraces mechanisms, processes and institutions through which collective decisions are made and implemented, citizens, groups and communities pursue their visions, articulate their interests, exercise their legal rights, meet their obligations and mediate their differences. Defined in this manner, it emphasises the nature and quality of interactions among social actors and between social actors and the state.

That scientific and professional discussions on the issue of *multi-level governance* intensified during the 1990s can be ascribed to the integration and expansion processes of the European Union. With the formulation of EU-wide common policies, more complex interrelations and requirements for the implementation of development policies between different levels of government have emerged. Carmichael (2002) stresses that "government" has become more variegated within different levels of government (*i.e.,* horizontally differentiated or provided by multiple agencies). In addition, government is geographically more diverse (*i.e.,* vertically differentiated or conducted on multiple levels). Therefore, multi-level governance stresses the complexity of policy making, implementation and responsibilities among different governmental and societal actors in their activities on supranational, national, regional, local as well as quasi-governmental institutions. Government activities tend to move in the direction of regulating public activities and to a lesser extent the reallocation of funds. Changes in governmental approach

towards multi-level governance are primarily the result of changes in the modes and nature of public sector activities. In sum, multi-level governance has changed the relation between policies and service delivery, and the emergence of different tiers of government has complicated the process of policy making. As a consequence, the co-ordination of services through several functional areas and levels of government is subject to more and greater problems. Tensions are also growing between (static) territorial space and (dynamic) functional space creating difficulties in the manner of government. Hooghe and Marks (2003) point out that the dispersion of governance throughout several jurisdictions actually stimulates flexibility. They also stress that centralised government cannot answer all the needs that derive from variety, whereas multi-level governance enables decision makers to adjust the levels of governance and better satisfy the requirements that derive from heterogeneity.

Nor is there a single definition of *good governance*, although growing emphasis is placed on a number of characteristics that reflect values and principles, norms and practices that derive from putting people first and at the centre. These core characteristics of governance are clearly interrelated, mutually reinforcing and cannot stand alone. For example, accessible information means more transparency, broader participation and more effective decision-making. Broad participation contributes both to the exchange of information needed for effective decision-making and for the legitimacy of those decisions. Legitimacy, in turn, means effective implementation and encourages further participation. And responsive institutions must be transparent and function according to the rule of law if they are to be equitable.

Romeo (2002) notes that *good local governance* can be defined as an institutional system for managing local public affairs, characterised by three critical dimensions (the three "P's"):

- *Performance* of the local authorities (fiscal effort and discipline, allocative and operational efficiency) in managing public resources and discharging their responsibilities for delivery of economic and social services, protection of the environment, management of natural resources, and promotion of economic development.
- *Participation* of organised and individual citizens in local public sector decision-making, through mechanisms that supplement and enhance, rather than replace or contradict, the functioning of the institutions of democratic representation.
- *Partnership*, between local authorities, civil society organisations and private sector units for the provision and production of local collective goods and services.

Romeo stresses also that the adoption of good local governance practices depends upon:

1. Changes in the policy, legal and regulatory framework governing:
   - *political, administrative and fiscal decentralisation* of public sector powers, responsibilities and resources, and
   - the *role and status* of civil society and private sector associations and organisations.
2. The build up of local governments' capacity along three dimensions:
   - the improvement of *individual capacities* through training of elected personnel and local administration staff;
   - the strengthening of *institutional capacity*, through the introduction of improved methods and organisational arrangements for managing local public sector resources;
   - the build up of a *systemic capacity* for effective and co-operative intergovernmental relations between local authorities and the central and de-concentrated public administration.

Importantly, the build up of local government capacity is understood as a demand-driven process where the keys are: the creation of financial and other incentives for local governments to invest in the building of their own capacity, and the establishment of clear local government accountability both "upward" to the national level and "downward" to their constituencies, with related systems for administrative and social monitoring and auditing. Good local governance is expected to have an impact on improved services delivery and local economic development. In this way, it becomes evident that good local governance is complementary to a well-functioning local government. Having a good legislative framework in place for local self-government is, although fundamental, only one precondition for local development. Another dimension to be considered is how local governments work with this legislation, and how in practice they implement all the rights and responsibilities they have.

The OECD and its LEED Programme has proposed a concept of local governance that is consistent with the above, although less concerned with municipal concerns. Research has been conducted to derive governance aspects from the local economic growth function, leading to the identification of three essential factors: policy co-ordination, adaptation of the relevant policies and programmes to the local conditions and participation of business and civil society in the shaping of measures and strategies. Stimulating these factors is supposed to fuel the drivers of growth that are most sensitive to the interdependence of programmes and initiatives conducted at various levels, such as entrepreneurship, innovation and skills (see Giguère in Chapter 1 and

Giguère, 2005). Accordingly, we now turn to the institutional structures for governance in Croatia.

An analysis of the institutional framework for local economic governance

The administrative-territorial structure of local governments in Croatia

The legislative framework of local and regional government in Croatia was established in 1992 with the introduction of the local government system. In the following years, various reforms of the territorial and institutional framework were introduced. In 2001 a new Law of Local and Regional Self-Government (LLRSG) was voted. It defined *counties* as the units of regional self-government, while *cities and municipalities* remained units of local self-government.[3]

Today, the Republic of Croatia is a unitary state with 20 counties referred to as regions, and the capital city of Zagreb, which is classified as both a county and a city. In total, there are *21 counties* that are considered by Croatian legislation as units of *Regional Self-Government (RSG)*. Sumpor (2004) stresses that until 2001 counties had dual functions and were primarily responsible for performing tasks delegated from the national level, while neglecting to a certain extent their own self-government functions. After the clear separation of the previous dual functions of counties (*i.e.,* national and regional), as units of regional self-government, they are still in the process of developing and strengthening their new role, particularly in relation to local governments as well as in relation to the national government offices in the counties that were established after the division. The existence of basically two kinds of public administration at county level, *i.e.,* the *devolved* RSGs and the *deconcentrated* national government county offices, has created a somewhat unclear institutional structure at this level of government. Even though counties are referred to as regional governments in Croatian legislation, they are actually too small to be considered as regions in European terms, and belong in fact to the local government level (NUTS III level). As Croatia is in the preparatory process for accession to the European Union, the Croatian Central Bureau of Statistics (CBS) has initiated a consultation to review possible scenarios for dividing Croatia into NUTS II regions. Scenarios involving one, four or five regions are still being discussed in Croatia and with representatives of EUROSTAT. Statistical regions would comprise a number of administrative regional units, *i.e.,* counties. However, a national consensus and decision on the most adequate division can only be achieved through the national political process.

The *Local Self-Government (LSG)* level consists of *124 cities or towns and 426 municipalities*; the precise number of LSGs increases frequently[4] (CBS, 2004). Besides the major cities in Croatia such as Zagreb, Split, Rijeka, Osijek, or Varaždin most of the cities are actually towns. However, the terminology in the

Croatian legislation does not make a distinction between these two terms. The *city or town* is a unit of local self-government with more than 10 000 inhabitants, constituting a unitary urban, historical, natural, economic and social space. The vast majority of towns have less than the minimum number of inhabitants, but the Law prescribes a list of exemptions under which a municipality can gain town status. The *municipality* is a unit of local self-government, consisting of the territories of several inhabited places representing a natural, economic and social entity, and which is connected by the common interests of its inhabitants.

The territorial size and population of the units at different government levels

The Republic of Croatia covers 56 539 sq. km of continental surface (including Adriatic Islands) and 31 421 sq. km of the Adriatic Sea along the coast. Its population is 4 437 460 (Population, Household and Appartment Census, 2001). The total number of 571 local and regional government units in comparison with the population of 4.4 million does not say much per se but knowing that from 1990 the number of LSGs increased fivefold and that it is continuing to rise (any LSG can apply for a different status without evidence of financial capability) regardless of the fact that many of the existing LSGs are unable to fulfil their functions (and are heavily dependent on grants from the central government). This trend is not sustainable in the long run.

Croatian population density is 78 inhabitants per square kilometre. Analysis of the county organisation reveals significant deviations from the average. The most densely populated county is the Croatian capital city of Zagreb, with 1 217 inhabitants per square kilometre and 779 145 inhabitants. Then follows the County of Međimurje with 118 426 inhabitants and a density of 162 inhabitants per square kilometre. The lowest population density is recorded by the County of Lika-Senj with 10 persons per square kilometre and 53 677 inhabitants. In other counties population density varies between 38 inhabitants per square kilometre in the County of Šibenik-Knin and 147 inhabitants per square kilometre in the County of Varaždin. The population of units of local government also varies widely: approximately 70% of the population live in cities or towns (urban) and 30% in municipalities (rural). Further, according to the Census 2001 data, only four cities have over 100 000 inhabitants, while there are six that have less than 3 000. There are also 28 municipalities that have under 1 000 inhabitants, while seven have more than 10 000 inhabitants and could become cities according to law. But regardless of their actual size, LSGs have the same responsibilities and perform the same functions.

The percentage of the population living in county centres indicates the concentration of the urban population. Five out of 20 counties (except the City

of Zagreb) have more than 40% of their population concentrated in the county's centre. Those are: the County of Primorje-Gorski Kotar 47.1% of population urban, the County of Šibenik-Knin, 45.7%, the County of Zadar, 44.9%, the County of Karlovac 41.9% and the County of Split-Dalmatia with 40.7%. The lowest urbanised percentage of population in 2001 was in the County of Krapina-Zagorje, 9.1% and the County of Vukovar-Sirmium, 17.5%. The estimate of regional gross domestic product (RGDP) by county shows that there are great differences in GDP per capita between counties. For example, 53.1% of the national GDP was produced in only 4 counties: City of Zagreb (30,1%), the County of Primorje-Gorski Kotar (8.1%), the County of Split-Dalmatia (7.9%) and the County of Istria (6.3%).

Functions of local governments

According to the LLRSG, units of local government should perform tasks of local importance which directly address the needs of citizens, and which are not assigned to state bodies by the Constitution or by law. It is interesting to note that economic development is not mentioned as a task of local government, but as a task of counties. However, local economic development can be considered as a task of local importance. Croatia has a significant number of municipalities that are far too weak to perform the legally required functions and tasks on their own and regularly rely on support and transfers from higher levels of government. According to the LLRSG, the county should perform tasks of regional importance, especially those which relate to education; health care; town and urban planning; economic development; transit and transport infrastructure; planning and development of the network of educational, medical, social and cultural institutions. Also, cities that have more than 30 000 inhabitants can provide services, which are actually the responsibility of counties, if they have sufficient resources for their provision. In 2001, as a part of the ongoing decentralisation process, 32 local and all regional self-governments gained greater responsibilities in education, health and social care, supported by equalisation funds.

The LLRSG only lists mandatory functions of local and regional governments in general. Bajo and Ott (2001) prepared a table listing all main functions and levels of responsibility by government level (see Table 3.A1). Details of the actual responsibility of particular levels as well as the performance of certain types of function are defined in detail in a large number of special laws and by-laws, in which expenditures are assigned specifically to each relevant tier of government, at the same time highlighting central government responsibilities. However, due to the vast number of such laws, by-laws and regulations, frequent changes, and amendments as well as new regulations, difficulties in implementation occur at local level. Many of these regulations are conflicting, contradictory, and apparently without

transparent funding. They are often neglected by the responsible levels of government, leading to poor provision of specific public services or none at all. This occurs primarily because the many responsibilities shared between the various levels of government, from national to local, are not clearly defined. Whence the utility of a better understanding of the nature of various functions. According to Sumpor (2004), the functions of local self-governments can be categorised into three main groups, namely:

- Functions that are the sole responsibility of local governments, *e.g.*, pre-school, housing and utilities. The delivery of such services depends entirely on the fiscal and human resources of the local government alone.
- Functions for which responsibility is shared with regional governments, *e.g.*, recreation, culture and religion – the delivery of such services depends on the capacities of the local as well as the regional governments, particularly their co-operation and communication.
- Functions for which responsibility is shared with both the regional and the central government, *e.g.*, general public services, elementary education, social security and welfare, mining, industry and construction, roads, other economic affairs and services – the delivery of such services depends very much on bottom-up and top-down relations.

All three groups exhibit specific needs and problems of local governments in providing public services according to their functional responsibility. Major problems arise when local governments depend on other tiers of government. Given the problem of fragmentation and the lack of clarity in the legislation, it is obvious that significant efficiency problems can be encountered. The still highly centralised Croatian government (mostly visible through fiscal data) simply cannot target all needs through standard top-down decisions. Yet at the same time, most local governments have no tools or systematic means of making the higher levels of government aware of their real needs. On the other hand, the counties are administratively and fiscally still too weak for this level to be of much use as an intermediary between the LSGs and the national level for the provision of public services. These problems are less pressing in the more developed, administratively and economically stronger local governments (*i.e.*, cities/towns) which are also more eager to take over new responsibilities and are more pro-active.

Analysis of the local economies and economic governance in Croatia

Employment and active companies across sectors and counties

First of all, it should be stressed that economic data at county level should be treated carefully and the results have to be considered only as indications, since most of the data is based on estimates. In addition, no data on the level

of local governments is collected by the Croatian central bureau of statistics. In this section the economic data available at county level is presented. In the next section some discussion of the relations between counties and cities will be presented based on fiscal results available for all local government units.

The structure of employment by category of activity shows that in 2001 most employed persons were in services (including construction, wholesale and retail trade, hotels, restaurants, transport and communications, financial and real estate services) for a total of 421,057 persons or 43.1% of total employment by sectors. Employment in the secondary sector (manufacturing) is the next largest category (287,410 employees or 29.4% of total employment by sectors). Only 3.3% of the workers in sectors were employed in the primary sector (agriculture), while 236,639 persons were employed in the public sector (or 24.2% of total employment by sectors). When analysing the employment structure across counties, significant deviations from the national averages are observed in the least developed counties like Vukovar-Sirmium, Virovitica-Podravina and Lika-Senj. Of total employed persons in sectors, 14.2% in the Vukovar-Sirmium County, 12.2% in Lika-Senj County and 11.9% in Virovitica-Podravina County were employed in the primary sector. The lowest share of employed persons in the primary sector of the total in sectors by county was in the counties of Šibenik-Knin 0.6%, the City of Zagreb 1.1% and in Krapina-Zagorje 1.3%.

The rate of unemployment in the Republic of Croatia, *i.e.,* the ratio of unemployed persons to the total economically active population, was 20.4% in 2001. At county level there were marked deviations from this average figure. An unemployment rate above the national figuer was recorded in ten counties, varying between 22.6% in the County of Lika-Senj to 31.1% in Šibenik-Knin. The lowest unemployment rate was reached in the County of Međimurje, 12.1% and the County of Krapina-Zagorje 13.5%.

In 2001, 175 243 active legal entities were registered in Croatia (companies, crafts, trades and free-lance). Of this total, 89 967 business entities were in crafts and free lance (51.5%), and 85 276 (or 48.5%) were companies active in various sectors. Analysis of the number of active legal entities across counties in 2001 discloses that most active companies were concentrated in the City of Zagreb (47 326), followed by 19 020 companies in the County of Split-Dalmatia, then 15 953 companies in the County of Primorje-Gorski Kotar, and 13 660 companies in the County of Istria. The lowest number of active legal entities in 2001 was recorded in the County of Lika-Senj (1 579), and the County of Požega – Slavonia (2 038). By sector, the highest number of active legal entities was recorded in services (incl. construction, wholesale and retail trade, hotels, restaurants, transport and communication, financial and real estate services) with a total of 60 379 companies or 70.8%. Of the total of 85 276 active companies, only 1 785

(or 2.1%) were active in agriculture, while 11 155 companies (or 13.1%) where registered as active in manufacturing and 11 957 companies were in the public sector (14%). The percentage distribution of companies by sectors in counties is similar to the structure on national level.

Economic performance at county level

In 2001 Croatia's GDP amounted to USD 19.9 billion or USD 4 486 in per capita terms (at current exchange rates). Estimates of the *regional gross domestic product (RGDP)* by county indicate significant differences in GDP per capita between counties. The RGDP varied between USD 192.6 million in the County of Lika–Senj and 6.1 billion in the City of Zagreb. On this estimate, RGDP per capita of the capital city Zagreb in 2001 was 76.3 per cent above the national level. Other counties with above-average GDP per capita were the County of Istria (34.6 per cent above) as well as the County of Primorje-Gorski Kotar (17.5 per cent above), both on the northern coast of Croatia. Per capita GDP was below the national average in 17 of the 21 counties varying between 58% of the national average for the County of Vukovar-Sirmium and 95% for the County of Varaždin. The county results presented reflect the fact that the counties, mainly in the north-western part of the country with the most advanced and economically developed urban centres (Zagreb, Rijeka, and Pula) have the highest per capita RGDP. This supports the thesis that infrastructure, business services, skilled labour, and higher housing standards are dominantly located in the major urban centres.

Total exports of goods by the Republic of Croatia amounted to USD 4.5 billion. At the same time, imports of goods were USD 7.6 billion. The foreign trade deficit amounting to USD 3 billion, or more than 15% of GDP, is a major problem. The coverage of imports by exports was only 60%. At county level, only seven counties recorded a trade surplus. Interestingly, of these seven, only Istria is one of the more developed counties, with a surplus of USD 72.3 million: the other six, although among the least developed counties managed to run a surplus were Sisak-Moslavina USD 37.2 million, Virovitica-Podravina USD 24.3 million, Požega-Slavonia USD 18.8 million, Koprivnica-Križevci USD 6.8 million, Krapina-Zagorje USD 5.5 million and Lika-Senj with USD 2.5 million. The city of Zagreb is at the other extreme with a trade deficit of USD 2.2 billion (or more than 70% of the total national trade deficit). Zagreb's share of total Croatian imports was 33% and its share of exports was 48.2%. The smallest contribution to national foreign trade was made by the County of Lika-Senj (one of the seven counties with a trade surplus), with exports amounting to only 0.1% of national exports and imports to only 0.02% of national imports. These trade figures display the interesting feature that significant trade deficits are generated in the more populated and economically more developed counties with strong urban centres.

Local economic governance in Croatia

A recently conducted study on local economic development (LED) policy in Croatia has yielded some important insights into the current state of affairs.[5] Generally, Croatian legislation referring to sectors of the economy is prepared, adopted and managed at national level whereas measures and regulations are implemented either directly top-down, through deconcentrated national institutions and government offices, or through delegation of tasks to local and regional governments. Laws and regulations whose economic impact on the country at large is significant are broadly defined on the national level and their implementation is managed through tiers of government which are *supposed to co-operate*. Local and regional self-governments are commonly viewed as promoters and supporters of small and medium-sized enterprises (SMEs) on their territory. Large industry is commonly considered to be in the domain of the national government and regulated through the national institutional and legal framework.

Croatian Local Self-Governments (LSG) are active in local economic development in two ways, depending on their fiscal strength, available human resources and political stability. One is a proactive approach, through promotion of economic development. The other relies on various measures to foster economic development. In addition, local and regional governments can design and offer their own programs and measures, or obtain information on programs implemented by others. Since 2001, a significant number of local and regional economic development initiatives in Croatia have been promoted and financially supported by the former Ministry of Crafts, Small and Medium Enterprises (merged with the Ministry of Economy in 2004). In addition, communication and interaction between the existing and emerging domestic and foreign business-related institutions is of crucial importance; recent developments include some spectacular and lively activities in SME development. Recent LED initiatives in Croatia include local government incentives (lower surtax on income tax, tax on unused land, utility charges and contributions), financing of local economic entities (annual credit lines), business support initiatives (over 30 public and private entrepreneurial centres and nine business incubators established), provision of business-related infrastructure (business zones), establishment of networks and associations, and promotion of human resources development (certified educational programmes, training and seminars).

LSG administrations can levy taxes, use part of the national tax which is shared with local budgets, levy charges and take up loans. Quite a few underdeveloped municipalities can also count on external financing, which may be obtained from the national budget or from various international sources. The funds collected in this way may be used for a number of

economic development incentives. Acting directly, the LSGs can reduce certain local taxes or defer charges. They can also give exemptions of fees for a limited period of time. Through national fiscal legislation, tax incentives (exemptions) have been defined for businesses which set up in LSGs or communes included in areas of special state concern (affected by war and underdeveloped areas), in mountain areas or on islands. Here, LSGs cannot act directly, but are able to give information to entrepreneurs and businesses who wish to set up operations. Tax incentives are usually combined with the development of industrial and commercial or mixed zones. The main promoter, the Ministry of Economy, launches loan programmes in co-operation with selected banks and offers them to municipalities rather than to entrepreneurs. This requires the LSG to have a high level of fiscal capacity as well as a capable administration, so that it can assist in the implementation and monitoring of a well-designed project or programme. Very few LSGs in Croatia currently meet these requirements.

Directly or indirectly, LED is managed by all three tiers of government. Larger municipalities and all 21 counties have departments that deal with economic issues. Ministries that are in charge of administering various aspects of overall development (environmental protection, spatial planning, reconstruction, finances etc.), have offices at the county level and in some 100 LSGs. There are also the state owned enterprises which implement their plans mainly at the local level. Finally there are municipal courts and municipal land registry departments, which are unavoidable stages in any local economic venture. The institutions that approach and assist potential entrepreneurs are not only the Croatian Chamber of Economy and the Croatian Chamber of Crafts, with their regional and local offices, but also some associations of LSGs and emerging local development agencies.

Analysis of fiscal capacity for local economic development

Fiscal analysis based on the consolidated general government data

As mentioned earlier, fiscal data are the only and relatively more reliable source of quantitative information for the analysis of the relations between counties and cities. Based on demographic and economic data, primarily collected and presented at county level, it can be assumed that the main economic poles in Croatia remain the largest urban centres in the country, namely Zagreb, Split, Rijeka, Osijek, and Varaždin. It can be observed that local governments which are more developed and have economic advantages due to the concentration of businesses there are in a better position to collect more of their own revenues as well as revenues from shared taxes. And they are in Croatia, as in other countries, naturally the mainly larger urban areas.

The economic and administrative strength of the major urban centres was also taken into account in the first phase of decentralisation, which was initiated in 2001. To this end, an analysis of the fiscal capacity of local government and administration units in the period 1999 – 2000 was conducted using selected indicators to portray relevant aspects of the real state of affairs in the local self-government financing system. The indicators for the year 2000, obtained by an empirical analysis of fiscal capacity and the ratio of current revenues to current expenditures for the basic functions to be performed by each local government unit, suggest that *184 municipalities and cities (or more than 30%) were unable to cover their current expenditures by current revenues* (Perko-Šeparović, 2003) However, the study does not address in detail the size of the local governments investigated nor whether they actually provide all the services in their legal remit. This needs to be analysed further, when it would probably turn out that the share of 30% mentioned above might be even higher. The weaker local governments either rely on central government transfers or simply do not provide the mandatory services.

To initiate the decentralisation process, 32 cities/towns (out of a total of 546 local government units in 2001) and 21 counties were selected to take over new responsibilities. By reason of the reform process and difficulties with implementing new procedures and IT systems in most of the local governments, fiscal data covering all local governments is still not publicly available. However, the Croatian Ministry of Finance did manage to publish aggregated data on the consolidated general government budget outturn for the period 2001-2003. These data refer to the central government and extra-budgetary funds, and there are also local data for the 53 units that entered the first phase of decentralisation in 2001.

In the period 2001-2003, the consolidated general government total revenues amounted to 46-47% of GDP, Expenditures and lending minus repayments exceeded total revenues; resulting in an overall deficit of around 3% of GDP every year throughout the period. Even though no significant changes are visible in the total figures, some changes did occur during the period. First, the central government revenues increased from 32% of GDP in 2001 to almost 39% of in 2003, while central government expenditures showed an even steeper change, from 26% of GDP in 2001 to 38% in 2003. This is the only part of the government to show a surplus throughout the period, albeit a declining one – from 5.5% of GDP in 2001 to 0.7% in 2003. These changes result solely from a change in fiscal policy *vis à vis* extra-budgetary funds in 2001, when the central budget took over the expenditures as well as the revenues of the pension insurance scheme. A further change in fiscal policy occurred in 2002, when the revenues and expenditures of the health insurance and unemployment cover contributions were integrated into the State Treasury

system. This change brought about a further decrease in extra-budgetary expenditures as well as revenues.

As mentioned above, Croatia is a highly centralised country. This is confirmed by two important indicators: the share of local government revenues in gross domestic product (GDP) and their share in the total government budget revenues. In 1999 the share of local budget revenues in the consolidated revenues of the general government budget was 10.3%, and their share of GDP was 5.4%. In 2000, the year before the launch of the first phase of the decentralisation process, the share of local budget revenues in the consolidated revenues of the general government budget totalled 10.9%, and their share of GDP amounted to 5.2%. The 2001-2003 fiscal data for the local level (based on 53 local units) shows no significant change during the period, when revenues rose from 4.1% to 4.7% of GDP, and expenditures rose from 4.3% to 5.2% of GDP. The deficit of local governments increased slightly from 0.2% to 0.5% of GDP in the same period. These figures show that the newly-introduced decentralisation process had not yet led to any significant changes in the local fiscal data.

The fiscal capacity of local government in Croatia

The analysis of fiscal capacity at the local level in Croatia still suffers some real limitations, as the last complete set of fiscal data in the public domain is for the year 2001. Based on such data, only a few general statements about possible trends can be made. For the aggregate of all local governments, the share of cities or towns in total revenues was 73%, while the share of counties was only 13%. As regards capital inflows and expenditures, the most significant share is generated by the cities or towns. At the same time, counties received 49% of the grants to local government units, which confirms that they have a significant need for additional financing. Also, in contrast to the counties, the LSGs managed to reach a coverage indicator above 1. As to administrative capacity, it is clear from the data on employed persons in local government administration, that cities or towns dominate, with 66% of public officials working in the city or town administrations (in counties only 10%).

Comparison of the indicators for the counties of Virovitica-Podravina, Šibenik-Knin and Sisak-Moslavina with those for the respective county centres, confirms the assumption that can be drawn from the aggregate data that the counties are weak compared to cities. In all three counties, the total revenues of the cities or towns significantly exceed the total revenues of the respective county government. The city of Šibenik and the city of Sisak managed to collect more revenues than their respective counties. The somewhat lower revenues collected in the city of Virovitica can be explained by a weaker economic structure. All three cities managed to cover their current expenditures by current revenues, while all three counties

experienced significant difficulties in that segment of their budget management. The share of capital revenues in the total of the cities of Šibenik and Sisak show that more than 70% was collected in the county centres alone. Virovitica again reports a significantly lower share (39%). At the same time, the counties collected very low or even zero income (Šibenik-Knin) from capital sources. The expenditure side shows similar relations between the counties and their centres. As regards employment in the public administrations, all three cities have more staff than their counties. The most significant share of public administration employees on the territory of the county is that of Šibenik (57% of the total).

Conclusion

This chapter has shown that the existing administrative-territorial setup and the functions that derive from the relevant legislation in Croatia do not match the needs of economic growth and development at the local level. In the light of the theoretical overview, the quantitative analyses and the qualitative comments presented in the preceding chapters, it is clear that the cities or towns that hold the status of county economic centre are stronger and better able to take care of local economic development than the county administrations. The main points highlighted by both the old and the newer theories such as cumulative causation, agglomeration and the effects of economies of scale are pertinent and can be seen in Croatia. The cities frequently mentioned as the strongest – Zagreb, Rijeka, Split, Osijek, or Pula are in fact regional growth poles and have the respective function and role in relation to the surrounding regions (as recognised in the central place or core-periphery models). To a lesser but still valid extent, this applies also to the second rank cities analysed in this chapter (Virovitica, Sisak or Šibenik). Their strength by comparison with counties is confirmed by the fiscal data but against this, missing institutional links (formal and informal, political instability and the low level of collaboration) render all the negative development effects recognised by theory (the backwash effects, the drain of skilled labour, the time taken for changes to work their way through) visible throughout Croatia. It is not surprising that neglect of the importance of the development role of the urban centres and the placing of sole reliance on the competence of the institutionally weak counties (without administrative history) has generated local economic governance structures that are not adequately organised to foster and promote development throughout the country.

In general, many current problems of local economic governance are an inheritance of certain legislative omissions in the past, when counties were introduced into the system of local governance without enough serious analysis and preparation. This is also true for the Law on local and regional

self-government. The definition of responsibility for local economic development in the legislation refers only to counties, but at the same time the role of counties remains unclear. There are also shortcomings in territorial division, which is still strongly influenced by politics, whereas expert analyses and warnings about the current system of local governance are ignored. In addition, counties are considered to be too small and too weak to be considered as regions meeting the EU definition of that term, although discussions on the introduction of a new regional level seem to be getting under way. At the same time, the significance and strengths of the urban centres have been completely neglected for the past 15 years. An additional and severe problem for better local economic governance stems from inadequate official statistics and the uneven quality of the individual, regional and local statistics; all of these are a prerequisite for monitoring local government performance.

As regards governance, interrelations and interdependencies between the counties and county centres have been neglected throughout the entire period. Furthermore, political as well as personal animosities and a degree of competition between these two levels of governance have aggravated the difficulties faced by many local governments and counties. Unbalanced development throughout the Croatian regions is most visible from a comparison of the data for Zagreb and the rest of the country, and it has a definite negative impact on the economic development of the country as a whole. It is true that there are a number of fruitful experiments and examples of innovation in local economic governance in Croatia, but they are mainly to be found in the stronger LSGs reviewed earlier, and their success is to a large extent based on individual efforts. Some of the LSGs in Croatia have had the opportunity to obtain experience in building partnerships and networking as well as broader citizen participation in the public sector, primarily through foreign technical assistance projects. The experience gained should serve Croatia well as it progresses along the road to improved local economic governance structures.

Notes

1. See: European Spatial Development Perspective (ESDP), Potsdam, May 1999, *http://europa.eu.int/comm/regional_policy/sources/docoffic/official/reports/som_en.htm*; European Spatial Planning Observation Network (ESPON), *www.espon.lu*.
2. Quoted in Stimson, Stough and Roberts (2002).
3. Historically, from 1967 until 1992 only the local – municipal – level of local government existed in Croatia. In 1992 counties were introduced with the status of government units (Pigey *et al.*, 2002).
4. Some mistakes occurred also in the determination of regional organisation and the application of equivocal legal regulations, partially caused by non-systematic

population surveys and improper presentation of the survey results. Additionally, the implementation of the laws revealed that several settlements were illogically attached to a local unit without any real regional affiliation (Pigey *et al*., 2002).

5. Draft report on "Local Self-governments in Croatia", USAID-Local Government Reform Project II, co-operation between the Urban Institute, Washington D.C. and Institute of Economics, Zagreb, 2004.

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ANNEX 3.A1

Functions and Responsibilities across Levels of Government

Function/Level of responsibility	National level	County	City/Municipality
1. General public services	X	X	X
2. Defence	X		
3. Law and order	X		
4. Education	X	X	X
4.1 Pre-school			X
4.2 Elementary	X	X	X
4.3 Secondary	X	X	
4.4 Tertiary	X		
5. Health care	X	X	
6. Social security and welfare	X	X	X
7. Housing and utilities			X
8. Recreation, culture and religion		X	X
9. Agriculture, forestry, hunting and fishing	X	X	
10. Mining, industry and construction	X	X	X
11. Transport and communications	X	X	X
11.1 Road	X	X	X
11.2 Rail	X		
11.3 Air	X		
12. Other economic affairs and services	X	X	X

Source: Bajo, A. and K. Ott (2001).

ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 4

Building a Governance Framework that Enables the Establishment of Partnerships in Slovenia: Comparison with Ireland and Finland

by
Zdenka Kovač

The process of building new forms of governance is of critical importance in Slovenia, where reforms have established regional development partnership structures to foster economic and employment development throughout the country. The comparison of Slovenian achievements with Irish and Finnish ones indicates that governance structures should link urban centres and the rural regions surrounding them to help to determine the specialisation of regions and stimulate their capacity for innovation. It also suggests that there is a lack of capacity in both technical and more strategic, bargaining and consensus building skills. The Slovenian analysis also points to the roles and responsibilities of national governments in providing a suitable strategic framework for local and regional initiatives and for setting up institutional structures that favour an implementation of policies that is consistent with shared goals locally.

Introduction

Modern societies have been challenged by the need to develop innovative tools for future development. How to achieve this involves two at first sight opposite goals – competitiveness and sustainable development (social, economic and environmental) – is one of the main challenges of development actors. Building creative communities and regional innovation systems with strong social capital, is one of the innovative answers to this challenge. To achieve this approach calls for robust multi-level public-private partnerships and requires the building of a management system called decentralised governance for development. Only highly educated, creative and action-oriented citizens of all groups can seek out new possibilities for better (sustainable) use of local resources in order to secure improved employment opportunities and develop new innovative social inclusion programmes

In this respect the best support that central governments can extend to stimulate the development of creative regions is by introducing decentralisation, not through the setting up of new levels of political administration, but by building up modern local governance systems, based on public-private partnerships.

Many good practice techniques relied on in various countries are solid proof that decentralisation through local governance systems pays off. Ireland and Finland are two such countries among those constantly on the lookout for more ways to advance the development of local governance. Against this, many countries are still struggling to develop the best model for themselves. Slovenia falls into this last group. For more than three decades it has taken many steps towards local self governance, but it seems that its political structures have not yet been able to agree to adopt the firm, long term oriented model that could deliver results similar to those achieved in Ireland and Finland.

This chapter analyses successes and failures in building up multilevel public-private decision-making structures in Slovenia to activate the endogenous resources of local areas and ensure balanced polycentric development and a high level of social inclusion for all groups of citizens. It compares Slovenia on the one hand, a transitional economy with the experience of Ireland and Finland, two of the most creative EU societies, but with rather different historical backgrounds. Both have been, used by Slovenian policy makers as a reference model, for better evaluation of the results of Slovenian efforts.

Slovenia as a case study: the background

Slovenia is a rather young Central European State, which in 1991 re-gained independence, almost 1 000 years after the first Slovenian state of Karantania lost it. The country emerged from the break-up of what had been for 70 years Yugoslavia. Previously it had been a part of the political structures of the Austro-Hungarian monarchy and before that the Venetian Republic for almost 900 years. With a population of around two million and a central geographic position, it has always been at the cross roads of the political interests and bargaining strategies of its big neighbours, as well as being influenced by one system of economic development system or another, created by the larger political powers in Europe. Slovenia entered the economic and political community of the European Union on 1st May 2004.

Socio-economic context

The country's population is slightly under 2 million, and is rather aged: pensioners account for over 25% of total. Apart from Slovenians, who constitute more then 88% of the population, there are two minority groups, Italian and Hungarian, (less then 1%) and a fast growing Roma community. About 10% of its citizens have roots in others of the former Yugoslav republics. The active population is slightly over 900 000, of which registered unemployed represent a little less then 100 000 (11%), and self-employed (including farmers), slightly over 100 000 (12%). The rate of unemployment as measured by ILO is around 6%, which clearly shows that quite a large share of the working population is employed on the grey market. Slovenia is considered as one of the most socially oriented transitional states in the EU. Over 25% of GDP is devoted to numerous types of social protection schemes (*i.e.,* low income assistance, social scholarships, subsidised rents, kindergarten fees, school food allowances, student board and lodgings, care of the elderly, social pensions, health care assistance).

The enterprise sector is still in the process of restructuring. There are at present, around 100 000 enterprises, of which more then 97% are small and medium-sized enterprises (SMEs). There are also around 70 000 farm households, of which more then half combine activities on the farm with paid employment or performing diverse other activities. Despite the transition period, which reduced the dynamic pace of economic activities, GDP growth in the last decade has always been far above the EU average (last year 4.6%). Measured at Purchasing Power Parities, GDP per capita at the end of 2003 was around 16 000 EUR, which puts Slovenia above 75% of EU average. Inflation still remains somewhat of a problem; 3.6% in 2004, but with a marked downward trend. One of the bigger problems of Slovenian enterprises has been the low added value of their products, which is significantly below the EU average.

In terms of political structure, Slovenia comprises 200 municipalities as the basic local self government structure, as well as the central authorities. For the purpose of implementing regional development policies, Slovenia it is at present divided into 12 statistical regions, with 12 regional agencies. The difference in terms of GDP between the most highly and the least developed region is in the ratio of 1 to 2.

A short history of democratic experience

The population of Slovenia has gained considerable experience of "peoples' democracy" in the course of its history.

The Karantanian constitution in the 8th century, which provided for representatives from different Karantanian regions to elect, or better, to confirm the King, was recognised by the American Founding Fathers as a good example of one of the earliest democratic constitutions, when they were looking for models for the US constitution in 18th century. This shows that a feeling for active citizen participation in political life was deeply rooted in the population. Nor was it totally lost even during the thousand years of lost independence; indeed, it was evident in the types of regional political structures that were in place during the Austro-Hungarian Monarchy.

After the dissolution of the Austro-Hungarian monarchy in the peace agreement of 1918, the territory of what is today Slovenia was split between Italy and Yugoslavia, and shared the political and economic developments of these two countries. After the Second World War, the present territory of Slovenia became part of Yugoslavia, where it experienced the transition from a highly centralised socialistic model in the 50s and 60s, and the struggle to introduce a more efficient socialistic system closer to the people in the 70s.Almost every ten years a new constitution was designed to this end, each time with a growingly decentralised political system in which more and more authority was delegated to republics, transforming Yugoslavia from a unified socialistic one-party system (but also with strong organisations that we could call socialistic version of NGOs and social partners, like youth organisation, socialistic alliance, unions, etc.), to a federal state conveying a high degree of autonomy to its republics while further conferring a considerable level of delegated authority to local self-managed communities.

Experimenting with the self-management system

In order further to decentralise and socialise decision making on socio-economic development in the 1970s a new, so called Self-management system was introduced. The aim was to replace state ownership by social ownership, and to introduce a "bottom up" decision making system on all matters of "common concern".

The "Law on associated labour" passed in 1976 represented a kind of Act of implementation of the new Constitution that had been, adopted in 1974. One of the main paradigms of the underlying policy was to secure the polycentric model of economic development and the transmutation from state ownership to social ownership. Previously state-owned companies had been transformed by the Law into "organisations of associated labour" in order to implement the socialistic version of the "bottom up" approach to financing the development of social services. Self-management communities were established at the local (LMC) and on the republican level (RMLC).

At the time, Slovenia, as one of republics of Yugoslavia, had 62 municipalities, which combined the performance of tasks of the decentralised state administration with tasks in the purview of local government authorities. The municipalities had authority to decide the rates of contribution for financing social services and communal taxes. In order to develop "social ownership" of what today we define as public services (*i.e.,* grammar and vocational education, child care, culture, sport, employment, social security, health security, pension insurance), the self-managed communities were established in every municipality. The Law provided that each should be governed by an assembly of representatives of workers elected in socially owned companies (organisations of associated labour), managers, public services, chambers of commerce and political organisations.

The LMCs had authority to discuss and adopt programmes for solving open local issues of a local nature in the fields mentioned above, and to propose to the municipal council the rate of contribution from wages and other sources needed for successful management of local social services, which were to be free of charge for citizens. At the level of municipal councils, the proposals from different LMCs were faced with the reality of available financial frames to ground the final decision about the rate of contribution from wages to cover the costs of activities for each of the social services. LMC assemblies were also used to discuss programmes and financial proposals for sectoral policies of national importance, and their representatives had to defend their views and conclusions in meetings of national assemblies. When decisions were finalised, the rate of contribution set by the national self-management communities was mandatory for all employees and other economic bodies (self employed, farmers, co-operatives and so on).

In order to seek out additional sources for investment in social infrastructure (such as school and kindergarten buildings, old age homes, health centres, cultural facilities, community centres, sport resorts, local roads, water supply investments) and to reinforce the principle of corporate social responsibility, municipalities could in addition introduce a so called "self-participation system". Every four years an investment plan was prepared

for the approval of citizens and the enterprise sector and a referendum held to decide the additional participation rate (usually around 1-2 per cent of the net income of each individual citizen). If a majority voted in favour, the system was introduced; otherwise not. Some village communities at an even lower level than the municipality decide have also had recourse to the self participation system to serve very locally based needs.

Despite the marked complexity of the system, which was certainly also too costly for efficient management, a careful analyst could not deny that it translated the basic forms and elements of local and national public-private partnerships and corporate social responsibility.

In terms of polycentric economic development, municipalities and political structures invested a lot of effort, to ensure job creation in remote regions and municipalities. Large enterprises were given incentives and special subsidies were provided by the Federal Fund for Under-developed Areas and the republic's budget was tapped, to open either a subsidiary company, or an enterprise unit

The self management system had only a short history. It lasted 15 years, far from enough to reveal, all its advantages and drawbacks. In the late 1980s, Yugoslavia entered into a period of massive economic and even bigger political crises. After Tito's death, there was no charismatic leader to bring the diversities of the Yugoslav republics out of crisis and keep the country welded together. The Communist party was losing its authority, literally day by day, and a time of major change was on the horizon. A growing chorus of voices could be heard to blame social ownership for the economic crises of the time.

Looking for new models

And changes came. First political, at the very end of the eighties, still as one of the Yugoslav republics, Slovenia introduced a multiparty system, then, at the start of the 1990s declared independence and undertook the transformation to private ownership and a market-based economy.

The political actors began to swear allegiance to "the free market and private ownership" as key tools for successful development. The institutions of the self-management system were dismantled and in a very short time replaced by governmental services and a centralised tax system. The privatisation of previously socially owned companies was put in hand, with the result that the erstwhile rather highly developed feeling of corporate social responsibility, with companies deeply involved in local social and cultural development, was rapidly dissipated. Pronounced to be a socialistic illusion and stupid to boot, social ownership was transformed by the new Law on privatisation into state or private ownership.

In the same period, a new Law on local self governance was passed to release local municipalities from the tasks of state administration (62 new state administrative units were established with relatively limited state administrative responsibilities). Municipalities became responsible for local communal issues, local health and social centres, kindergartens and also in part for grammar schools and for support of local NGOs. The Law on financing of municipalities entitled municipalities to 1/3 of the income taxes collected from citizens permanently resident in a municipality. Most of them also became eligible for so called equalisation payments from the central budget, up to the level of "proper consumption pro capita", which was based on a special methodology devised by the Ministry of Finance. Consequently, municipalities' budgets were funded mainly by the central taxation system. Their only locally collected sources, which they are authorised to address, are communal taxes and taxes on the use of land for construction and building. A property tax which could become another source for the coverage of municipal needs has not been introduced yet.

Apart from that, the Law authorised the process of downsizing through splitting of larger municipalities which started in the mid nineties. It was resorted to enthusiastically by different parties and the number of municipalities increased from 62 to almost 200. This brought about a problem of division of, on the one hand, responsibilities for "common public services" which are mainly located in the bigger municipalities (former centres), and on the other, properties previously held in common. Because of disputes, these processes slowed down the development process at the local level.

The big question is, whether so many municipalities – the smallest do not exceed 800 inhabitants – are not too weak for efficient local management. It arises because despite the large formal responsibilities for grammar schooling, kindergartens, local health and social problems, local cultural and sports facilities and local communal infrastructure, examination of their real authority and financial capacity shows that most of their income derives, not from their economic vitality, but in the main on financing from the central budget. At the same time, it cannot be denied that in reality, some rather small municipalities in less developed regions have done a very good developmental job during the past ten years.

The main problem is that the lack of clarity about their role in economic development has engendered a, situation in which municipal authorities have been very keen to invest as much as possible in local roads and water supply systems, but less willing to take on responsibility for the real economic development of their communities such as SME development, human resources (especially adults), job creation, investment in modern economic infrastructure such as business zones, incubators, innovation centres, etc. Discussion has now focused on whether responsibility should be borne by the

enterprise sector, or the central government. Partly this is the consequence of two realities: first, that the tax system has not given municipalities an incentive to get involved in this field, and second, that state policies are too centralised and in only few cases has the government involved municipalities in the design and implementation of development programmes.

Establishing local development partnerships for the first time

At the end of 1996, influenced by the Irish model, the government of Slovenia accepted a proposal by a special design group and initiated a policy of promoting the creation of local partnerships. The programme to support local development initiatives was devised and implemented in co-operation with two national agencies: Employment Services of Slovenia (ESS) and the Small Business Development Centre (SBDC). The aim was to support the creation of local public/private development partnerships (municipalities, chambers of commerce and crafts, agriculture advisory services, employment services and NGOs) for promotion of SMEs and job creation based on endogenous resources.

The legal form of a local partnership was not prescribed. The local partners were merely required to nominate a local co-ordinator and design at least one local development project (connected with SME development and job creation), to be supported by a governmental programme. The partners could also apply for funding to cover training costs for a local co-ordinator. A special training programme was initiated by the ESS and the SBDC for promoters (co-ordinators) of local development, with domestic and foreign (mostly Irish) trainers. In principle not more then 50% of the costs of the planned activities could be covered by the national grant scheme; the rest was expected to be covered by local partners. It was a requirement that the local partners be municipalities, representatives of the enterprise sector, unions and NGOs, and that the partnership to be set up should cover an area with a population of at least 20 000.

The immediate response to the public tender was surprisingly good. In the first year 58 newly formed local partnerships applied and 48 met the requirements of the tender. In the following years, some of the early initiatives collapsed and some new ones emerged; at the end of the 1990s there were 43 local partnerships, which had established common local development centres (LDCs), as a basic common development organisation at the local level. There is still a tendency for further merging, which will slowly reduce the number of around 30 local-partnership organisations to around 30, each covering an average area of 65 000 population.

On the one hand, this process can be viewed as satisfactory, as it gives real experience of a "bottom-up" approach. On the other hand, the many

inconsistencies in governmental and local municipal policies slowed down the process of strengthening the partnership approach. It has also become clear over the last eight years that even partners from the private and voluntary sectors do not yet fully understand the power of building partnerships for development.

Here are some considerations in support of what has been said above.

- *Absence of consistency and co-operation at national level*

  It was planned that other national agencies or ministries would directly join the initiative of ESS and SBDC in order to ensure local integrated development, and in 1997 a special Inter-ministerial agreement was signed providing for joint efforts and better measures for mutual co-ordination at the local level to foster SME development, technological innovation, human resources development, job creation, rural innovation and management of the cultural and natural heritage. This agreement has not yet been fully implemented.

  In order to stimulate an integrated local development approach, a special UNDP/UNIDO project was launched in 1997 by the Ministry of Economy and the Ministry for SMEs. It, defined the standards to be used by different public agencies and ministries to further support integrated local development. But the government never fully took it as a basis to design long term oriented sustainable policies.

  Despite many individual efforts, ministries still mainly apply a "closed garden system". There is still a kind of competition among ministries seeking, to launch their own initiatives. This creates very narrowly focused local institutions and projects, with inability and/or unwillingness to build partnerships and participate in an integrated approach. Evaluation of the role of social partners shows their main focus is still on wage negotiations and the protection of social rights. Not much has been done in the direction of better use of available resources, especially human resources, in order to improve the basis for wages and rights. Civil society plays a very weak role here. This is in part due to the fact, that the organisations concerned do not display enough capacity to join forces, but remain relatively fragmented and have very limited resources.

- *Missing capacity and co-operation skills at the local level*

  Established local partnerships have at all times been operating below optimum level. They have never been able to make commitments that have achieved critical mass in support of local development projects, or obtain sufficient funding either at the national or the local level. In addition, it would seem that partners from the enterprise sector at the local level have very rarely showed capability for an active partnership approach. They still organise most of their activities or common services through their own

networks, or the local or regional offices of chambers of commerce. Lately, many have come to consider local partnership organisations as their competitors, or claim that LDCs are sufficient, as the chambers could perform the tasks.

Even ten years on, many municipalities still do not fully understand the importance of the partnership approach; many hire their own staff and design development projects on their own. It should also be noted that very few trade unions and NGOs at the local level have actively joined the partnerships. All of this shows, that even after 10 years, it can hardly be said that our local partnerships and their organisations are fully in shape.

A more successful development of LDCs is to be observed in areas eligible for financial support from different types of international programmes in operation before Slovenia joined the EU (especially PHARE). This is a clear sign that partnerships will come together strongly when they can benefit from additional financial resources for their common projects (SBDC, 2003).

This short history of the promotion of the principle of an integrated development approach through partnerships clearly shows that the main "illness" inhibiting better results is the "illness" of not fulfilling agreed policies. It would seem that the inconsistent and rather conservative roles of the social partners and the weak civil society sector in Slovenia reflect the fact, that despite the many attempts that have been made to develop an entrepreneurship-friendly environment, Slovenia is falling to the bottom of the European league table in this matter and is becoming more and more bureaucratic according to the Global Entrepreneurship Monitor.

- *But the capacity to survive gives hope for the future*

Even bearing in mind the obstacles which inhibited the development of LDCs as local partnership organisations, it can be firmly stated, that in recent years these organisations have proved their ability to survive. Despite scarce funding, they today employ altogether 214 professionals and play a key role as business support centres. They provide various types of online information to some 20 000 SMEs, act as promoters of local clusters, sponsor women and youth entrepreneurship and play an important role in designing local business zones and in ensuring the access to voucher-based advisory systems for SMEs. In addition, many of them play an active role in implementing parts of employment and social programmes and rural development initiatives.

Despite the patchiness described above, it is clear that LDCs have became the backbone network for decentralisation of many government initiatives and an important supplier of development projects, to be supported by EU structural programs and initiatives. It is to be, expected, that in future years these organisations will play a very important role in the implementation of EU structural funds.

Initiating regional structures as a "top down" approach

Apart from the local partnerships "bottom up" initiative, Regional Business Centres (RBCs) were established in three pilot regions in 1977, using the combined approach, mainly with the support of the Ministry of Economy and the support of the PHARE programmes. Their main role was to organise regional micro-credits and guarantee schemes and to stimulate development of incubators and technological centres. Apart from the MoE, the participants in the creation of the RBCs were again municipalities, banks, chambers of Commerce, and in one case even private companies. But in this area too, the changing nature of national policies has prevented, the RBCs from realising their full potential.

Rather than expanding further the then on-going local and regional networks, the government, via the Ministry of Economic Planning and International Relations, put the design of the Law on balanced regional development in hand in 1998.The Law introduced 12 statistical regions and 12 Regional Development Agencies (RDAs), the main aim being to co-ordinate the design of 12 regional development programmes in as many statistical regions. The Law reflected the substantial compromises needed in order to get enough political support and parliamentary approval, and was for that reason inconsistent in many regards. In particular, it did not introduce a clear enough legal basis for the decision-making system or the management of the operational activities of regional partnerships for development.

It was expected that during the preparation of regional development programs, the management structure for its implementation would also be designed and that the regional partners would take on responsibility. This did not happen, and the processes became mainly dependent on the ability of directors of regional agencies to obtain resources and initiate projects. The preparation of regional development programmes was co-financed by national funds, and it was considered as part of the preparation for the implementation of EU structural policy. The National Agency for Regional Development (NARD) was established to co-ordinate the process, but instead of playing a co-ordinating role it became a kind of competitor of the Employment services and SBDC; at best, or at least the co-operation between them was notable for its absence. It will be remembered that the RDA Law was very flexible as regards the type of organisation and indeed allowed any kind of organisation, delegating authority for the establishment of proper organisation to municipalities in the region.

In the main, former RBCs or even some LDCs took up the role of RDAs (in some cases the networks of RBCs and LDCs were established for this very purpose), but due to the vagueness of the Law, there was a lot of confusion about the allocation of the roles of different institutions at the local and even

the national level. On the one hand, the local actors establishing the RDAs and LDCs were the same institutions and partners, but on the other, the RDAs which had retained the roles of LDCs and RBCs, had to deal with three different co-ordinating agencies at national level. Despite many worthy tries, the problem of funding the activities of either class of institution was not properly solved. There was much frustration. As a consequence, RDAs, instead of becoming a real co-ordinator and stimulant of regional economic development, were insufficiently financed from national or municipal sources to execute this role. In cases which they were set up as separate institutions, they became competitors of local partnership organisations (competing on public tenders). Over and above the unsolved problems of organising funding the regional structures were short of an efficient management. Although the establishment of regional programme committees was required before starting the process of preparation of regional development programmes, these committees were most often paper tigers, large, inefficient, and with no clear commitment. This explains why the programmes that were designed are wish lists, rather than a statement of priorities and structures for realisation of the programmes. The roles of the partners were not clear and the sources of finance expected from, the EU and central and local public budgets respectively were fudged, and with far too great expectations for the period 2000-2006. (For more, see Government of Slovenia, 2004.)

The positive side of the story is that in order to support the realisation of priority projects designed by different regions, the government has since 2002 allocated grants of about 25 million euros per year under the so called "direct subsidies programme". In addition, each year the regional development fund has provided long-term loans of about 25 million euros. This programme has at least begun to stimulate the regional development approach in parallel to national horizontal policies. Furthermore, some regions have become eligible for several million euros of international (PHARE) funds for the same purpose.

The most obvious problem inherent in the project design process at regional level has been to separate projects of local importance from projects of regional importance. As municipalities have played the most important role in regional programme committees, it has happened frequently, for the reasons cited above, that projects for development of local infrastructure, such as local roads, have requested funds from the government although they were not projects of regional importance. In several regions, as the regional programme committees do not have real authority, sharp disagreements between different municipalities have made it, almost impossible to take decisions about priority projects.

In the early years, unsolved problems in obtaining funds to finance their activities left RDAs with difficulties in developing real professional capacity to support regional programme committees. There was also an increasing

volume of complaints by different RDAs, that too many governmental programmes are designed and implemented by different ministries and national agencies without consultation of regional committees, and in disregard of defined regional priorities, or worse, that at times, the interventions of some ministries in certain regions, had been in conflict with regional programmes.

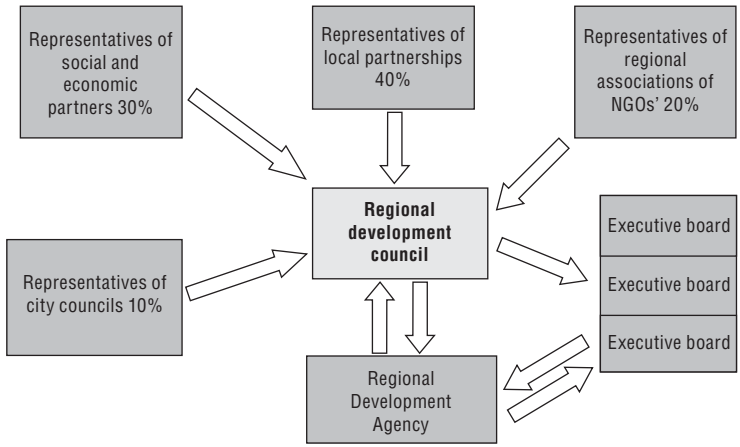
New efforts in building decentralised governance

All the above describes weaknesses of the ongoing system of building local governance system in Slovenia at the time. Dissatisfaction at both, national and local level led to the decision, effective from the beginning of 2003, to create a new ministerial position better to co-ordinate regional development issues and structures, and also better co-ordination of the different ministries and agencies involved in regional development. In order to fulfil this mission an updated strategy for an integrated approach to the build-up of decentralised governance, through multi-level public-private partnerships, was designed. It soon became evident, that getting approval of it within the government, would be no easy task. The political parties in the government coalition had different views of what should be done in terms of decentralisation. The upshot was that two parallel policies aiming at further decentralisation of the development authorities were designed inside two different ministries. One was designed by the Ministry for Internal Affairs and aimed to introduce a second level of political structures (12-14 political regions), with regional administrations and "regional parliaments", elected through regional political elections with their own sources of finance. Though it was publicly promoted as a decentralisation of an overly centralised state, it was obvious and expected that with the introduction of political regions, municipalities would lose part of their authority.

The other proposal was by the administration under the Minister responsible for regional development, together with regional development agencies, using the Finnish model of regional development councils as a basis. The upgrading of current system was designed on what we could call an area based public-private management approach to development. Fourteen so called "development regions" were designated, to be managed by public-private partnerships, organised in regional development councils whose proposed, role, structures and authority were defined by the new Law on balanced regional development. The councils would be constituted by representatives of municipalities, city councils and regionally organised employers, unions and civil society organisations (see Figure 4.1).

Members of the regional development councils, would be constituted by representatives of: local development partnerships (30%), city councils

Figure 4.1. **The regional development partnerships structure as proposed in the new Law**



(regional centres) (10%), social and economic partners (40%) and NGOs (20%). The number of members would depend on the size of the region and would vary from 20 to 40 members. The representatives would be elected inside each organisation according to its internal rules.

The president of the regional council would be nominated by the members and elected by a majority of votes. As he would be the representative of the development region, the council should seek to elect a high level, charismatic person with strong leadership qualities.

As councils would need to be quite large to represent all the most important development partners in the region, operational management decisions would be delegated to various executive boards, such as for instance: for human resources development, for enterprise development, for rural innovation, for economic management, etc. In addition to their position as members of councils, the members of executive boards would also be representatives of national public agencies, financial institutions, development and educational institutions or companies.

The Law also defined the roles of:

- Local development centres as initiators and co-ordinators of different local project based partnerships and local clustering projects, SMEs and NGOs assistant centres and co-ordinating rural innovation processes at the local level, to assist in dealing with local development needs.
- Regional development agencies. As professional organisations these would back up regional development councils in designing regional development

programmes, organising action to promote regional investment and develop regional development instruments (such as infrastructure of regional importance, stimulating sectoral specialisation of the region, *i.e.,* stimulating and designing regional innovation and the development of learning regions). At the same time, they would work together with LDCs in identifying the needs of sub-regions and devising projects to meet these needs.

The multi-yearly financing of the partnership projects and development programmes would be secured from national, local and EU sources. Before starting the preparation of regional development programmes, government would prepare macro-economic scenarios, a development strategy and an appraisal of financial resources available from the national and the EU budgets.

Keeping the partnerships going

The new Law proposed a new system of implementation aiming to ensure greater consistency between national policies and regional investment priorities in order better to activate regional resources. This would be secured by a negotiation between the government and regional councils in which, the proposed programmes would be assessed from the standpoint of different national priorities and the availability of financial resources. The process would conclude with the signature of a multiyear "Agreement on co-operation between the government and the regional council for the development of the region", including an estimate of the uptake by the region of financial resources in each programming period to be supplied from national, EU and local level sources, and a note of the instruments to be used for stimulating various fields of regional development. It would also contain the list of the planned investments of national importance in particular regions during the planning period. This procedure would be similar to that used in implementing EU structural policies and would yield financial frames to support development of each region over a period of 6 to 7 years. The contribution of national and EU sources would depend on the level of development of each individual region.

In order to simplify co-ordination at the national level, the three existing national agencies (Agency for Regional Development, Agency for Investment Promotion and Small Business Development Centre) would be merged into a new National Agency for Development. The Law proposed to give an additional role to the National fund for regional and rural development, namely the provision of professional and financial assistance for PPP projects, and to secure additional funding for municipal, regional and national investment in regions by recourse to private capital. The Law

also provided that national development strategies in different fields (for example, human resources development strategy, employment promotion policies, competitiveness and SME development, technology and innovation, rural development) should be designed to include regional aspects of development, and laid down that all the ministries should act jointly with regional councils to design new instruments (grants, loans, professional assistance) to help speed up the development of less developed regions.

- *Challenges remain for the new government*

  Before the Law passed all the stages of parliamentary approval, the elections in autumn 2004 brought a new coalition into power. The parties in the new coalition agreed that it "will put in life the 'development regions'", whence it can be inferred that the build-up of multilevel public-private partnerships and area based management will continue. However, from the tenor of ongoing political debates one may fear, that neither the concept of public private partnerships, nor the concept of corporate social responsibility has been rendered clear enough, and that there are still many voices urging in favour of priority recourse to administrative, and political regions rather than partnerships for development and innovation. In short, the challenges remain. What is important is that polycentric sustainable development should remain a priority, at least in all the official documents.

- *Still, some positive results from "grammar school" period*

  It is nevertheless important to stress that the rather slow ongoing processes have yielded positive results. For example, the RDAs together with the network of LDCs, were able to design and implement several hundred investment projects of local or regional importance, based on partnerships among municipalities and the enterprise sector (in rare cases even NGOs), attracting more than 150 million euros from municipal, national and EU funds along with a smaller amount from the private sector. The list of projects (non-exhaustive) includes such headings as regional micro-credit and guarantee schemes, human resources development schemes, incubators, technological centres, industrial zones, infrastructure for tourist activities, local roads, water pipelines, waste management and water cleaning systems. And the general awareness of the importance of the regional aspects of horizontal policies has become sharper.

Some regions, even before the adoption of the new Law have followed its main features and set up regional development councils, harmonised with the structure proposed in the Law.

Comparison with Ireland and Finland

Ireland and Finland have been important role models for Slovenian policymakers at all levels. The chapter now turns to the results achieved (or not achieved) so far in Slovenia compared with Ireland and Finland, and concludes with the lessons to be learnt in order to do better.

Finnish multilevel development partnerships

Finland, with a population of 5.5 million, is divided into 19 regions, plus the autonomous province of Åland, and 85 sub-regions, which are composed of local authorities. Municipalities have very wide competences, from statutory responsibility to provide basic and secondary education, health care and social welfare services to voluntary activities in culture and leisure. All 452 municipalities are members of the Association of Finnish Local and Regional Authorities, which organisation represents their interests and provides expertise and services.

Before entering the European Union, Finland paid limited regard to the regional level, but had strong central and highly autonomous municipal levels. A more coherent regional policy was designed in the 1970s in order to prevent further migration from rural areas to cities by reduction of regional differences. Some results were achieved, but in order to be better prepared for EU regional policy implementation, further reform was put in hand aiming to strengthen the regional level by the establishment of regional councils.

The Finnish regional councils are, composed of municipalities, and function as regional development authorities that are responsible for planning programmes in their region jointly with other actors. Regional councils are in charge of general regional planning; they also prepare and monitor the implementation of regional development plans and co-ordinate development measures in their region. Regional councils are also responsible for regional plans and for voluntary functions agreed upon by the region's local authorities. They were established by Finland's Regional Development Act which came into force in the beginning of 1994, one year before Finland became a member of the European Union. Regional councils, in other words Finnish regions, are joint municipal authorities comprised of their member municipalities. The Development Act was the one of the few major changes in Finnish legislation which had a direct connection with Finnish accession to the EU and the implementation of the Union's structural policies. In order to strengthen the public-private partnerships, the councils established Regional Management Committees constituted by representatives of the social partners, NGOs and representatives of councils. As regards professional staff supporting the regional development councils, each council employs, there is on average 30 full time professionals (see Report on Study Tour Finland, Government of Slovenia, 2003).

Sub-regional co-operation has recently, becoming more common and diverse. At time of writing, 85 sub-regional partnerships had already been established. Co-operation at this level can bear on involve land use planning, economic development policy, transport and communications systems, environmental care, and other service sectors. In 2000, to promote sub-regional co-operation and strengthen the partnership approach at sub-regional level, the Ministry of the Interior and the Association of Finnish Local and Regional Authorities launched a voluntary sub-regional co-operative project. The partnerships have mainly project-based flexible structures. This form of partnership has been developing constantly. At present there is a committee to deal with EU matters in every government ministry, and in most of them there is also a person who represents regional partnerships. (Verkkotoimitus Webbredaktion, 2003)

The case of Finland shows clearly that regional partnerships cannot develop efficiently in the absence of a consistent decentralised system of national institutions. Analysts found that at the outset, the main problems in building up a consistent decentralised governance system have been the dispersion of regional organisations and the disparate instructions given to them by ministries. At the regional level, there has been some co-operation between regional authorities and labour market organisations, but the engagement of enterprises and educational institutions in regional policy and planning has been less than wholehearted and there have been no systematic attempts to engage citizens in a democratic dialogue. The Employment and Economic Development Centres (TE) were created in 1977 to address this problem. The TE-Centres are joint regional service centres of the Ministry of Trade and Industry, labour districts of the Ministry of Labour and the agricultural, forestry and fishery districts of the Ministry of Agriculture and Forestry. A total of 15 TE-Centres were in different regions of the country. They are centres of expertise concerning the development of industries, human resources, labour force, rural issues, technology and exports. The main aims of the TE-Centres centres are to unify the dispersion of regional organisations and strengthen the role of the State administration in the Centres' regional policy in industrial matters and the labour market. As regards Finnish regional development, the TE-Centres have taken on the main responsibility for the forward review of regional activities, while the regional councils are responsible for the co-ordination of regional development. Regional forward review is an important tool in itself for the development of partnerships because it creates synergies, networks, and future-oriented collective intelligence. It may be impossible to create learning organisations or even learning regions and create regional innovation systems, if forward review activities are not performed well (see for example Florida and Tinagli, 2004). In this regard the TE-Centres' resort to regional forward review since 1997 has

played a very important role in strengthening capacities for decentralised governance by recognising relevant changes in business and working life, competences and technology as early as possible, by acting proactively to increase the effectiveness of the decisions and actions of TE-Centres and deepening the expertise and understanding in regional business and working life, competences, technology, internationalisation and rural issues to be taken into account by regional councils when designing regional development programmes (Kaivo, Marttinen and Varelius, 2003). The most recent subject of debate in Finland concerns the desirability of moving the currently state-governed TE-Centres into the jurisdiction of regional councils.

Irish partnerships for development

Ireland, as a country with a population of 3.5 million, and one of the most successful examples of socio-economic development in the last 15 years, has one of the most successful records in Europe of using local partnerships to address the problems of balanced local development. Three types of local partnerships have been developed: County Enterprise Boards, Area Partnership Companies and LEADER Companies. The process of "new localism" is particularly interesting in Ireland as a country with very strong centralised administrative system. Partnership is, however, recognised by the government as having an important role to play in local development.

It was a response to deal with the inefficiency of the then centralised sectoral programmes and was especially encouraged by the success of the national social partnership established to address the growing socio-economic problems of the mid-eighties. The historical perspective gives a clear picture of the enormous influence of EU structural policies and initiatives on the development of local partnerships in Ireland, especially the most recent, LEADER and INTERREG. Through the establishment of LEADER, Local Action Groups were supported in 34 areas each covering 65 000 people on average, and a total of 100 million euros from the EU and national funds was allocated to support the projects. Each group has on average 5-6 professional staff members (managers, project development and activity officers). They concentrate on the promotion of rural tourism, SMEs, and capacity building of the voluntary and community sector.

In terms of size of funding, the most important for the development of partnerships was, however, the Local Development Programme 1994-1999 which in five years allocated around 140 million euros for support of various kinds of partnership projects. Through a subprogramme "The Local Enterprise", 35 County Enterprise Boards (CEBs) were established. Their aim was to promote the creation of SMEs and micro businesses with advice, training and start-up grants.

In 1991, the Irish Government established and funded 12 Area Partnership Companies (APC), to act as a local response to the problems of long-term unemployment and social exclusion; their number rose to 20 by 1996. The success of the pilot scheme prompted the national expansion of the initiative, which became a significant part of the Operational Programme for Local Urban and Rural Development (OPLURD, 1994-1999) since superseded by the Local Development Social Inclusion Programme (LDSIP 2000-2006). ADP has a central office and Local District Partnership Offices (LDP). Its Central Board is the controlling body, and consists of 22 members representing the statutory agencies, the social partners, and the community/voluntary sector. In addition, each of the five LDP Offices has two community representatives on the Central Board. Some companies combine the two roles.

The partnership board is responsible for ensuring that there is co-ordination and strategic direction within the area as a whole, and that actions undertaken at a local level by the local district partnership offices are in line with the strategic objectives outlined in the company's plan. The APCs, by developing a targeted, flexible, integrated development approach on the local level, slowly took over a stronger role in the implementation of national programmes and achieved considerable success. Decentralisation processes in Ireland were more the result of the impact of EU structural policy rules than the real will of Irish government to introduce a DGD system. Between 1989 and 1993, Ireland had seven distinct regions, with authority exercised by local councils, national government officials, representatives of EU and others, sitting as a working party to examine the expenditure of EU funds. In 1994 for the purpose of the new structural programming period, their number was increased to eight, and in 2000, they were transformed into two cohesive regions. According to assessments by Irish researchers, the two regions were designed more to line up with parliamentary arithmetic, than to reflect economic concerns. One of the reasons for the inception of a rather weak regionalisation was the likely loss of power of the central government (Brown and Stafford, 2004).

Though governments did not decentralise their policies, public agencies such as FAS and ENTERPRISE IRELAND established regional units with considerable powers and allocated funds to them, putting them in a position to provide strong professional and financial support to local partnership organisations.

A brief comparison of three approaches

The comparison between the approaches of Ireland, Finland and Slovenia reveals the following similarities and differences:

1. *The role of municipalities.* All three countries are rather small, with strong central governments. Municipalities are numerous and small in all three countries, but with some differences in authority. Finland leads by degree of authority, and also the volume of the resources they manage. Irish municipalities share responsibility and financial sources with counties. In Slovenia municipalities have rather strong responsibility for social issues, but no clear mandate regarding economic development, and they are very much dependent on central budgeting for their funding.

2. *Looking for new ways of stimulating polycentric development.* All three countries give polycentric development and ecologically friendly policies a very high priority and all have been looking for ways to go beyond the classic methods of decentralisation since the 1970s.

   Slovenia had a specific approach in this regard, introducing a local self-management system with a strong content of multilevel partnerships even while it was still part of socialistic Yugoslavia. The response to the economic crisis in the 1980s was the introduction of a multiparty system and the emergence of an independence movement. Then, in the belief that a market-based economy with private ownership would solve all the development challenges, the transition process was started – a massive process of privatisation and denationalisation. This was followed by the collapse of many of big companies and the introduction of a strong state role associated with a primarily capitalistic style of economic management. A marked centralisation of development policy and the taxation system accompanied this process. In term of social partnership, this period was a significant step backward; the philosophy of corporate social responsibility withered on the vine and trust between social partners with it.

   The initiatives for promoting local and regional partnerships emerged in the second half of the 1990s but due to inconsistencies in national policies and the unclear role of municipalities their growth has been rather slow and has resulted in rather weak regional and sub-regional development structures.

   In Ireland, the response to the economic crisis in the mid-1980s, was the adoption of a strong national social partnership agreement for development In the early nineties this was followed by promotion of local development partnerships. A new governmental policy was designed on this basis, supported by a significant allocation of national and EU funds. Three different types of local partnerships were developed, followed by strong decentralisation of national agencies. That the regional level was chosen for social partnership management first in six and then two more regions was mostly due to the need for mechanism to implement EU policies.

   In Finland the policy makers looked for different approaches, first through decentralisation of national policies. In light of the process of EU

harmonisation, regional partnerships with strong authorities were organised, in the mid nineties, followed by the integration of public agencies oat the regional level into regional economic and social development centres. In the third stage, sub-regional partnerships were promoted, but always with the strong role of municipalities in mind. Regional development councils were authorised to make decisions about the allocation of EU and national funds.

3. *Regional innovation partnerships*. The aim of both the Irish and Finnish approach was to develop partnerships co-operating closely to innovate in the exploitation of local potential for social and economic development and orient national policies to support of their efforts. This was especially so in Finland, with decentralisation of universities and stimulation of the economic specialisation of different areas through the creation of the "polis" system, which specialised human resources skills in different regions and R&D activities in different regional centres. In Ireland the same process started with the inception of a network grouping a large number of regional technical colleges, regional incubators and technological parks. These networks provide a substantial professional backup for local and regional partnerships.

   The Slovenian processes in this respect have been slow to get under way and are lagging far behind Finland and Ireland. Decentralisation of universities and the development of regional advanced professional colleges started only two years ago, with the foundation of a third university (unfortunately mainly with social science programmes), and the first regional professional colleges, dealing mainly with management issues. Only very lately, on the initiative of the new regional policy, has a start been made on the introduction of regional human resources development funds, regional specialised and advanced professional education programmes, incubators and technological centres. They are the precursors of movement towards real regional partnerships for innovation, but growth here has been limited by the availability of human resources in the regions and the still limited availability of EU and national funds

   The results are as might be expected. Whereas Ireland's and especially Finland's regions are at the peak of their regions' creative powers and innovative capacities, Slovenia's regions, apart from one central one (the capital city Ljubljana), lie very low on the same ladder. This could be one of the main reasons why added value in Slovenian products remains far below the EU average, and it also explains why the economic sector has not so far grasped the real importance of playing an active role in regional development councils.

   There are also huge differences in development capacity between Ireland and Finland on the one hand and on the other Slovenia, which has a much

lower number of professionals employed to back up local partnerships and regional councils.

4. *The influence of EU policies*. In all three countries there is clear evidence of the marked influence of EU policies in designing and structuring multilevel partnerships. In Ireland, they were in many instances structured in order to implement EU structural funds and initiatives after the major economic crisis in the mid-eighties. In Finland the regional approaches preceded the country's entry into the EU (decentralisation of universities for instance), but in the phase of harmonisation just before accession, the pace quickened and became clearly focused on securing the polycentric development of highly specialised regions under the management of regional development councils.

   In Slovenia, after the collapse of the self-management system described above, the processes advanced rather slowly, but were still highly influenced by EU policies and models. As in the first programming period 2004-2006 Slovenia was considered as one region in EU regional policies. In these circumstances, it was rather hard to define a clear role for regional partnerships but further efforts are being made to devise a much stronger role for them in the period 2007-2013.

Lessons to be learnt

All three cases show that building up a successful decentralised governance system is a rather complex and long-term process which needs to be accompanied by many changes and adaptations as it proceeds. Its success has always been very much influenced by political will, which determines the policies of ministries and municipalities. But there is a first clear lesson to be learned by comparing the three cases, namely that there is a need for a firm and systematic capacity-building, long-term oriented development strategy, to be adopted as a common strategy by the national social partners, and in particular by the ministries and agencies without exception. A partnership strategy needs to be precise enough to answer the following questions "With whom, with what, in what ways, and when should the actors involved work in partnership?" Slovenia represents a good example of how slow the process may be if these preconditions are not fulfilled.

Apart from organising training and technical assistance as part of the promotion of local partnerships, financial funds should be made available at national and municipality level to support local partnership projects. Also, on order to stimulate a more active role of the economic sector in participating in common development projects, special tax incentives should be designed. The case of Slovenia also shows clearly that if the role of local municipalities in all the fields of socio-economic development is unclear while the income of

municipalities is too dependent on the national budget, it is very hard to design and implement a consistent strategy at the regional level.

In terms of training, planning and the technical skills of local actors should of course be developed and adapted to the local political reality and the community's needs, but in addition, as local governance is a highly political process, capacity development initiatives should focus on strengthening political capacity such as bargaining, consensus building, and consolidation of all the factors necessary for shared decision–making.

The case of Slovenia, when contrasted with Ireland and Finland, clearly demonstrates that no initiative without long-term consistency can produce the hoped-for results. Too many different initiatives by various national institutions usually culminate in an overly atomised multi-institutional system, which in turn tends to inhibit the development of an integrated approach at local and regional level. In the opposite direction, the case of Finland shows how important it is that the government design the integration of decentralised national policies at the regional level in order to get the regional partnerships under way (TE-centres). The same role has been played by the decentralised policies of some Irish national institutions. A very important part of knowledge-based support for partnerships can be conveyed by a decentralised system of universities, professional colleges and research centres. These are still missing in Slovenia, but very much present in Finland and Ireland.

The case of Finland in particular shows that in order to stimulate innovation capacity and the economic specialisation of a region, it is very important on the one hand to stimulate the development role of cities and regional centres as a kind of "specialised polis", and at the same time to organise a firm link between them and the rural parts of the region. This process, totally absent in Slovenia, is a clear pointer to the direction in which Slovenia should in future make a massive effort to ensure polycentric development

Efficient local governance requires the active involvement of all three actors, *i.e.,* government, civil society and the private sector. Such involvement on local level is impossible, or at least cannot be successful, unless a firm partnership between these partners has been formed at national level to ensure national ownership and sustainability. Ireland is a good example of this. The integration of the civil society sector in Slovenia has yet to begin. How to ensure its active participation at all levels has become a subject of political discussions only very recently, the result of pressures exercised by EU policies. In this respect Slovenia should design new tools to strengthen the capacity of the sector, whose numerous institutions and large membership, are significantly undercapitalised, while there is a shortage of skilled management. Lately, however, several research projects have been started to

identify obstacles for the sector's further development in order to revitalise what was once a well-developed social economy. Apart from a legal and fiscal system in need of review, the main challenge here will be how to develop the trust among different groups of people that was lost during the transition period.

To summarise, the three cases of development of decentralised governance compared here confirm that the building of public-private partnerships is an unavoidable part of the process in developed democratic systems and that with some lag, it is becoming part of decentralisation policies in transition countries in Central and Eastern Europe also. The case of Slovenia is a good example of how complex the process is when, because of permanent changes in political structures, values and trust have been lost. This is why it is even more crucial for transition countries to develop efficient local governance. It is up to the central authorities together with the social partners to develop an enabling environment at the macro level and to ensure through the strong support of an inspired leadership that programmes are launched for capacity building at the local level, and that dialogue towards a common agenda and understanding of stakeholders' self-interest becomes a permanent process. It cannot be stressed enough how important is the selection of the most appropriate entry point based on common local priorities targeting large population groups to participate in the process of decision making and implementation.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 5

Strengthening Non-governmental Organisations for More Effective Local Governance and Partnerships in Serbia

by
Vladan Jeremić and Željko Šević

The potential benefit for Serbia offered by multi-sector partnerships is enormous: they could provide solutions to burning issues in local communities in terms of local development while they could bring about welcome transformations within and across sectors due to their impact on increased access to resources, service-focused leadership, participatory and inclusive decision making practices, and results that build on synergies. Partnership development, however, faces a number of outstanding problems, linked to the legal, administrative and historical framework, that constrain the emergence of NGOs and their participation in civic life. A number of obstacles with regard to trust, communication and capacities in the local communities aggravate this situation. The government has to learn to communicate effectively with citizens and their initiatives, whilst NGOs have to be more aware of their social responsibility. Well-established NGOs and local government should play a more pro-active role and combine their resources and skills towards collective ends.

Introduction

The very concept of partnerships is relatively novel in the political science literature. It has been traditionally absent from the classical literature which made a clear delineation between the government (public sector) and the citizens. The governments was to rule and to ensure that the necessary level of social trust and cohesion is in existence, whilst the people (whether seen as subjects or citizens, voters or political elements, etc.) were there to follow the rules and be ruled. Even in democratic countries, those who had rights to vote would transfer their rights to "democratically elected" representatives and for a number of years (usually three to five) those duly elected would discharge public functions on behalf of those who exercised their electoral rights. In non-democratic regimes, the story was different, but again the very essence of the state apparatus was more or less similar (excluding, of course, the most oppressive regimes that surpassed even themselves by the scale of destruction of human life).

Again, traditionally in Europe state and nation-building has been perceived as large-scale centralisation, which of course directly supported the power-distance model in which people choose and those elected rule. Usually peoples' activism appeared to be campaign oriented. All the political issues would re-emerge before the election and the fuss would die down once the general or local elections were over. Some other forms of protest would be marginalised and generally mildly tolerated, for example the women's suffrage movement in the late 19th and early 20th century. Disenfranchised minorities were given the opportunity to organise, but were politically and socially marginalised to ensure that they would not endanger the very basis of the political system within which they tried (rightfully) to operate. The importance of local (or alternative) communities has also widely differed from country to country. Whilst in Europe, the *etatism* has been fairly omnipotent on the continent, in the communities of the United States were cherished and often seen as the real source of power (see Tullock, 1992). This may be due to the particular experience of nation-building in the United States, where the new territories and states were largely created from the bottom up, rather than through territorial reorganisations and top-down political relations.

The expanding state that got its stronger boosts from the two world wars conducted in the 20th century, has increasingly influenced social life. For instance, World War II brought about intervention in property rights, and

"socialisation" of classical property rights (Duguit, 1920). This trend of "state-spreading" has been present for most of the 20th century and it was certainly true in the 1980s when the first problems with the size and scope of the state sector emerged in the developed western democracies which faced the problem of financing the quite expensive welfare state that has emerged following the huge human disasters earlier in the century. The Anglo-Saxon countries in the 1980s experienced fiscal squeezes and it was necessary to re-examine the scope of the state, and ascertain what needed to be done to ensure that the state could continue operating successfully in years to come. The foundations for the emergence of New Public Management (NPM) were set, and the process could have been put into motion (Šević, 2004). The process of re-engineering the government has been put into motion (Osborne and Gaebler, 1992). This has created room for the government to look at the partnership and other forms of collaboration with the wider community and to move from a classical power-distance mode of conduct to collaborative and co-operative models of the relationship.

However, collaboration and co-operation can be seen in a number of ways; and focused on different aspects of social life. The partnership can be seen primarily as economic collaboration or as a form of new governance in which there is an increased degree of mutual interaction between the various levels of government and the local communities.

Re-examining partnerships

In the literature on economics and public finance, partnerships are usually seen in a fairly narrow fashion – as a mode of collaboration between the central or more often sub-national government or government controlled body and a private entity, and in which the financing is jointly provided for building up infrastructure. Public-Private-Partnership (PPP) has been seen as an innovative mode of financing new and regenerating failed infrastructure primarily in developed countries, where the private sector has the financial capacity to engage in such ventures. Along these lines the UN defines PPP as a "strategic necessity rather than a policy option", representing "a unique and flexible solution to implement infrastructure projects" (UN, 2002, p. 3). However, there are many different meanings of public-private partnership (Rosenau, 2000). Since any relationship involving some combination of the private, voluntary and public sectors is can potentially be labelled a "partnership", it may be useful to clarify what is meant here by the term. PPP demonstrates the characteristics of collaboration, focus on services, particular length, trust, innovation and risk allocation (for more see Grimsey and Lewis, 2004).

Different forms of PPP demonstrate different combinations of these characteristics. First of all, PPPs seek to draw upon the best available skills,

knowledge and resources, whether they are in the public or the private sector, and deliver value for money in the provision of infrastructure. Although it may seem at first sight that the PPP focus is on assets, it in fact relates to services and the public sector purchase of a particular service. PPPs are long-term and relational, as short-term agreements are costly from a transaction point of view and cannot be socially justified, either easily or at all. Any kind of partnership is a high-trust relationship and if there is a high level of uncertainty between the partners the partnership may not work as planned or wanted. Well-designed PPPs support innovation and allow better risk management by both partners. The government often can offer positive tax incentive schemes for PPPs in order to strengthen collaboration between the organisations from different sectors of the society.

A partnership that goes beyond financial dealings is a partnership that entails collaboration in the policy process between the government and the interested stakeholders. To a large extent, the recently dominant business model of stakeholders may be easily used to understand the model of especially local partnerships in the public governance process. Partnerships include an extraordinary range of community, political, strategic, sovereignty and environmental relationships. A partnership is often perceived as an "everything-and-nothing" *polysemy* that raises many critical suspicions (Lerner and Craig, 2002). The political partnership has been seen as an instrument for empowerment of local communities, and in fact "federalising" the existing policy processes (Tullock, 1992). As this has been fairly uncharted territory, it is difficult to define the "local partnership" in great detail. Local partnerships are to a large extent the development of local political conditions and on-going institutional and political changes. A decade or so ago, it was impossible to imagine people in the former socialist countries being engaged in a political partnership process. Now, this is becoming the part of the political culture and the norm taken as reference.

The optimal way to develop many opportunities and address many challenges involves a diverse array of organisations working together. Organisations bring with them distinct resources, capabilities, goals, ideologies, cultures, and values, and through the process of mutual interaction new values are created and the innovation process sustained. However, it is not that easy to collaborate, especially if the organisations are from distant spectrums of the society. The challenge of working together increases when rich and poor, government, business, civil society, various languages and different government systems are brought together. This is why many partnerships, although they may look natural, in fact fail. There is little common culture to share and keep the players stick together, or it may simply

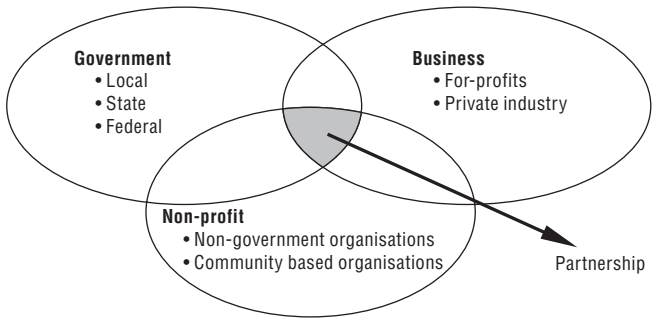
be that the organisations are unwilling to give up something of their own routines to embrace a new quality that collaboration and partnership can offer.

Partnership is a formal or formalised relationship that has to be based on common needs and shared values to succeed. The main players have rights and duties to respect and have yet to be ready to forgo some immediate short-term gains to gain a greater good that will be shared later. Thus, the partnership should, for instance, enable businesses to expand their markets, develop new products, lower production and delivery costs, expand their investment presence, etc. At the same time, a well-designed partnership should enable the government to spur privatisation, while increasing accountability, to reduce direct involvement in law enforcement, whilst increasing effectiveness, and promote and improve social cohesion (address the problem of social alienation and disfranchisement). In turn the civil society should improve the access to (public) goods to lower strata of the society (the poor and marginalised), promote new economic opportunities for citizens, or reduce the negative environmental impact of development (Jeremić, 2004).

As we have pointed out, partnership assumes collaboration between different spectrums of the society. We expect that collaboration will be established between two or three different sectors of the economy. In Inter-sector partnerships we assume that there is collaboration between at least two of the major sectors namely government (the public sector), businesses (the private sector), and the non-profit sector (the civil society).

All over the world, inter-sector partnerships are addressing many of the complex issues in society, such as housing for the poor, health care, and economic development. By working in inter-sector partnerships, governments, businesses, and nonprofits are able to reduce duplication of effort, stimulate creative solutions, and produce initiatives that any one sector could not produce alone. They are valuable because they provide a foundation

Figure 5.1. **Inter-sector partnership model**



for future collaborative efforts and support decentralisation, which is a key concern of donors. As a process, inter-sector partnerships can increase social cohesion and produce sustainable structures and social change.

In an inter-sector partnership, government may include local, national, and international agencies. The non-profit sector consists of non-governmental organisations that express and exhibit community beliefs and values by providing services, advocacy, and contributions to the collective good of the residents. The business sector includes private for-profit organisations that produce goods and services.

The benefits and challenges of inter-sector partnerships arise from the very different interests and goals of the three sectors. Government agencies are concerned with creating and maintaining public order and distributing public goods and services. Business is interested in producing goods and services and making a profit, while non-profit organisations' primary concern is maintaining community values and beliefs and providing direct services. Creating effective inter-sector partnerships thus requires skills and processes that utilise the differences to encourage exchange and creativity.

Theory has identified the following benefits and challenges of inter-sector partnerships (Wadell and Brown, 1997):

Benefits

The benefits of inter-sector partnership include:

- Reducing duplication of effort and work at cross purposes
- Providing better co-ordination of resources, products, and services
- Helping each sector achieve its own goals
- Addressing large–scale issues that no one sector has the resources or the ability to resolve alone
- Transforming the capabilities of the participants
- Creating a new range of outcomes
- Increasing understanding of each sector's constraints
- Creating bridges among different communities
- Providing the foundation for broader change

Challenges

Some of the challenges that participants may face in inter-sector partnerships include:

- High levels of conflict
- Intolerance of the values and goals of other partners
- More concern about power and control than about solving problems

- The time it takes to produce concrete outcomes
- The time needed to get to know the partners and build trust between them

USAID, as the major agency promoting partnership in transitional and developing countries has also listed the following issues as the major challenges in developing and operating a successful partnership locally and nationally:

- Acknowledging that building a partnership is an incremental process
- Committing resources
- Managing risks
- Overcoming systemic barriers
- Avoiding dependence on individuals
- Building accountability and transparency

According to Waddel and Brown (1997), inter-sector partnerships present more challenges because they have greater diversity and low task specification compared with intra-sector partnership, where partners are more similar than different. The wide range of values, benefits, norms of behaviour, and cultures of sectors often show up as differences amongst organisations (Hall, 2004; March, 1988). In inter-sector partnerships, partners must spend more time building and identifying common ground from which to work than in more mono-cultural collaborations. It is also important to understand, value, and utilise the different skills, expertise and opinions in the work of the partnership. Usually, inter-sector partnerships have low task specifications because partners agree to work on general problems that are relevant to all three sectors and their constituents. Even though there is agreement on the general problems, partner organisations may decide to take very different actions to address them. The partnership co-ordinates these actions in a way that is the best for the community and the partners.

Modern community partnership assumes that all the interested stakeholders will demonstrate significant interests in local issues. It is therefore to be expected as a norm that the public, private and civil sectors will collaborate and that inter-sector partnership will take place, despite all the above mentioned challenges. In reality, the partnership process is a learning process in which organisations hailing from different sectors learn how to deal with partners whose experience is somewhat different from theirs and whose expectations are therefore not those that are initially shared. However, with rapprochement it is possible that the organisations will establish a long-term relationship and be successful in managing the partnership, and through innovation, influence developments in and the development of the local community.

What is needed to make a successful partnership?

Partnership has to meet a number of cumulative criteria in order to be deemed successful. Usually the following factors are seen to contribute to a successful partnership:

1. *Agreement that a partnership is necessary*. The partnership is a formal or formalised relation and consequently it is necessary to work out the obligations and duties of all the partners involved. It is not necessary that there be a formal contract, but there should be some form of formalised agreement between the interested parties.
2. *Respect and trust between different interests*. The partnership is a high-trust relationship, and consequently it is necessary for all those involved to demonstrate higher levels of mutual trust and respect. Lack of trust can initially hamper the achievement of results, and ultimately lead to the break-up of the partnership.
3. *The leadership of a respected individual or individuals*. Traditionally, theory has emphasised the importance of management in joint projects. For partnerships, there is a need to have leadership structure firmly developed wherever an appropriate leadership style is practiced to ensure success. Co-ordinating a large number of partners not only requires much talent, but also a lot of tact and ability to compromise without forgoing the basic aims of the partnership.
4. *Commitment of key interests developed through a clear and open process*. Transparency and accountability are the basic requirements for the successful application of a partnership agreement. Over time, priorities may (and will) change, as well as possibly, the perceptions of the participating partners. Therefore, it is necessary from the very outset to define what the minimum common ground is, and stick to it closely throughout the life of the partnership (if possible). Of course, there will be some natural developments over time, but in that case, all the parties involved have to decide on a redefinition of priorities.
5. *The development of a shared vision of what might be achieved*. Initially all the parties to the partnership will have their individual agendas and perceptions of partnership. However, if the partnership is well planned from the very beginning it is possible for partners to begin early in the partnership to develop their shared visions, priorities and the list of expected outcomes. Collaboration and co-operation assume the trading of certain values, forgoing some short-term gains for the greater good to be achieved later (sustainable long-term results).
6. *Time to build the partnership*. Partnership requires a lot of time to build, and usually it is much easier to build another partnership after partners have

past experience of each other. Short-termism in partnership building can incur huge transaction/social costs and consequently should be avoided at all costs.

7. *Shared mandates or agendas*. The impending partnership will have more chances of success if the participating organisations have shared mandates and agendas. Therefore, it is often very useful to seek to develop some common values even before the partnership project is undertaken. Good preparatory work leading to a well-defined partnership agreement may prove to be a crucial input into the partnership building process.
8. *The development of compatible ways of working and flexibility*. All organisations have their particular corporate cultures, shared values and routines. To a large extent, organisational tradition is about defining and redefining routines. When two or more organisations are to collaborate, they have to forgo some of their peculiar routines and try to develop joint routines, exercising a high level of tolerance and flexibility.
9. *Good communication, perhaps aided by a facilitator*. Following from the organisational specifics, organisations have particular ways in which they transmit information. It follows that at the very beginning, organisations may find it a problem to ensure that they understand each other and communicate in an effective manner. Also, over time, they will have to develop good communication links and their own parlance when it comes to the partnership project and its implementation.
10. *Collaborative decision-making, with a commitment to achieving consensus*. The majority voting rule may be a tradition of democracy, but managing a partnership project with decisions taken by majority vote is the best road to – disaster. Specifically, it is necessary to engage all the partners, and this requires ensuring that all the interested stakeholders be given a chance to express their opinion and to interact with the others on an equal footing. Consensus, therefore, has to be a high priority target, achieved whenever it is possible to reach it.
11. *Effective organisational management*. At the very end, the project requires some administrative co-ordination of joint and individual efforts. To do that, it is necessary to have a good project office, capable of ensuring that the project management is sound and that all partners are communicated with in good time and that dealings with actors outside the project are conducted in a timely and professional manner, on behalf of the partnership and individual members discharging the common functions.

In contrast, there are some factors that are conducive to unsuccessful partnerships, for example: a history of conflict among key interests; preponderance of one (usually bullying) partner; lack of clear purpose; goals that are unrealistic or over-ambitious for the partnership; significant

differences in organisational ethos and professional routines (usually without a desire to modify and recast; a significant lack of communication amongst partners; unbalanced power and control; the lack of key interests; the existence or re-emergence of possible individual or collusive hidden agendas; discrepancies between committed inputs and expected (and delivered) outputs/outcomes, etc. (Jeremić, 2004).

Rethinking the Serbian case: Government and civil society on a joint mission?

The 1990s were marked in Serbia by a mushrooming of non-governmental organisations which significantly contributed to the development of the civil society. Serbia, as a former constituent republic of the Yugoslav federation, inherited a pretty mild socialist model of people's self-management. In contrast to other socialist countries, Yugoslavia was highly decentralised, and exhibited a number of characteristics of confederation rather than federation. Most of the state functions (excluding defence and foreign affairs) were assigned to the constituent republics and even the court system pyramid finished at the republican level. Many, if not in fact all the federal institutions (with the notable exception of the armed forces) were ineffective and had no powers over the republics. The constitutionally prescribed reconciliation process was very long and ineffective. Of course, with the experience of the economic downfall in the 1980s the already loose Yugoslav federation became even more dysfunctional. With the promulgation of the independence of the western republics, the federation imploded, finally leading to a number of ethnic conflicts on the territories of the former Yugoslavia. Even now, when there is no on-going open conflict, the question is how long the situation will remain stable.

The late 1980s saw a major political conflict within the Serbian Union of Communists, which resulted in Slobodan Milošević regaining full control of the Serbian political scene. All the alternative political factions, a characteristic of Yugoslav communist parties (as in fact all republics had their own Union of Communists, loosely co-ordinated at the federal level, despite a formally fairly strict structure), were trounced in Serbia, as the Milošević faction won with an overwhelming majority. Despite the general belief that Milošević did not enjoy popular support, the truth is somewhat different. His fairly democratic rhetoric won the public ear, and later the public eye. In the early years of his rule (roughly up to 1991), he exhibited the characteristics of a strong leader, but not necessarily a dictator (for more, see Vujadinović, *et al*. 2003; 2005).

The emergence of alternative political parties in 1990 was greeted with serious suspicion, as to a large extent it was perceived as something that could affect societal stability. In the first elections, organised in 1991 following the

promulgation of a new Serbian constitution in 1990, Milošević's domination was overwhelming. The opposition parties were either marginalised, or simply pressured not to question the domination of the newly created Socialist Party of Serbia, the successor to the Union of Communists of Serbia and its satellite organisations. The consolidation of power in Serbia under Milošević coincided with the beginning of armed conflict in the other republics, embroiling the ethnic Serbs living there, fearing that they would be marginalised in the newly created republics, which immediately embarked on the nation-state building process, in the process overemphasising the role of the dominant ethnic community. Unfortunately, the international community reacted slowly, hesitantly and finally very clumsily, displaying an incredible degree of inertia and over-simplification of the issues. The recognition of the communist-set administrative borders of the republics as the international borders gave a spur to nationalists on both sides of each border and led to serious conflicts. Internally, the armed fighting enabled the ruling party in each of the republics concerned to deal more harshly with the opposition, claiming that they were protecting the (nation-)state from the enemy, saboteurs, and traitors within its gates.

A considerable growth in NGOs took place in these circumstances. At the same time as the political parties were under strong pressure from the government, a number of NGOs were developed to address specific issues and they often supported the political parties. It should not come as a surprise that there was a significant overlap between the membership of the opposition political parties of the period and NGOs. NGOs were also important in dealing with the hardships faced during the hyperinflation of 1992-1994, distributing needed humanitarian aid especially in the early 1990s when the UN Security Council imposed international sanctions on Serbia-Montenegro (at the time the Federal Republic of Yugoslavia). NGOs were involved in the research, broadcasting, humanitarian aid, alternative education, civil actions, etc.

The years of Milošević *Sultanism* (1995-2000) were marked by the need of opposition parties to look for alternative channels to reach the people and a net of NGOs was used for this purpose. There is still research to be done on the role of NGOs in ousting Slobodan Milošević and his regime in 2000, but there is some evidence that it was important (see: Birch, 2002). One may accept this conclusion *prima facie* since two major NGOs at the time of the Serbian October Revolution are now political parties (the movement *Otpor* – Resistance and G-17, which in the meantime had become an umbrella holding registered as a humanitarian/social NGO, grouping the G-17 Institute – a think tank of undecided ideological provenance and G-17 Plus, a political party that is now the second most powerful political force in the Serbian government).

After the victory of a coalition of opposition forces in late 2000, the relationship between the government and NGOs seems to have deteriorated.

There is reason to believe that the NGOs were seeking public and probably monetary recognition of their role in the victory of the opposition, but that the government, at the time led by late Prime Minister Dr. Zoran Djindjić, was not particularly willing to share the (juicy) fruits of victory. The relationship has been lukewarm ever since, although both sides have genuinely tried to improve relations over the last few years.

Nowadays, the relationship between government, NGOs and business in Serbia is characterised by a lot of initiatives undertaken by the NGOs, an unenthusiastic reception by the government and no co-operation with the business sector. There are a number of reasons for this, ranging from the lack of political will in some instances, to the restrictive provisions in the fiscal legislation. A few months after the new government was formed (January 2001) the 3rd Forum of Yugoslav NGOs was held in Belgrade from 17th to 19th May 2001.

The resolutions of the Forum invited the government to:

- pass a new law regulating the third sector respecting European standards, the draft to be prepared in full collaboration with NGOs;
- ensure ongoing communication with NGOs, aiming at identifying citizens' needs and involving NGOs in their solution;
- provide public grants to NGOs;
- support co-operation of businesses and NGOs in local communities (two-partner collaboration projects);
- use the NGOs' capacities in conducting the government business, where there is a reason to do so;
- allow NGOs access to the data needed for the implementation of civil sector projects.

Up to now the successive "democratic" governments have failed to draft and pass the law on NGOs. The third sector is still regulated by the Republican law of 1982 and the federal law of 1990 (although the State Union does not have any right to regulate the third sector, as this is originally among the duties of member states). There were some low-level contacts between the government and NGOs regarding the law, but no significant move towards the preparation of the draft has been recorded. However, the government has used the capacity of NGOs in a number of instances when legislative initiatives were put forward by different NGOs, primarily of the think-tank type.

It is generally agreed (Jeremić, 2004) that the relations between the government and NGOs have improved since 2000. Initially, there were regular meetings of NGO representatives with the Serbian Prime Minister and this was the tradition during the government of Dr Djindjić. The meetings were

organised by FENS, which is an umbrella NGO association in Serbia. However, it seems that the relationship between the government and NGOs have deteriorated anew in the last few years, after the second post-Milošević elections in Serbia. During Dr Djindjić's tenure as Prime Minister a number of government departments approved grants to NGOs, following public announcement and competition for the allocation. Notably, this has been done by the Ministries of Social Affairs, Environment, Culture, Education and Sport. In a few instances the government ministries have invited NGOs to contribute to drafting laws and to offer their advice. However, it seems that in most cases this was done after the active participation of foreign donor organisations (Jeremić, 2004).

A few years ago, the NGO Policy Group and FENS conducted a survey of NGOs to ascertain what can be offered to the government (at both national and sub-national level). The results showed that NGOs have fairly wide range of interests and that in fact government may draw on their expertise in a number of areas, including among others education, research and development, local community development, cultural activities, democratisation, citizen support bureau activities (legal advice, etc.).

The government has also created the Socio-Economic Councils which comprises the representatives of government, trade unions, and employers. Thought was given to including interested NGOs in their work not only at the state level, but also at sub-national government level. It seems not only that NGO membership has been envisaged, but also that the Councils failed to have a serious impact on development in the country. Also, despite initiatives to include NGOs in the re-training of the labour force and improving the structure of its qualifications, nothing was done in this field. Even more interesting, in the government documents the NGOs are not mentioned as an important factor.

Up to date experience of the government-third sector interface in Serbia suggests that there is a need to strengthen the links between the government and NGOs, beyond the regular (or now less regular) consultative and protocol meetings. In the final analysis, the government has to make up its own mind regarding the role of the third sector and its relationships with the sector. At present there is no national strategy on the third sector, but this is hardly surprising given that there are no national strategies for other far more important issues either. There is reason to believe that there is a need to address personality issues, as many of the obstacles to closer and better collaboration stem from the fact that many officials on both sides are not very co-operative and open to necessary compromises and innovations.

However, the Serbian NGOs realise that there is a need for action on their part as well, and they have concluded that in order to collaborate with the government, it is necessary:

- to initiate and develop co-operation with the government and its institutions, showing more flexibility and innovativeness in proposing joint projects;
- to press the government institutions to address citizens' problems more effectively and efficiently; and
- to insist on transparency of the government's work.

Despite the importance of these resolutions it is difficult to assess to what extent these targets have been reached. In fact, NGOs have been fairly active in keeping the government under pressure and re-emphasising the burning issues regularly, seeking the appropriate government response. Also, the role of the third sector in keeping transparency in focus cannot be disputed, and is second to none. The NGOs in Serbia are an important 'social audit' instrument that is difficult to challenge.

It has also been realised that a healthy and long-term relation with the business sector (the private sector) is necessary to ensure a sustainable long-run position of the third sector. In a transitional economy it is fairly difficult to ensure financing of NGOs, especially after the foreign donors have withdrawn from the country. To address these problems the Forum concluded that it is necessary:

- to spur the business sector to support NGO projects;
- to develop common projects especially in the field of education and training (in fact re-education and re-training of laid-off workers);
- to work jointly on setting-up local foundations that would be a source of finance for local NGOs, and *be an instrument of "community reinvestment" for socially responsible businesses* (authors' emphasis).

However, the co-operation of NGOs with the business sector is still very limited. There are only a few examples of this kind of co-operation and they can be found as occasional primarily financial support for NGO activities as a part of promotional campaigns. Sometimes one finds the private and the third sector consulting about the issues facing local communities, but this is still viewed rather as an exception than a rule. There are in fact more cases where local communities and businesses conflict, with disputes for example about the polluting practices of enterprises. Socially responsible businesses have a genuine interest in supporting the local community and build their social reputation very carefully. However, in transitional economies, in which people are far more price sensitive, businesses may decide that profit maximisation is the primary concern, leaving the social responsibility aspects to be addressed somewhat later.

The problems of setting-up local partnerships: Is there hope on the horizon?

In this chapter we have constantly argued for multi-sector partnership as a possible solution to many burning issues in local communities. However, the

analysis of the Serbian situation shows clearly that there are outstanding problems that must be addressed before partnerships can be a respectable form of local initiative.

Based on the current experience of NGOs with partnerships in Serbia, and following the interviews with major players conducted in 2004, the following problems still remain when considering building further multi-sector (inter-sector) partnerships in Serbia:

- The absence of an institutional/legal framework regulating the status of domestic NGOs (as we have already noted, the legal regulatory framework is at best outdated, going back to 1982 and 1990).
- The lack of an appropriate legal framework for the international organisations operating in Serbia (putting them in the peculiar position that they are operating literally illegally on Serbian territory).
- The lack of communication and information sharing amongst the sectors, preventing any serious inter-sector collaboration and partnership.
- The absence of a strategy for many NGO sub-sectors, the government and its individual departments, and the business community at large.
- The lack of mutual trust between the sectors.
- The regular overstatement of organisational capacities and capabilities, which ultimately leads to potential partners being misled.
- The lack of trust in partnership as a potentially feasible and efficient model of collaboration.
- The inability of NGOs and local communities to define their interests and priorities in a timely and efficient fashion.
- "Belgradisation" of major players, meaning that the partners are heavily influenced by the headquarters of their "parents", making them indifferent to the definition of their own priorities, which they subsume to those promulgated by the centre.
- A surprisingly low capacity in some sectors (especially business and partly government) for inter-sector partnership.

Despite a number of years of successful operations, the NGO community in Serbia still has a problem in demonstrating its capabilities and gaining the trust of other players. Somehow, NGOs are perceived as not serious enough and "pure associations of citizens". This may be due to historical reasons. In socialist Yugoslavia, citizens were *de jure* allowed to organise and express their own interests through two types of organisations: *social organisations* and *citizens' associations*. The former were established by citizens to serve certain societal interests, the latter were also established by citizens, but to serve their group needs. However, in socialist Yugoslavia all these organisations,

especially the social ones, were perceived as an integral part of the political system and were "advised" to be the members of the Socialist Union of Working People (the successor to the National Front), a Socialist social front organisation.

The difference was that social organisations were as a rule supported by the government and financed from the budget, whilst citizens' associations were as a rule self-sustained through membership fees. However, it was very difficult to decide whether a given society was a social organisation or a citizens' association. For example, the Amateur Fishermen's Association was in fact a social organisation, and some regulatory capacity was even delegated to it by the government departments. Therefore, based on pre-1989 experience, people have reservations about the genuine nature of new NGOs and to what extent they may be an extension of some other organisation. It may even be thought that some long-existing social organisations could be extensions of the former regime, much as some new NGOs were more or less publicly the extension of the erstwhile opposition parties. As the law of 1990 introduced the registration principle (rather than licence principle promulgated in the 1982 law), it was literally impossible for a government department to deny registration to any organisation that met minimum legal requirements (*i.e.,* not racist, nationalist, chauvinist, terrorist, etc. in its nature). This was largely extent exploited, and the number of new organisations soared to unprecedented levels.

However, it is even more worrying that local government has relatively low capacity when it comes to local inter-sector partnerships. The local offices have fairly limited human resources to deal with innovative ideas coming from the outside the local administration (Jeremić, 2004). Local communities also face a continuing problem with mobilising young people on local community projects, and with motivating other stakeholders to take part in them. This is aggravated by high staff turnover in local government units as well as the constant changes in priorities, which, when in fashion attract a small number of the best staff, although they may be not the best specialists for a project. Although at the republican level there is at least an annual protocol meeting with the Prime Minister, at local level there is usually no such practice, and everything is often left to private contact between NGOs and local government officials. In many municipalities this informality works in the short-run, but when the projects gain in size, this informal governance structure militates against further developments.

Similar problems arise from the tax driven legislation. At present it is impossible for a foreign entity legally to fund an NGO in Serbia. Similarly it is difficult for a domestic company to fully fund an NGO. As Serbia is a transitional country with a fairly low GDP per capita (assumed to be around USD 2 000) in which the government has problems taxing the business

sector, there is no incentive for businesses to support third sector organisations. Traditionally, "social organisations" in Serbia were tax-exempt bodies. Whether they still are is not clear. Clearly NGOs warrant some preferential tax treatment, but at present it is not clear how and how much. Similarly, private sector entities are given a rather small tax break for charitable support – 1.5 to 3.5 per cent – which is not enough to ensure adequate support for the third sector when the foreign donors leave the country. Without clearer tax rules it will be difficult to envisage the interest of other sectors in engaging in partnership projects in local communities. Experience of developed countries with PPPs has shown that it is necessary to offer some tax incentives to the private sector if it is expected to play an active role in partnership promotion.

Conclusion: The future of inter-sector co-operation

Partnerships in Serbia have since 2000 been increasingly emphasised as a form of governance rather more than infrastructure building. National experience with partnerships has shown that there is a clear political willingness to co-operate on behalf of the government, NGOs and some business, but there is a need to do more work on the promotion of mutual trust and understanding of individual specifics. However, clearly little is being done on the promotion of common actions originating from, and to the benefit of, different sectors of the society. Although communication links have been improved over time, there is still much to be done on this front, but by all the stakeholders. The government has to learn to communicate effectively with citizens and their initiatives, whilst NGOs have to be more aware of their social responsibility and not limit themselves to emphasising the responsibility of other two sectors: the government and the private sector.

Based on the current experience of inter-sector collaboration and partnership, the *scenario to follow* should include:

1. *Reiterating the pro-active role of NGOs*. Experienced and well-established NGOs seek the support of local government. In this process, both partners contribute with their skills and resources to achieve common goals.
2. *Pro-active role of local government*. Local government fosters establishment of NGOs. In some cases its representatives should become members of the managing boards of the NGOs. In this case, the fundraising capacity of the NGO would be combined with the ability of the local government to provide access to different donors.
3. *Promoting wider consultative processes*. As a result of discussion among local community actors (local government, NGOs, business associations, trade unions etc) a common point of view is formed.

4. *Promoting "partnership" on different (foreign) donor initiatives*. Partnerships start as a project financed by a donor. After completion of the project, the partners try to continue their relationships.
5. *Promoting (if necessary) outside mediation*. A person (a representative from government, NGOs or even business) initiates co-operation between different sectors based on his/her personality and good relationships with other sectors.

If these moves are made it will be possible to promote partnership activities by many different sectors in the Serbian transitional society. As the transitional process develops more opportunities for partnership will emerge, and even more important, such partnership can be an important instrument for empowering local communities, especially in an epoch of world-wide globalisation in which many communities lack experience and must develop the capacity to deal with the challenges ahead. However, through partnership, even poor and democratically nascent communities (see O'Rourke for the Vietnamese experience with citizens' actions) may be able to work for their own benefit and ensure that their genuine local interests are met, at least partially.

Even though many challenges are associated with creating an inter-sector partnership, the benefits are enormous. When recognised and implemented effectively, inter-sector partnership can bring about beneficial transformation within and across sectors. Partnerships that are transformational in their intent include common visions and goals, increased access to resources, service-focused leadership, participatory organisational structures, inclusive decision making practices, focus on both process and outcomes, and results that are synergetic and bring about sustainable change.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 6

Enforcing the Participation of Civil Society in Local Decision Making: The Lessons from the South-East Europe Experience

by
Haralambos Kondonis

Local civil society and the private sector should work in synergy with local authorities for education, economic development, social cohesion, and local good governance. Only the local community's participation can make local development sustainable, enforce transparency and accountability and make information accessible to everybody, minimising the dangers of corruption. Corruption is a real possibility when decentralisation is under way and the powers of the local authorities are undergoing transformation; to guard against it calls for the prior establishment of transparent structures, civil education and training. Enforcing the active participation of civil society in decision making is a central element of a strategy to improve governance in a region and foster policy effectiveness. This strategy should aim to strengthen transparency and accountability, define better the responsibilities of each stakeholder, increase the capacity and the professionalism of local authority officials, and promote the core values of citizens' participation in local community affairs. Training programmes for local authorities should be mechanisms that encourage participation of the local community and specific social groups.

Introduction

Local and regional authorities are vital components of a sound democratic state structure. Building up the capacity of local and regional authorities is therefore necessary, through an institutional and fiscal decentralisation process[1]. However, decentralisation does not a priori mean greater democracy if it is not combined with capacity building, citizens' participation, transparency, effective services, and democratic elections.

The experience of several South-East European countries shows that decentralisation, if unprepared and without a consensus, can undermine state stability and local good governance. The task of the international community is to keep a balance by promoting a functional approach intended to improve the provision of services to the population with efficient use of the available resources. Transfer of problems from the central to the local level must be avoided, in order to allow democratic institutions to flourish in local communities with the active participation of civil society and the co-operation of central government.

International organisations have put emphasis on this dialogue. Bringing together ministries responsible for local self-government, local authorities and their associations and NGOs is a pre-condition for national policies or national work programmes on good local governance to be effective. It is a given that reforms of legislation are necessary, but it is also necessary that the implementation process be monitored by all the parties involved.

Moreover, strong local and regional authorities mean more effective and sustainable cross-border co-operation. Nowadays, in practical terms, cross-border co-operation that is initiated by local authorities is minimal and sporadic. Absent are substance and long-term planning, the participation of people and civil society, and visible results pertinent to citizens' everyday life.

Unfortunately, capacity building of local authorities and cross-border co-operation very often remain hostages to ethnic and political differences, generating significant delays in the democratisation, reconciliation and development process.

We can overcome those problems by strengthening transparency and accountability, defining responsibilities, increasing the capacity and the professionalism of local authority officials, and promoting the core values of citizens' participation in local community affairs. Citizens' participation in

this process is valuable and necessary. A shortfall in information and co-operation with the local civil society, social groups, such as women and youth, jeopardises good local governance. Responsibility lies in the hands of national and local governments to initiate programmes which focus on people who face discrimination and possible marginalisation. Non-governmental organisations and local agencies should be partners in projects that promote citizens' access, social cohesion, and equitable economic sustainable development.

Building a strategy and the challenge of implementation

After the collapse of the authoritarian regimes in South-Eastern Europe (SEE), democratisation and institution building at central level were immediate priorities, combined with the creation of an environment promoting stability and economic development. It soon became evident that the democratisation process can only be sustainable if it is participatory, meaning the inclusion of the local authorities, unions, civil society, and representatives of the private sector. Fifteen years of transition in Eastern and South-Eastern Europe prove that the dilemma between state and regional stability versus decentralisation and building effective local authorities is a false one.

What is really dangerous, as it is in every aspect of social and economic life, is the transformation of competences without the appropriate preparations, *i.e.,* without long-term strategic planning, training, resources, and of course political consensus.

Up to the present, the European Union, and international organisations and international financial institutions, such as the Council of Europe, UNDP and the World Bank have underlined the role of local and regional authorities and assisted the SEE countries to form their strategies for fostering enhanced local democracy. But it should be pointed out that every SEE country has its own internal territorial pattern and its own history of local governance. Therefore, each of them must find out what particular model of local and regional self-government is most appropriate to its political structure. Similarly with the different local democracy models within the European Union, and given that there is no EU *acquis communautaire* on local governance, SEE countries should exchange experience without necessarily developing a common regional model. The latter could prove inflexible, ineffective and dangerous for their democratisation and consequently for the course of their European integration.

In addition to the traditional "local level", the "region" is increasingly becoming more important, functioning at a "state minus one" level. "Regions" are considered closer to the EU policy of creating "stronger institutions

Table 6.1. **Administrative organisation of SEE countries**

Country	Administrative organisation
Albania	12 prefectures/regions, 36 districts, 65 municipalities, 309 communes
Bosnia and Herzegovina	2 entities (Federation of Bosnia and Herzegovina and Republic of Srpska), Autonomous district of Brcko; Federation divided into in 10 cantons; Republic of Srpska organised in 64 municipalities and 2 cities governed by special laws
Croatia	21 counties (including the city of Zagreb), 122 towns, 424 municipalities and 6 767 settlements
FYROM	123 municipalities (number planned to decrease)
Serbia and Montenegro	2 entities (Republic of Serbia and Republic of Montenegro) and 2 autonomous provinces: Kosovo and Vojvodina Republic of Serbia divided into 29 districts

Source: Committee of the Regions (2005), "The New Neighbourhood Policy with Particular Reference to the Balkans", First Interim Report, February.

capable of implementing their own development policies. Accordingly, the SEE countries that already have candidate status or are well ahead in their Stabilisation and Association Process are eager to proceed with reforms at the regional level.

One of the most important efforts in that direction was the SEE Ministerial Conference on "Effective Democratic Governance at the Local and Regional Level", organised by the Council of Europe, the Stability Pact for South Eastern Europe and the host Croatian Government, in Zagreb, in October 2004. During the conference the SEE Ministers responsible for Local Self-Government signed a Memorandum of Understanding, committing themselves to strengthen local democracy in co-operation with international organisations and regional initiatives.[2] In particular, the Zagreb Declaration adopted by all the participants in the Conference reaffirmed the importance of local democracy, underlined the importance of cross-border co-operation between local authorities, and agreed on specific criteria for local government reforms.[3]

The process of preparation and the follow up of the Zagreb Ministerial Conference revealed both prospects and shortcomings regarding local democracy issues in SEE. Decentralisation is still politically or ethically sensitive in many areas, such as Serbia and Montenegro, Bosnia-Herzegovina, and the Former Yugoslav Republic of Macedonia (FYROM). In some cases lack of capacity, personnel, and effective structure even at central/ministry level and limited political will impede efforts toward concrete development by central governments to put local democracy high in their agenda.

The South-East European governments finalised their Work Programmes for Better Local Governance in February 2005, in close co-operation with the

Council of Europe, underlining the commitment of the central political authorities to reform and to build local capacities. Additionally, a dialogue was started between national governments, local authorities, their associations and the local communities regarding the immediate needs and the future planning of local governance. Beyond the finalisation of the Work Programmes, the challenge is to monitor and evaluate their implementation on a state-by-state basis.

One of the most important elements of the Zagreb Ministerial Conference was the implementation of dialogue between the central government and the local authorities and their associations. This was envisaged and partly achieved in the Work Programmes and strategies as finalised after a constructive dialogue with the national associations of local authorities and local agencies and organisations. In all the above-mentioned efforts, the regional Network of Association of Local Authorities of South-Eastern Europe (NALAS) played an important role.

NALAS is an ambitious Council of Europe project to bind related associations more closely and to qualify them as equal partners in the national dialogue on local democracy and decentralisation. NALAS is in transition: it was moving its secretariat from Strasbourg to the region, electing a new Executive Director, and organising its first Assembly in May 2005. Beyond its contribution prior to and during the Ministerial Conference, NALAS was in the process of identifying its immediate priorities and main partners, as well as enhancing co-operation and information exchange with municipalities and civil society.[4]

The improvement and implementation of reforms in local democracy legislation is a challenge for both the international organisations and the South-East European countries. Reforms are focusing on local good governance, capacity building, raising awareness of decentralisation, strengthening professionalism, transparency and accountability of local administration and improvement of its services, enforcement of the dialogue between all parties concerned, development of local leadership and strategic management, and ensuring the participation of local civil society.

This involves:

- clearly defined competences and responsibilities of local authorities, avoiding overlaps, grey areas, and over-supervision by the central government, and feasibility in the light of the available resources;
- legislative reforms that will put the implementation and the consistency of the legal framework on solid ground;
- professionalisation, motivation and transparency of the appointment and performance of the local authorities' staff; creation of the framework of the relations between central and local government;

- qualification of local authorities and their associations as equal partners in an institutionalised dialogue with all parties concerned, in particular the central government;
- enhancement of the local democracy culture of the local leaders, based on accountability, transparency, delivery on promises and services to the public, encouragement and active participation of local communities and social groups in local affairs;
- focus on everyday problems of local people and communities and strategy planning for local economic development, social cohesion and inclusiveness in close co-operation with the central government, through closely-co-ordinated mechanisms and agencies;
- exchange of information, life-long staff training on public administration, know-how and technology, productive use of international programmes, accessible to all members of the community;
- agreement on core guidelines that are well-planned and implemented by all parties concerned in every South-East European country, in close co-operation with the international community.

A very positive development is that the international community has shown an increasing interest in local democracy in South-Eastern Europe. The European Union, through EuropeAid, the Enlargement Directorate and the European Commission's regional offices, supports specific projects on local democracy in SEE. In addition the CoE-Congress of Local and Regional Authorities (CLRA) continues to work closely with local elected representatives. The World Bank and the OSCE Missions have underlined the importance of fostering local democracy. Furthermore, the Committee of the Regions of the European Union is becoming involved in the region for the first time. Together, the CoE-Congress of Local and Regional Authorities and the Stability Pact organised a conference on Local and Regional Authorities in the Western Balkans, in Pristina, in summer 2005, in an effort to transfer the experience of regional authorities of the EU member states to the region.[5]

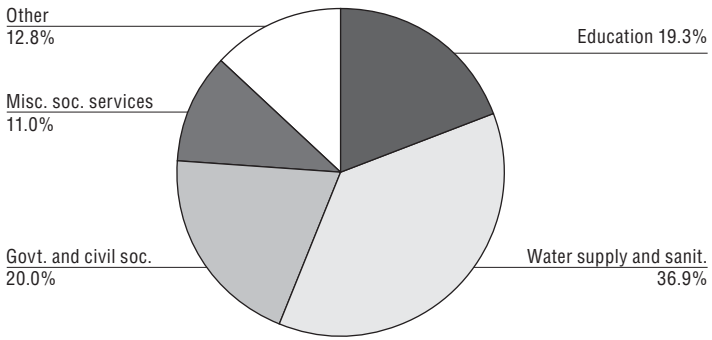
The Stability Pact felt that the interest from the donor community has to be mapped out to increase effective co-ordination. Accordingly, the Open Society Institute under the auspices of OECD/DAC and the Stability Pact undertook the Donor Assistance Mapping Exercise, to create and test donors' database on local democracy projects for the South East European beneficiary countries. Here are the major findings of the study:

- Specific local government assistance amounts to 10-15% of the total amount of donor assistance to Stability Pact countries.
- The largest receivers of local governmental assistance in the region are Albania and Serbia and Montenegro with 31% and 22% of all local

governmental assistance, respectively. Croatia, FYROM, Romania, and Moldova follow, each accounting for between 6 and 13% of all local governmental assistance.

- 20 donor countries were active in funding local governmental assistance projects in the region (the European Commission, International Financial Institutions (entities, such as the International Bank for Reconstruction and Development, and the World Bank/International Development Association are counted as separate "donor countries"). There is a considerable concentration among donors: more than two thirds of assistance funds were provided by four major donors: Germany, Greece, the European Commission, and IDA.
- More than one third of local government-related assistance supported water supply and sanitation projects. One fifth of aid funds was spent on both education and government/civil society projects. The remaining one-fourth was spent on other fields such as health and population programmes (Figure 6.1).[6]

Figure 6.1. **Fields of local governmental assistance in Stability Pact beneficiary countries (2003)**



Capacity building and fiscal decentralisation

The decentralisation process and the effectiveness of local and regional authorities are closely connected to the authorities' operational and structural capacities. In many cases in South Eastern Europe reforms affecting local self-governance are not implemented due to lack of resources and staff. On the other hand, the issues of capacity building and the process of fiscal decentralisation are political issues, dependent on political choices made by the central government. In the countries of the region the budget for local expenditures as a percentage of the GDP typically ranges from 5.6% to 8.5%, except in FYROM, which reached only 1.8% of GDP, in 2003. For comparison, in

Table 6.2. **Local and general government budgets**

	Government expenditures in percentage of GDP	Local expenditures in percentage of GDP (%)	Local expenditures in percentage of general government expenditures (%)
Albania	27	6.7	23
Bulgaria	38	6.5	16
Croatia	49	7.5	15
FYROM	27	1.8	7
Moldova	25	7.2	29
Montenegro	42	5.8	14
Romania	32	8.5	25
Serbia	25	5.6	25

EU member states the similar budget is from 10% to 30%, with the highest rate in Scandinavia.

Despite the low percentage of local expenditure, a considerable increase has taken place since 2000 and related legislation has been adopted. The issue of implementation of legislation on decentralisation remains central, and in many cases a certain under-funding of local services is caused by general budget restraint and fiscal difficulties at the central level.

Municipal property and taxation issues, budgetary separation, transparency and reassurance about fiscal allocations are matters that have to be dealt and defined clearly. In many cases, however, municipalities have no right to hold property and do not enjoy discretion in expenditure despite recent reforms in the relevant legislation.

Furthermore, fiscal issues impinge on capacity building: the need to enhance local leadership, to improvise services on a professional and sustainable basis, to train the staff of local authorities and their associations. The latter are matters that are closely connected to the political choices and willingness of the central government gradually to build the necessary capacity for effective local governance. This in turn is connected with the realisation of the responsibilities of the local authorities and their associations to provide services, to represent the needs of the community, to be accountable to their citizens, and to be transparent in their everyday functioning.

In many cases, limited assignment of resources by central to local governments and the limited power or ability of local authorities to raise their own revenues and incomes make them less independent and self-sustainable. Furthermore, significant disparities in development potential and governmental support to regions and municipalities within one state can cause dangerous imbalances, with severe socio-economic and political consequences, ranging from internal migration and urbanisation, through

economic stagnation of peripheral and border areas to loosening of social cohesion and inter-ethnic and intra-regional competition.

How funds from the central governments are allocated to local authorities has to be legislatively defined and scientifically planned according to the developmental needs of the country's areas and sectors. It must also be institutionally guaranteed and politically supported on a long-term basis. It is rather difficult to speak for effective local governance, when resources are allocated and staff is hired or fired depending on which political party they are members of.

Assuming that the legislative framework has been defined and that capacity has been strengthened, good leadership and management are still needed to promote the effectiveness of local authorities and the active involvement of the local community in order to strengthen the process of institution building and democratisation.

The challenges in strengthening local and regional authorities and the decentralisation process are that legislation reform, political will, capacity building, fiscal decentralisation, training and services, have all to be connected and decided in common through a constructive dialogue between the central and local authorities, civil society and the private sector.

Capacity building and training programmes for local authorities and civil society are the cornerstone of any future development towards strengthened, reliable, participative and effective local governance. It is encouraging, that international organisations have realised this and are focusing more effectively on these aspects.

Promoting participative democracy at the local level

Training of local authorities and civil society is closely linked with participative local democracy. Training programmes are mechanisms that encourage participation of the local community and specific social groups. There is therefore need for a National Training Strategy based on a comprehensive Training Needs Analysis in collaboration with all major stakeholders.[7]

Up to now training programmes have been rather sporadic, proposed and concluded by international agencies and NGOs, and focused on local politicians and leaders. The results of these programmes are limited, since there is no long-term planning. The capacity and the effectiveness of local public administration are rarely improved, and in most cases, training excludes the staff and interested individuals coming from the community.

A local administration and leadership that increases its capacity and improves its performance, attracts the interest of its citizens and of

professional staff. Increased training capacity means more scope for the community to participate actively and to contribute and, from this vantage point, to be in constant dialogue, to demand and to control, thus assembling all the elements of a participative and sound democracy.

Regarding local democracy issues, it is noteworthy that civil society is rather passive, even in SEE countries in which local NGOs have a very good record.[8] This indicates that the members of the community consider local affairs as the task and the privilege of local leaders. These in turn tend to focus their efforts on strengthening their position *vis-à-vis* the central government, sidelining the participation of the local community and the dialogue with it. This fact has a clear bearing on the training of local leaders and their understanding of participative democracy and inclusive local institutions.

Furthermore, the local authorities can play a leading role in sensitive issues, especially in post-conflict areas. Inter-ethnic relations, co-existence among different ethnic and religious groups, and the return of refugees and internal displaced persons to local communities are heavily dependent on the policy of local authorities. To this end, civil education, programmes for the youth, women and disabled people and active participation of local NGOs are methods that should be strongly encouraged.

The local civil society and the private sector should work in synergy with the local authorities for education, economic development, social cohesion, and local good governance. Only the local community's participation can make local development sustainable, enforce transparency and accountability, and make information accessible to everybody, minimising the dangers of corruption. Corruption can arise easily when the process of decentralisation transfers and powers to the local authorities, unless transparent structures, civil education and training have previously been put in place.

Beyond certain limitations of local capacities and training, the main problem regarding the limited participation of citizens' organisations in local affairs is the mentality and political culture which dictates that "citizens' participation ends with the elections" and that "decision-making process open to citizens is forced by international actors".[9] Better information, civil rights education, "training for trainers" programmes, public hearings, citizens advisory groups, local community councils are all measures that should be supported and gradually implemented.

Citizens' participation in this process is valuable and necessary. Lack of information and co-operation with the local civil society and social groups jeopardise local democratisation and the development process. Responsibility lies with national and local governments to initiate programmes which focus on people facing discrimination and possible marginalisation. Non-governmental organisations and Local Democracy Agencies should be more

active partners in projects that promote citizens' access, social cohesion, and equitable economic sustainable development.

Linking local democracy and cross-border co-operation

Despite the large number of cross-border projects, mainly funded by international organisations and donors, the strategic guidance and capacity which could promote substantial and sustainable cross-border co-operation in South-Eastern Europe is lacking. The Thessaloniki Declaration pointed out that "inter-regional co-operation constitutes an essential element of the Stabilisation and Association Process".[10] In this framework, cross-border co-operation (CBC) is an important tool for the integration of the countries of the region

Three elements are necessary for successful strengthening of cross-border co-operation:

- an appropriate legislative framework on local governance,
- local administration reform and capacity building, and
- political support of the central government.

Cross-border co-operation has worked well where immediate basic common problems were tackled, such as economic stagnation, unemployment, natural disasters, or promotion of the participation of all social and ethnic groups. CBC networks have remained self-sustained when they were cost effective and planned on a long-term developmental basis.

As national governments of the region clearly prefer to think twice about cross-border co-operation within the region ("internal CBC"), EU accession is the guiding force of cross-border co-operation, especially with EU member-states ("external CBC"). The latter is politically supported by the South-East European governments and financially backed by the European Commission. By contrast, "internal CBC" is rather new and international organisations lack the necessary experience so that broader and effective synergies are needed.

Until the beginning of 2003, as far as cross-border co-operation is concerned, the European Commission focused on integrated border management issues, dealing with the fight against organised crime, illegal migration, traffic in human beings, and promotion of police co-operation. There has since been a broader approach to trans-frontier co-operation by the European Commission, including civil society, private sector, and local authorities in its strategy.

The considerable increase in the budget available for cross-border co-operation projects in the EU Regional Multi-annual Indicative Programme (MIP) for 2005-2006, which allocates 33 to 39 million euros, is a positive signal.[11] In July 2004, the European Commission approved an increase of 15 million euros in the 2004 allocation, in order to finance the New Neighbourhood Instrument

programme. In the MIP objectives and expected results, co-operation among regions and municipalities, the participation of civil society, co-operation amongst local communities and the development of capacity at local and regional level have a central position.[12] Every year, the European Commission allocates 15 million euros for "external CBC" (Neighbourhood Programmes) and 3 million euros for "internal CBC" (CARDS CBC). It is important that both types of CBC function with the same objectives and using the same mechanisms, guidelines and methodology, given that in the future this distinction will not exist, since all the countries of the region will be EU member-states.

Furthermore, the recent EU enlargement gives the region greater possibilities to participate in INTERREG and CBC Phare programmes within the framework of the EC Neighbourhood Programmes. Clearly, South-East European local and regional actors need more information on how to access EU funding.

At the same time, EU enlargement challenges the international community to be flexible and adaptable, since the EU and the Schengen borders change rather often. Only with clearly defined objectives and goals, long-term planning and effective mechanisms can cross-border co-operation function in a positive and structural way to contribute to integration in Europe of the countries of the region, simultaneously reinforcing trans-frontier co-operation with the EU member states at large.

Changed borders also make the visa regime a central issue. Certain regulations exist and visa liberalisation cannot be expected in the near future. On the other hand, visa facilitation and new special regulations are needed and the European Commission is ready to submit a specific proposal to the European Council soon. In this framework, mobility programmes for specific social groups, such as students, young people, women, scientists have to be encouraged.

In addition, existing cross-border co-operation frameworks can be examined for a "best practices and lessons learned" approach. Amongst them, several Euro regions remain valuable networks, despite certain shortcomings. Initiatives within the framework of the Ohrid-Prespa and the Southern Adriatic Euro region, the Presevo-Kumanovo-Gjilan-Trgoviste (PKGT) micro-region, and the recent establishment of the Adriatic/Ionian Euro region by the CoE-Congress of Local and Regional Authorities are encouraging examples. On the other hand, the effectiveness of cross-border frameworks and projects is still questioned. What is needed is a methodological framework which will guarantee training, long-term planning, evaluation and follow up of the CBC initiatives.

The challenge is to create self-sustainable CBC networks based on a long-term plan. How can we provide direct results that are visible in peoples' everyday life? How do we deal with immediate and urgent problems, such as

unemployment, lack of services and access to information? It is noticeable that when CBC networks of local authorities are created only for political reasons, without being functional and without targeting the immediate needs of their citizens, they have proved to be "empty balloons" for domestic political consumption. By contrast, micro-projects or micro-regions with the active participation of the civil society and with specific targets, well-structured in working groups addressing themes that are directly linked to citizens' everyday problems, under the leadership of local authorities, which are keen to co-operate even at inter-ethnic level, are the guiding examples for future initiatives. A balance between political incentives and the functionality of projects is needed to optimise the results of CBC networks.

In many cases, local communities in border areas suffer from a shortage of professional staff to deal with available international programmes and funds. The lack of know-how and of appropriate technological equipment is an additional problem. Few local and international organisations and local development agencies are presently active in this field; they ought to be supported and their work intensified. Further, a legal framework on cross-border co-operation does not exist or is unclear and cross-border initiatives still work under the full political control of central government, very often with inadequate funds. A noteworthy feature illustrating how unclear political environment affects trans-frontier co-operation is that important international treaties and conventions have not yet been ratified by all members of the international community.[13]

In order to strengthen cross-border co-operation, capacity building at local and regional level and the participation of members of the local communities in activities and programmes are all needed. In the opposite direction the existence of cross border programmes and networks could help the building of local capacity and promote local good governance.

Local authorities, civil society and local communities have to be informed about and actively participate in national and international programmes that promote local capacity building, local administrative reforms and cross-border co-operation.

Conclusion

Building the capacity of local authorities and promoting the participation of local communities are policies that promote democracy and stability at all levels of the social and political environment in every country, including South-Eastern Europe. The decentralisation process is an essential element of democracy only if it is participative and inclusive. Decentralisation without previous or simultaneous capacity building and training of local authorities, local administration staff, and civil society will stagnate; it will not promote

functional democracy. Strong local authorities not accountable to the local communities could hinder rather than foster sustainable progress in the field of social and ethnic differences and civil rights.

The effort to build participative and effective local authorities and local good governance is a long-term process, which has not been completed even within the European Union.

The challenges are numerous. We have to:

- understand local democracy,
- clearly define the assignment of competences and resources,
- implement legislative reforms,
- create professional structures,
- define the relationship between state authorities and local government,
- strengthen the institutional dialogue,
- secure transparency and accountability,
- secure local economic, social and environmental development,
- promote leadership and strategic management,
- provide services and training,
- develop a political culture of community participation, and
- create structures and networks for cross-border and inter-ethnic co-operation.

In other words, our task is to build local democratic institutions which will be in the service of their own citizens. They should continue to function effectively and inclusively, as a beacon of a "democratic institutional memory" for the coming generations, regardless of the political changes or administrative reforms that the future may bring.

Notes

1. The author of this chapter would like to thank Amb. J.D. Bieler (Stability Pact), Mr. M. Peretti (European Commission), Mr. A. Zardi (Council of Europe), and Mr. A. Ionescu (OSI) for their co-operation on local democracy issues.
2. Memorandum of Understanding, South-East European (SEE) Ministerial Conference on "Effective Democratic Governance at the Local and Regional Level", Zagreb, 26 October 2004.
3. Final Declaration, SEE Ministerial Conference on "Effective Democratic Governance at the Local and Regional Level", Zagreb, 26 October 2004.
4. See NALAS Strategic Plan 2004-2007, Strasbourg, October 2003, and NALAS Declaration, SEE Ministerial Conference on "Effective Democratic Governance at the Local and Regional Level", Zagreb, 26 October 2004.

5. Stability Pact for South Eastern Europe, Working Table I, Local Democracy / Cross-Border Co-operation (LODE/CBC) Task Force Reports, April 2004 and April 2005.

6. G.Hajnal, Kelen-Consult BT/ OSI-LGI, Report: Creating a Test Version of Donors' Assistance Database for 2003 for the Stability Pact Beneficiary Countries on Local Democracy, under the auspices of the Stability Pact for South Eastern Europe and the OECD/DAC, April 2005.

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8. S. Sofianski, « Les enjeux de la démocratie locale en Europe du Sud-est », Council of Europe, Congress of Local and Regional Authorities, CG (11)7 Part II, 11th Plenary Session, 28 April 2004.

9. The Association of Local Democracy Agencies (ALDA), Report to the SEE Ministerial Conference on "Effective Democratic Governance at the Local and Regional Level", Zagreb, 26 October 2004, p. 4.

10. Thessaloniki Declaration for the Western Balkans, June 2003, Porto Carras-Halkidiki/Greece.

11. "MIP aim is to support activities under the 10 Neighbourhood Programmes launched in 2004 and the 6 CARDS CBC programmes to be launched in 2005". European Commission paper on "Border Region co-operation in the Western Balkans", Stability Pact LODE/CBC Task force Meeting, April 2005, p. 4.

12. CARDS – EU Regional Multi-annual Indicative Programme (MIP) for 2005-2006, pp. 31-35.

13. For example the Madrid Outline Convention on Trans-frontier Co-operation between Territorial Communities and Authorities, Madrid, 21 May 1980.

ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 7

Participatory Democracy: From Ideals to Realities – the Lessons from Three Localities in Croatia

by
Irena Đokic, Nenad Starc and Paul Stubbs

*Participatory democracy must bridge a gap between ideals and realities and is a sophisticated process. The analysis of case studies in Croatia shows that different types of participation are required, for each group of stakeholders and, at different stages of a participatory process (*e.g.*, preparation, adoption, and implementation of a given programme) to minimise the risk of undue influence. Participation is more than the mere opening of a workshop to the public. It means rigorous, triangulated, multi-faceted, methodology including interviews, surveys, focus groups, and continuous dialogue and reflection at each stage. Overall, effective participation requires the understanding of power as a set of complex social, political and economic relations. Without this, participatory development programmes can reinforce the status quo and reward the most articulate groups and the already developed and highly skilled municipalities.*

Old practices: alive and kicking

An optimist could argue that Croatian regional policy has started its transition and that the rich history of socialist planning has left some useful experiences and secured a certain level of planning culture and so forth. A pessimist could argue that writing laws and even programmes is easy and that too many conditions have been lacking for their implementation. Socialist planning was methodologically ill conceived. The first ten years of transition brought no experience in terms of monitoring and evaluation, and decisions are still made in the old non-transparent way.

Both views should be taken into account here with a remark that the pessimist could find more evidence to back up his/her statements than the optimist. New legislation has called for programming in a social and economic environment stuffed with development documents labelled "strategic programmes", "strategies", or "long-term plans". In the last ten years, they have been prepared at all levels, starting from the national level down to the level of local boards.[1] The common characteristic of all these documents is that they do not get implemented and that existing institutions do not seem to care. Since development programming has been called for by both national legislation and EU documents, the current practice of programming requires analysis.

The preparation of a municipal development programme starts with the recognition that the usual day-to-day decision-making is no longer acceptable and that the development of the municipality should be managed. This is usually recognised by the mayor or a couple of members of the municipal board, who, in an attempt to solve the problem, conclude that they need a strategy. In order to develop a strategy, the mayor searches for a competent person or an institution that might be able to do it for them. He often finds no one in the municipality and ends up in one of the regional centres or most probably in Zagreb, the capital. Since no institution exists at present that could provide relevant guidance, the mayor uses his personal connections or randomly gathered information and eventually finds someone who is willing to prepare a strategic document. This may be a consultant or an informal team of consultants, but also a scientific institute, one of the country's five Economics faculties, or a consultancy firm. In the course of the negotiations that follow, the mayor and his/her board members express their development views and proposals, whereas the consultants rarely expose the methodology

that they are going to use and simply state that the programme can and will be prepared. After the contract is signed the consultants visit the municipality, gather data, have further talks with the mayor, visit municipal administrators and directors of important local firms and retreat to the capital. After a while (it takes some 6 months to prepare the document) the strategy is completed and delivered to the municipality – and is sometimes followed up by a presentation.

A sample of these documents reveals an almost standard structure. This "standard" development document starts with an exhaustive and informative exposition of the current situation beginning with the natural characteristics of the area and ending with a description of the municipal economy and social services. Data is often insufficient for a thorough analysis, but this part is nevertheless far better than the rest of the document. Development objectives are taken to be understood universally and are not given much explanation. As a result most of them could apply to almost any municipality in the country. In consequence, no action plans are developed that state "*who does what, in what time frame, and for how much money*". Development recommendations are general and addressed to the municipal administration or to some vague unspecified higher governmental level. Recommendations are often stated in passive form (itself awkward in Croatian). A wish list that includes statements such as: "supportive infrastructure should be improved", "conditions for faster growth of SME should be secured" and similar are to be found in this last, usually very short, chapter of the programme.

Such an approach is a legacy of socialism. No matter how much this approach is rejected in seminars for local administrators, it still determines the understanding of the development process and its management. Quite a few local development programmes prepared in the 1990s resemble those of their predecessors from the 1970s and even from the 1960s. Most of the programmes of the 1990s, thus, could serve as a justification for decisions that have already been made, but not really as documents on which decisions are to be based.

One of the side effects of the legacy is the lack of institutional analysis. Institutions were not a welcome research subject under socialism and anybody who undertook programmes carefully avoided questioning the capacity and organisation of those that made decisions. The skills for such an analysis were never developed, and as a result this lack of experience of institutional analysis is felt even today. Institutional Economics is still not taught in Economics faculties and the programmes that specify development measures and assign them to previously analysed institutions are exceptionally rare. Another side effect relates to the municipal budget. It is rarely analysed and almost never examined in connection with the development programme. Even if the programme has stated how much

money is needed for its implementation, there is no counterpart in the municipal budget and it remains unclear where the funds will come from.

The mayor and his or her Board are thus left with a document that is of little use and the same knowledge about what they should do as they had before the strategy was prepared. The mayor soon turns back to urgent daily problems and continues to do what was previously the reason for searching for a strategy. The document stays on the desk for a while and soon ends up in "a drawer" as it is commonly put.

Strategies at the national level are prepared in a similar way. The beneficiaries are ministries, state agencies or some sectoral association, whereas on the supply side one finds the same consultants that are usually engaged in the production of municipal strategies. The contracts are bigger and the contract period may exceed one year. The final stage appears to be the same, however. The strategies produced are of little use, like those prepared for municipalities and counties, and the final destination is again the drawer.

The reasons that this relatively useless activity still goes on are to be found on both sides. Municipal mayors, county prefects and Board/Assembly members are rarely knowledgeable regarding strategic development (but at the same time, they hesitate to rely on advisers). There is no experience and the administration is not skilled enough and, as a rule, not motivated to undertake such work. In addition, the economic environment in which the municipality is supposed to be managed is in turmoil and is highly unpredictable, so it seems that only day-to-day decision-making, a type of crisis management, remains as a tool. The administration at national level is better off in this respect, but nevertheless is too often equally non-operational. The state administration has generally proven to be unable to derive action plans from the strategic documents, let alone their implementation, monitoring and evaluation. On the other hand, the consultants responsible for the programmes and strategies are not around when it comes to the implementation of these strategies. The contract expires when the document is delivered. The consultants collect their fees and leave, while the administration is left alone at the moment when consultations are needed most.

Even the optimists cannot claim that such strategy production ever implied real participation either under socialism or in the first decade of transition. Socialism in Croatia bore a self-management label which by definition implied participation. It was largely fictional, however. At best it existed as *ex post* participatory public hearings on the occasion of the preparation of physical plans. The occasion of the preparation of so-called socio-economic plans (municipal, regional and national) was never used to obtain development views or derive the development interests of those

affected by the plan.[2] The fact that the plan had to be adopted in the municipal assembly *i.e.*, by those that were democratically mandated to do so, was considered sufficient. The fact that in a one party system democratic voting is preceded by non-democratic selection of candidates was not considered relevant to the matter.

The first decade of Croatian transition brought no changes to this. The new post-socialist state was established by means of a multi-party political system introduced by the withering socialist state, but participation in the political system was not reflected in economic decision-making. The development practice in which the list of participants in socio-economic decision-making boils down to the mayor, a couple of council members and few consultants can hardly be called participation. After almost a half of century of socialism which had participation written on its flag and a decade of transition which brought back citizens' rights, it had to be imported from the countries which in socialist times had been considered as non-participatory.

Dealing with the inflow of resources

It would be a distortion of the truth to argue that the agents of this development planning during the age of socialism were always domestic. Nevertheless, the explosion of external agencies and consultants seeking to intervene in local development management occurred in the early 1990s when transition corresponded with war and humanitarian emergency. The early years were not at all dominated by a sustainable development perspective, much less by a participatory approach. Rather, the foreigners' focus on humanitarian relief and the provision of shelter led to two contradictory relationships with local politicians and policy makers. One approach tended to ignore them, working through international and local NGOs, bypassing even the central government and, in essence, establishing a parallel system of support and infrastructure (Harrell-Bond, 1993).[3] The other worked with local authorities but tended, in the context of the need for rapid implementation and immediate results, to limit consultation to a small circle of powerful politicians, and to utilise "connections" to ensure that projects began on time and achieved their results, akin to a kind of "technocratic clientelism" (*cf.* Tendler, 2000; Braathen, 2005). The external need to get things done simply reconciled itself with the internal emphasis on the informal and the possibility of turning adversity to one's personal advantage.

Towards the end of the 1990s more complex arrangements between those who commissioned programmes and the agents implementing them developed, focused on longer-term questions of economic and social development, democratisation, and the building of capacity. On many

occasions, these turned out to be just new labels for the same wine in the same bottles, with donors, national and local politicians, and implementers complicit in the presentation of one project after another as a "success" without any significant impact on institutional practices nor, indeed, on the well-being of the wider population. The stacks of documents in drawers grew incrementally, thicker because they were now almost compulsorily presented in two languages, with Croatian translators and intermediaries, especially those conversant in the strange language of "project English", experiencing a concomitant increase in their importance and value.

Despite a large inflow of external experts, and not inconsiderable inflows of money, albeit much of which flowed equally quickly out again in the pockets of foreign consultants and in the "tied" nature of some infrastructure investment clauses, little in the way of good practice was genuinely transferred. Much less was any new discourse or practice created, merging the Croatian context and circumstances with best international experience. Models and frameworks from abroad,[4] were carried in the heads of foreign consultants, working through skilled local intermediaries, and transplanted root and branch in Croatian soil, only to wither and die or turn into a hybrid totally unlike the original plant.

A small group of cognates (those in the loop) learnt certain situational logics fast – how to read and respond to requests for assistance (RFAs); how to speak diverse truths to diverse audiences; how to understand the different interests and key mandates of a range of international agencies, often working with multiple identities and shifting organisational forms (local-international; public-private; formal-informal; state agency-academic institution-NGO-consultancy company). Workshops and study tours began to be the technologies of choice of the new development elite, taking their place alongside feasibility studies, logical frameworks, and evaluation reports based on dubious assumptions and maximising particular interests. In the process, dualities of modern/traditional; urban/rural; expert/practitioner; centre/periphery; and advanced/underdeveloped, already present in the previous era, were amplified and reproduced in new forms. All the actors, donors, implementers, local and national politicians, academics, NGOs and so on, played their parts well, stuck to their scripts, were careful never to speak out of place, so that the play became predictable, routine, and rarely, if ever, had an audience, much less an audience moved to get on stage itself, and begin to act and change things.

New contexts, new initiatives

After almost a decade of this, something changed. Like all such changes, it was at first barely perceptible. In retrospect its causes are both contextual

and coincidental. Contextually, the end of the war in Croatia and the assertion of full Croatian sovereignty began to lead to a thawing of relationships internationally and a gradual normalisation of political society. The end of a decade of rule by one political party in a multiparty system in 2000, and the building of a consensual political goal around membership of the European Union, allowed for the posing of questions of development, albeit in the context of significant demographic change and growing inequalities in income and in human and social capital. Internally, a rhetoric of decentralisation and subsidiarity rested alongside a continued centralised state, with considerable political and administrative resistance to reform.

Externally, the themes and the nature of assistance changed. At last it became more long-term, more developmentally oriented, and predicated on the building of partnerships for institutional change. Large grants for parallel provision became a thing of the past and, instead, a combination of loans and external advisors, from the outside, began to relate more meaningfully with internal actors within Ministries, newly founded agencies, and non-state actors. The new buzz words were regional and local development, small and medium enterprises, clusters, community mobilisation, social advocacy, and income generation. Within this, a space was created, for the first time, for more emphasis on strategic development planning.

In addition, the 1990s had seen, globally, a considerable shift within leading development agencies, with an emphasis on governance, institutional change, stakeholder involvement and, above all, participation, with the last concept moving from the margins of particular progressive NGOs and social movements to become a central part of the rhetoric, and to an extent reality, of programming by the World Bank, USAID and so on. In the process, of course, "'participation' no longer has the radical connotations it once had" (Mosse, 2001, 17). Obviously, something of a critical edge is lost when one of the main messages of the many manuals and toolkits which followed this entry into the mainstream states that "citizen participation is a management tool and contributes to better effectiveness in management" (Urban Institute, 2003; 5). However, the fact that participation entered the mainstream discourse and practices led to a sea-change in the way in which projects related to local authorities, with much greater emphasis than previously on processes of change, on transparency and on accountability.

The growth of a kind of "cognitive Europeanisation",[5] in which a vision of a Europe committed to regional development combined with a practical sense that, should the right choices be made, Croatia could benefit considerably from European Union funding and programmes, led to a different set of projects and commitments. Importantly, the European Union itself, learning lessons from the Eastern European accession process, also began to

concentrate on Croatia less in terms of a reconstruction agenda and more in terms of a development agenda (Hauser, 2003).

A small number of projects began to be framed much more in terms of flexible programming, genuine partnerships between a small number of external actors and diverse internal stakeholders, and crucially, more of a process orientation in which, instead of an obsession with successful outcomes, emphasis was placed on learning through doing the importance of reflexivity and the creation of feedback mechanisms. They all focused on local self-government which appeared the most suitable environment for such efforts. One such programme was launched in a co-operation between the German agency Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) and the Institute of Economics in Zagreb (EIZ). It started in 2000 with the explicit aims of building local capacity for development planning, introducing a participatory approach to local development planning and disseminating the corresponding methodology across the Croatian municipalities and towns on the one hand and through the rapidly growing professional group of local consultants on the other. In the three years that followed, a rather small group of Croatian and German experts produced a small number of pilot local strategic development programmes, published corresponding guidelines, established an Internet portal (*www.regio-hr.com*) and held numerous seminars and workshops. A somewhat intense experience, partly concerning participation, was gathered, and it is this we reflect on here, with no claims to the objectivity which would have come from detached observation of the processes noted.

The town of Virovitica

In the beginning of 2001, GTZ and EIZ searched for the first municipality or town for which to prepare a strategic development programme. They finally approached the mayor and a couple of members of the Town Board of the town of Virovitica (a town in Slavonia, at the edge of the war zone near the border with Hungary, 170 km^2, 22 500 inhabitants). GTZ and EIZ experts proposed the preparation of a strategic development programme in a new participatory way, stressing the fact that the programme cost would be covered externally and requiring an official statement about the willingness of the town structures to commit themselves to such an endeavour. Faced with an offer that they had no reason to refuse,[6] the Town Board decided on preparation of the programme, and offered assistance in terms of data collection and organisational matters. In February 2001, GTZ and EIZ searched for, and eventually engaged, a small group of town administrators and experts from the County Institute for Physical Planning and sub-contracted the preparation of separate structural analyses of the town's economy, social services, environmental protection system, physical planning mechanisms,

and of the institutions responsible for development management. The contractors began their analysis in March and accomplished their tasks by September.

In October 2001, representatives of the interest groups identified in the course of the analysis were invited to two workshops where development problems and goals were arrived at in a fully participatory manner. The workshops were a "social success": everyone took an active part in discussions, the atmosphere was excellent and the list of goals that the participants arrived at was quite convincing. Not all the interest groups had representatives at the workshops, however. Large local firms, health care personnel and members of the judiciary were not represented and their opinions had to be deduced by interviews and local experts' estimates. An action plan containing a long list of measures based on the goals defined in the workshops was completed by December 2001 including a draft programme for the period from 2002 to 2005. A public hearing started on 17 December 2001 and lasted until 25 January 2002. A rather thin pile of written comments and amendments that arrived were considered by the GTZ and EIZ experts and the draft was ready for adoption by the end of January 2002. On 18 February 2002 the town council of Virovitica adopted the Programme and committed the mayor to its implementation. The Action Plan for 2002 contained all the information that the mayor and his team might have needed to start implementing the programme: every measure had a responsible institution defined; the priorities and time spans were set; and the required finances were estimated.

Implementation never commenced, however. The mayor was forced to resign a couple of months later, which caused what is in Croatia the usual domino effect and more than half of the administrators that took part in the preparation of the strategic programme were dismissed. The new mayor brought his own crew but showed no interest in the programme. In visits which GTZ and EIZ paid to the town administration in 2002 and 2004, it was clear that there had been no progress. The programme was remembered well by those that took part in its preparation but the new brooms did not even know which drawer the document had been put in. Ownership of the programme, a category warranted so much by foreign consultants, was not achieved. Local politicians usually started meetings with GTZ and EIZ experts with the same sentence, beginning: "Your programme".

The town of Samobor

Bearing in mind the Virovitica experience GTZ and EIZ experts decided to wait for a bottom-up, or demand-driven, initiative rather than approaching another town or municipality. It did not take long. In November 2001 the town council of Samobor (a town near Zagreb, 250 km^2, 35 000 inhabitants)

established a development council of 15 Samoborians, with the task of formulating a development strategy. In January 2002 the most active members of the council contacted the Central Government Office for the Development Strategy where they learned about recent GTZ and EIZ efforts. Contact was soon established. A co-operative arrangement was made in which Samoborians would take an active part in the analysis of the town's economy, social services, environmental protection, physical planning and development institutions, while GTZ and EIZ experts undertook the role of methodological co-ordinators and *ex-ante* evaluators. The council members were paid from the town budget and the analysis started in January 2002. It was accomplished early in March 2002, so that the workshops were conducted towards the end of the month. They were socially even more successful than in Virovitica but also better attended and full of information about projects in progress. Even at this early stage it was obvious that the already well-developed town of Samobor was not starting from scratch but needed to organise its development activities better. Discussions about measures started in March and ended in August 2002 with a draft development programme for the period 2002-2012 and an action plan for the period 2002-2004. On 6 September 2002 a public hearing was launched with presentations in local boards, posters, weekly radio-talks and copies of the draft all over town. When it closed on 25 October, the experts and council members faced quite a pile of written comments and proposals. Towards the end of November 2002 the town board and then the town council adopted the Strategic Development Programme together with the 2003 town budget. Two months later the implementation seemed threatened by the mayor's resignation but it soon appeared that the town administration started to implement measures nevertheless. In summer 2003 sporadic meetings with various town administrators revealed that two thirds of the programme measures were being implemented. It turned out that almost 80% of all the measures and projects had begun to be implemented already in 2002 and that the programme was praised as the first development document that had managed to embrace everything that was going on across town departments, public utilities and some 40 local boards.

Samoborians never discussed the programme implementation structure much. It was assumed that existing departments and public services would know what to do. They did "own" the programme. As for the politicians, the new mayor did not seem to care as much as his predecessor but the opposition did. Quite a few attacks and calls for resignations heard in council sessions in the year 2003 were based on claimed failures of "those in power" to implement this or that element of the programme. As for the large firms there was not a single hint that they had read the programme let alone implemented it. As in Virovitica and anywhere else that GTZ and EIZ experts got involved in the local development, those responsible for most of the employment, most of the

town's GDP and most often for the greatest part of the environmental degradation did not participate in anything at all. In Samobor, this was particularly crucial as one important company was able to utilise its contacts to ensure that elements of the programme which ran counter to its interests were never implemented.

The island municipality of Šolta and other islands

Another Croatian municipality was approached by the GTZ/EIZ team but the context was quite different. This was the island municipality of Šolta (an island 9 NM away from the Dalmatian town of Split, 58 km^2, 1 300 islanders) while the context was given by the National Island Development Programme adopted by the Croatian Parliament in 1997, and the Island Act passed in 1999. The Act prescribes the preparation of Sustainable Island Development Programmes (SIDPs) covering 26 Croatian islands/groups of islands and 14 State Island Programmes (SIPs), as well as the Annual Island Programme containing inputs for the national budget proposal for the next year. The structure given by SIDPs and SIPs implies full bottom-up/ top-down relations and resembles ROPs and SOPs which have become almost compulsory development documents in the EU. This structure was attractive enough to get involved in and GTZ and EIZ simultaneously approached both the municipality and the Ministry in charge for regional and in particular island development.

The Ministry agreed that the first SIDP ever should be prepared on the island of Šolta and so did the municipality. GTZ and EIZ experts disembarked on the island for the first time in April 2001, but had to wait another month and a half because the mayor who agreed to the preparation of the programme lost the municipal elections. Towards the end of May 2001, after the elections, the new mayor readily accepted the proposition and the group of experts started to analyse the island in June 2001. An expert in physical planning was found on the island and sub-contracted. Others had to be looked for in Split and Zagreb. The analysis was completed in September 2001 and the usual set of economic, social, environmental, physical planning and institutional reports was delivered. Towards the end of September 2001, workshops were held and representatives of island interest groups as well as the representatives of the Ministry in charge discussed problems and defined development goals and the development vision. The contracted experts and the mayor worked on measures until December 2001 and on 22 December 2001 the public hearing was called. It ended on 25 January 2002 with just a written comment or two so that the experts could easily prepare the final draft. On 27 January 2002 the municipal council adopted the Programme for the period of 2004-2007 and passed it to the Ministry for further procedure, while the mayor started implementing the programme. The further procedure implied adoption by the Croatian Government which would have made Šolta's

sustainable development programme the first local development document adopted on two management levels and having introduced the top-down/bottom-up approach in practice.

This did happen, but no less than 22 months later on 21 November 2003. The new brooms in the Ministry in charge that replaced the old ones after the elections in January 2004 responded somewhat more quickly and appointed a specific administrator to implement the first SIDP. The implementation started with difficulties and soon came to a standstill. The mayor tried what he could while the appointed administrator tried nothing so that the usual routine of visiting Zagreb and asking for development money continued.

The ownership of Šolta's SIDP was vested solely in the person of the mayor. The rest of the islanders that attended the workshops as well as the nine existing island municipal administrators were detached from any implementation so that the first Croatian SIDP has been making its way very slowly. Meetings with the mayor in 2003 and 2004 showed that the measures and projects from the programme were implemented way behind schedule and without necessary state support. In the course of all these years the only large firm on the island has been increasing its hotel capacities without any reference to the programme. Needless to say, they never attended workshops nor have they ever participated in any other aspect of the strategic development programme.

An interim report card

A lot was observed in the course of the three years of attempts to introduce improved development planning in Croatia. The most promising observation is that most of the experts and those who were hired by experts learned rapidly and mastered the elements of the new methodology well. In spring 2004 the Ministry in charge of island development contracted 8 consultancy firms to prepare the remaining 25 sustainable island development programmes. Given the fact that they were all first timers, the task was accomplished quite successfully and the number of able consultants increased considerably.

While Croatian consultants, mayors and others involved in preparation of the programmes felt quite comfortable when it came to analysis, participation proposed by the expatriates was a new issue. It has been offered as a part of the overall development methodology and, as an approach, appeared unquestionable. It was clear that any democratic approach to strategic development decision making necessarily leads to the proposition that no one should do it but "the people". Participation, thus, seems to secure a minimal development consensus which is the least that one would expect from the system that came to replace socialism. As a

methodological tool, participation has been offered in the form of gatherings of representatives of interest groups (now called stakeholders) in order to arrive at development problems and goals. However, the three pilot programmes revealed some difficulties in the approach and quite a few problems concerning the use of the tool.

The pilots observed

The workshops that were conducted in the course of preparing the programmes did refresh the existing way of producing development documents. Each and every workshop was a lively social event which revealed the ability of local people to deal with development issues and propose solutions. This social success was coupled with some shortcomings, however. First of all it was obvious at the very beginning that information flows amongst all that were involved in the programme development were insufficient and that the existing communication culture is inappropriate. Participants were told about ties and feedback mechanisms that should exist between the analysis and the formulation of problems; between the formulation of problems and the way one formulates goals; and so on, but only a little of this information was passed on and utilised. This happened mainly because the existing approach to development planning relies on already understood, ready made, goals that no one really questions so that the analysis chapter of the programme part stands apart as information to the reader rather than as a basis for the formulation of problems and goals. Participants thus stated goals without reference to the analysis, formulated measures without regard to the overall development context that was arrived at in workshops, and so on; whereas the consultants kept delivering copies of the analytical papers assuming that they would be read systematically and critically. Participants sometimes stuck to their own scripts, without paying too much attention to other participants' proposals, even when the measures proposed were obviously mutually exclusive or when the same money was being earmarked for more than one project.

This led to workshop results which were "non-robust", as statisticians would put it. It appeared that workshops guarantee the grassroots character of every problem and goal stated, and that everything that is stated is indeed a problem which may even cause amendment to the previous analysis. However, workshops do not guarantee that all the problems that come out of the analysis will be stated. In addition, little or no account is taken of the possible absence of key interest groups. If particular representatives do not show up at a workshop, their absence is rarely commented on, much less compensated for. When some important representatives are missing – as happened regarding firms and health care institutions – the workshop results are very questionable. As a tool, workshops thus appear necessary but not

sufficient. The danger of "workshop fetishism" in which the nature of the success of gathering people together to talk is overplayed, is a serious problem in participatory development programmes.

Despite the use of the term above, some of the representatives of particular interest groups tended to also pursue their own, personalised, agendas, and appeared either unable or unwilling to pursue the broader interests of the group they represented, much less to engage in compromises, conflict resolution and alliance-building. Again, selection of these representatives tended to be left to, and therefore reinforce the power of, the mayor. Lack of experience in these issues tended to lead to a "trust in the process" of workshops by the consultants and a reluctance to interfere.

The foreseen weaknesses in institutional analysis proved even more constraining than expected. Croatian consultants appeared unskilled in institutional analysis and could not pass much to the equally unskilled local experts sub-contracted to actually undertake the analysis. Analyses of actual decision-making processes, power structures, and formal and informal lines of responsibility, were uncharted, with the institutional analysis chapters reduced to description of various jurisdictions and prerogatives copy-pasted from various by-laws and statutes. One of the most important features, the gap between mayors who take on development tasks, and take care of external contacts on one hand and municipal administrators whose work is reduced to everyday routine activities in the other, was overlooked in all programmes. On the island of Šolta, this led to a misleading conclusion about administrators' participation later in the implementation of the programme.

The content of the analysis was much wider and better structured than in usual Croatian products of the same kind but it still missed any rigorous stakeholder analysis. The impact of stakeholders, their importance in decision-making and their willingness and ability to participate were not analysed, with problematic consequences in terms of workshop and programme outcomes. Essentially, stakeholders were simply listed and the same invitations were sent to all. This false equality clearly acted as a disincentive for some important stakeholders. More focused analysis would have predicted that some key stakeholders would not show up unless or until their participation was approached differently.

The problem of the disjunct between political interests and local bureaucratic administration was noted above. The role of local politicians and the problematic over-politicisation of their interest in development programmes also had important, though largely unforeseen, consequences. In each and every pilot, individual political figures, tempted to personalise power, followed their own interests and tended to use the preparation and adoption for their own, short-term, political ends. However, in no case did the

political momentum continue after adoption, there being no significant political kudos from successful implementation. The complexities, then, of the relationship between personal power, political opportunity and interest, and the bureaucratic imperatives of local civil servants, were not addressed, much less the very different pace and time scales involved in political and bureaucratic survival.

Defining participation

On reflection, it is clear that the ex-patriates brought participation to Croatian strategic development as a self-understood buzz word which matched no practical experience in Croatia. The socialist legacy either did not encompass participation or, in so far as it had such a rhetoric, this had negative consequences in terms of the renewed encounter with the term. In addition, in the context of war and a renewed centralised government, rhetorically seeking to unify "the people" but rarely practising participatory democracy, there was no internal regeneration of the concept, either.

In this "contact zone" of conceptual "import-export" (Clifford, 1997), there was no shared understanding of participation, much less any nuanced definition beyond the trivial: participation means that everybody should take part in the development process; and the simplistic: participation is achieved through a couple of workshops.

Other crude dichotomies tended to be produced in this process, too: that between a "cult of experts", on the one hand and a "deskilling of expertise" on the other. In addition, external experts tended not to think through their own position, role and interests, preferring to think of themselves as outside the process when, clearly, whether they chose it fully or not, they were inside it.

Often, no distinction was made between the principle of participation and the pragmatic practicalities. In addition, the need to distinguish between different types of participation (perhaps in terms of a hierarchy or ladder of participation, such as that developed initially by Arnstein, 1969), in which different types are applicable to different stakeholders, at different stages of the development of a programme, was something learnt through practice rather than a prior given. More sophisticated stakeholder and institutional analyses are, therefore, crucial prerequisites for determining the obstacles to effective participation, to minimising the risk of undue influence by particular stakeholders at each stage of the progamme: preparation, adoption, and implementation.

Participation is, therefore, more than a workshop or two. It implies a no less rigorous, triangulated, multi-faceted, methodology including interviews, surveys, focus groups, and continuous dialogue and reflection at each stage. Inclusive development is, therefore, a process in which no one interest

dominates, and in which diverse, sometimes conflicting, interests are named, worked on, and resolved. If this occurs in ways in which even those who lose offer a degree of support, and a view that the process was "fair", then a separation of powers is legitimate and necessary. Modelling participatory governance in which diverse interest groups reveal problems and define goals, the entire community is consulted; various experts and professionals define the raft of potential measures, administrators implement policies in the most effective and efficient manner possible; and politicians support the programme's development in all phases, take an active part in implementation, and bear the political consequences, is, perhaps, a more realistic and yet sufficiently ambitious, goal for such programmes.

Alongside participation, then, the other buzz word of "empowerment", necessitating a sophisticated understanding of power, not as a fixed asset, but as a set of complex social, political and economic relations, needs to be addressed and worked with in an equally nuanced fashion. If this is not done, strategic development programmes can reinforce the status quo, and reward the most articulate groups, the already developed and highly skilled municipalities. An over-emphasis on seeking to change power relations risks non-implementation, a loss of credibility, and a reinforcement of informal, non-accountable methods and mechanisms. In either case, greater attention to a rights-based approach to strategic development programming is clearly needed (*cf.* UN OHCHR, 2002)

What is to be done

Being a kind of an interim report, this text does not offer solutions but rather, through intensive engagement with case examples, has sought to emphasise the importance of learning through doing, and the development of mid-range concepts, theories, and practical ways forward based on specific cases and contexts. "What is to be done" or, rather, what can be done in terms of the next steps towards a better development management practice in Croatia can be deduced from the lessons learnt so far. They can be summarised briefly.

Firstly, different types of participation need to be promoted for different stakeholders, at different stages in a development programme. This does not mean, however, that participation can be turned on and off at will; it should be continuous throughout the process of preparation, consultation, adoption and implementation of a programme. The use of a development matrix seeking to understand the relationship between stakeholders and phases is a useful tool here.

Secondly, programmes which promote participation can bridge the gap between, and transform, (over) politicisation and (over) bureaucratisation,

relating both to wider interests and an overall "public good". This suggests, in fact, that development programmes stand or fall by the ways in which they understand and promote good governance, and ensure that institutional and other blockages are addressed and dealt with effectively.

Thirdly, consultants are stakeholders too: the knowledge and skills they have, or should have, oblige them to take an active part in decision making, although there is a need to avoid imposing their solutions. More training in process issues, in facilitation, mediation and conflict resolution, needs to go alongside training and capacity building in some of the more obvious analytical tools.

Fourthly, participation as a methodological tool needs to be constantly worked on and improved, alongside or rather, in an inter-relationship with, improved institutional analysis and stakeholder analysis. In the end, the linkages between these three tools is crucial in bridging the gap between analysis, formulation and implementation.

Fifthly, de-mystifying participation involves disseminating models of good practice to local administrators and politicians as well as amongst local consultants, themselves growing in number and importance and with a need for new skills.

Sixthly, participation does not fit easily with short-term programming eager to achieve quickly demonstrable successes. At its best, participatory development is no less strategic nor calling any less for management or "steering" than any other kind of development. Above all, it makes all of us "subjects" of development, with active agency, rather than objects or beneficiaries. It involves a journey, and learning, in which there are shared, but also, different, opportunities and constraints.

In the end, one lesson appears to be particularly important. Pilot programmes that were offered to mayors and their boards to be accepted as a free ride failed in implementation whereas those that were asked for, demand-driven as it were, survived the critical time after adoption and got implemented, sometimes without major reference to the external assistance itself.[7] The assessment of the readiness and willingness of the chosen municipality/town to get involved in preparation and later in implementation of the programme appears crucial. No consultant should disregard the fact that it takes two sides for efficient consulting and that a mayor's acceptance to receive a free of charge programme from consultants from the country's capital is not enough. The need for development management has to be recognised by all as well as the necessity of implementation of what has been arrived at in a participatory manner.

Notes

1. The Human Development Report for Croatia 2001, reports on 104 national strategic development documents prepared for the Croatian government, various public utilities and other national institutions since 1991. Production has continued so that since 2001 an additional dozen documents have been prepared. Strategic development documents at lower levels are equally abundant (Human Development Report Croatia 2001, UNDP, Zagreb 2002).
2. Neither is it the case that business decisions in self-managed firms were arrived at in a participatory manner. This point needs further elaboration and a paper much longer than this one. It is a pity that research on ex-socialism is not "in" nowadays in transition countries. Eyewitnesses will be soon gone and references lost.
3. A Governmental Office for NGOs established to co-ordinate this became operational no sooner then 1998. Quite a few foreign donors and agencies still tend to ignore it.
4. Usually, these models and frameworks were not from neighbouring countries with similar problems but were, rather, those prepared by agents from the overdeveloped world and implemented, originally, in the under-developed world. The often heard cry "Croatia is not Africa" could have been responded to by the more complex phrase "in this sense, Africa is not Africa either".
5. "Cognitive Europeanisation" is "the incorporation of the EU discourse into national discourse, preferences and aspirations" (Guillén and Álvarez, 2004, 298).
6. "All external assistance is welcome" was a frequently heard mantra in those days.
7. *Cf.* Sirolli (1999) for the clearest statement of this by now familiar lesson which, however, does not rest easily with the demands of donors.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 8

Mobilising the Population for Maximum Impact: UNDP's Experience in Albania

by
Kalyan Pandey

An initiative launched by UNDP in Albania seeks to mobilise people to promote their development through their own resources and to participate in the decision-making process actively. The project is based on the fact that a participatory approach to community development requires responsible, well-informed and pro-active people. The results show that mobilisation works best if it is institutionalised within local government, and if the latter has developed a role of catalyst, providing guidance to the community, creating an enabling environment, facilitating fund raising and institutional support. Local government officials can usually play this role effectively provided that their capacities are enhanced to the required level. Training should be targeted towards the staff involved in planning and decision making on local development initiatives, and should include advice on accounting procedures.

Introduction

Conventional attempts to reach out to the rural areas for development have shown that due to the lack of a "people-oriented" vision, the standard models of development are no longer effective as they have failed to respond fully to the needs and aspirations of the people. Moreover, these methods have tried to design and improve delivery mechanisms for various development inputs and have focused on increased production as the main goal. Furthermore, conventional methods have relied on a centralised bureaucratic delivery mechanism. However, a key element has always been neglected *i.e.,* in order for the delivery mechanism to function properly and fulfil its objectives, there has to be a receiving mechanism at the grassroots level. But more important than acting as a receiving mechanism, an organised group of people can be involved in their own capacity development, leading to self-empowerment. Full participation at the grass-root level is possible if the rural people are organised. In short, traditional development actions have ignored the very essential aspects of community development such as sustainable organisation, development at the grass-roots level, the capacity building of people-focused organisations, and the proper mobilisation and utilisation of their social capital.

Recently, it has been widely accepted internationally that in order to promote sustainable rural development, community involvement is essential in all phases of planning, designing, implementing and benefit sharing of the programme. A properly designed community mobilisation process leads community members, both male and female, to establish self-governing institutions which act as the sustainable organisations for development, helping people to enhance their capacity to receive and use it, and also to work together for household and community initiatives.

Based on this conviction, UNDP has been allocating substantial resources towards supporting activities designed to promote and facilitate effective and democratic governance globally. UNDP's focus on governance has been supplemented by an increasing recognition that governance starts within communities, villages, and towns, and that local governments provide the basis for the concept and structure of governance. Many UNDP activities supporting decentralisation from the centre to the regions, districts, the local governments and communities demonstrate that community involvement at all levels can be an effective means of achieving critical objectives of human

development, thus reducing poverty (Decentralised Governance Monograph: A Global Sampling of Experience, UNDP/MDGD).

The basic concept and approach of community mobilisation emerged from the fact that a participatory approach to community development requires responsible, well-informed and pro-active people. Ignoring the involvement of people is a barrier to participatory local development efforts and to the reinforcement of civil society. It is universally accepted and advocated that without community involvement and citizens' participation, development initiatives in neither the economic nor the social sector have little chance of success, especially at the grassroots level where the majority of the population resides. Community dynamics can be ensured by full participation of people through the establishment of local self-governing institutions at the grassroots level to harness the potential of government, non-government and citizens to achieve the objective of sustainable social and economic local development. *And Social Mobilisation is the process that is applied in many countries to ensure this community dynamic*.

The basic objective of Social Mobilisation is "to mobilise local people, in the form of their own organisations, to promote their development through their own and other resources and to actively participate in the decision-making process for improving their lives and villages".

The conceptual package of Social Mobilisation

There are basically four elements of the Social Mobilisation conceptual package that must be related to the reality on the ground:

- Organisation development at the community level.
- Capital formation for community assets.
- Training for human resource development.
- Socio-economic development through external support.

Organisation development

The social mobilisation process is based on the assumption that rural people, especially the disadvantaged (poor) are willing to perform many activities themselves and thus get organised to work together if they live in close proximity and share common interests for community development. The foremost requirement in this process is that people organise themselves into a broad-based and multi-purpose Community Based Organisation (CBO) to help improve their situation. A properly designed social mobilisation process leads community members, both male and female, to the emergence of self-governing institutions which act as sustainable organisations for

development, helping people to enhance their capacity to receive and utilise and also to work together for household and community initiatives.

The CBO is a mass coalition of all those residents of a village whose continuing economic and development interests are best served by organising themselves as a group. Such an organisation can be created around an activity of importance to most of the villagers. Before he or she becomes a member of a CBO, the individual struggles against a harsh environment. Once (s)he is organised in a broad-based group, the individual has the leverage with which to address and tackle problems which (s)he could not have done alone. The group can function in various fields depending on the needs of the individuals that compose its membership.

Social Mobilisation is based on the active participation of all households without any discrimination. This is necessary for the whole society to move together in consensus and to build community-level social capital. When CBOs enter a maturity stage, they will be linked to the development process of other development partners, leading to a participatory village development programming process. Such a link could be established with local government agencies, NGOs donors and private businesses.

Capital formation for groups' development through community savings

Once organised, a CBO is potentially powerful, but without capital it will never realise its full potential. Hence, as a necessary condition, all members deposit monetary contribution in a savings account at their regular meetings. The savings generated by individual members are the assets of the Community Organisation (CO) and are the first step towards their self-reliance. The generation of capital through savings is of paramount importance to the viability of the CO and can be used to finance subsequent micro-enterprise development at the household or village levels. The CO can lend money to its members for a return that satisfies local credit needs and at the same time contributes to the CO savings.

Training for human resource development

Villagers can maximise their potential not only by organising themselves but also by upgrading their existing skills. Rural people already possess a range of skills. However, in order to manage new inputs and technical knowledge, these skills need to be built upon. Various skill development training courses are offered to individuals selected by the CBO on organisation development, leadership, saving and credit programmes, agriculture, livestock, forestry, book-keeping, marketing and other key disciplines. Trainee selection is left to the CBO since only its members know who has the greatest

potential for training and who will be best able to perform the job as village specialists. Once trained, these village specialists, in turn, will impart knowledge to other villagers thus promoting local human resource development.

Socio-economic development

Community people must have an incentive to organise themselves. They require high returns from any social innovation to offset the risk involved in change and to compensate for the extra effort often required in terms of labour. The socio-economic development component provides a mechanism through which a CBO and its members capture the potential benefits of social change. It involves processes for enhancing existing social capital by organising villagers around the productive sector since this not only persuades them to adopt the social mobilisation process but also gives them a reason to remain organised.

A CBO will only be regarded by its members as a sustainable organisation when it becomes a vehicle helping to satisfy their basic needs. Since CBO members are unable to do this unaided, it is important that they be supported by external sources and local governments to increase their productivity. The social mobilisation process performs this support function in such a way that the CBO will gradually develop the capacity to attempt to tackle its problems independently. The eventual aim of social mobilisation is to see that the CBOs develop into autonomous self-governing institutions. It would, however, be unrealistic to hope that a CBO could answer all its members' needs from local resources alone. The CBO should develop a capacity to enter into the market sector and to forge linkages with other government and non-government agencies, where necessary, so that the prioritised needs of CBO members are met on a continuing basis. In this way CBOs can act as a receiving mechanism at the grass-roots level. A fully matured CBO has an advantage in that it is not a passive and dependent receiving mechanism but can identify and prioritise its own needs and can prompt the delivery mechanism into action. As its capacity and autonomy develop, and as the management system evolves, the CBO will move from an organisation to a local self-governing institution.

CBOs should have access to the following support for their economic and social development when they reach the self-governing stage.

1. *Capital Grant Fund*. The Micro Capital Grant (MCG) can be provided to CBOs as an incentive for increasing their productivity through improving infrastructure in the social and economic sectors as well as enhancing the organisations' resource management capacities. Such grants can be made available through the local/central governments, INGOs and NGOs, donors and private business enterprises. As an essential element, MCGs from

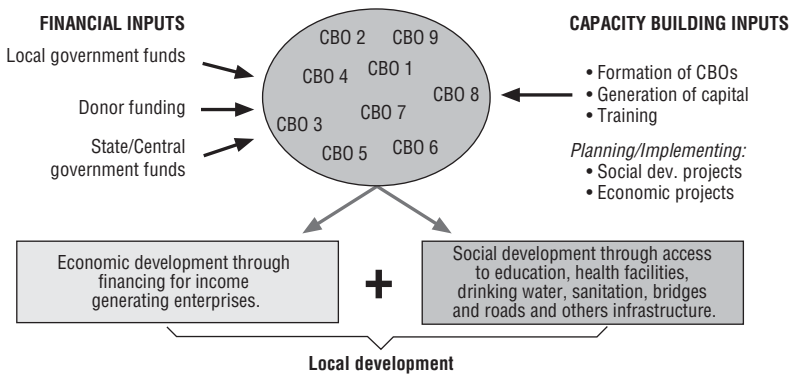
donors are matched with cost-sharing contributions from the municipality and CBOs.

2. *Micro-Credit*. Micro-credit is one of the components of economic development within the social mobilisation process. The credit facility will provide an access to CBOs for credit support for entrepreneurial activities to be undertaken by the CBO members, both men and women. In the initial phase of CBO formation, the savings generated by the CBOs are the only source of the credit that can be granted to the members of the CBOs. However, after some time, it is assumed that CBOs with a good credit record can be linked with financial institutions or other credit agencies to provide them with loans for initiating income-generating activities. Necessary training will have to be provided to the CBO members in preparing the business proposals for accessing the credit.

Basic approach to Social Mobilisation

The following figure illustrates the process and application of social mobilisation, being applied by UNDP in implementing a variety of projects and programmes to achieve its corporate goal on democratic governance, poverty reduction, crisis prevention and recovery, and environment.

Figure 8.1. **The CBO process**



How can social mobilisation efforts help local governance and development?

Social mobilisation is the process that works on the basic premise that successful local development fosters a form of social, political and psychological empowerment that occurs when rural people have access to a social base of power and productive wealth. Access to social power enhances access to political power while increase in productive wealth leads to improved livelihood. Social empowerment helps to enhance the active

participation of the people, leading to the development of popular economic organisations of local communities. It brings hope, builds skills, turns individual problems into collective ones, and creates a conducive environment for the collective benefit of the community.

Social mobilisation is a social learning process geared towards the development of a community mechanism that empowers communities to meet the economic and social needs of individual members as well as of the community as a whole. Social mobilisation promotes the establishment of organisations at the grass-roots level, generation of capital for the economic development of the organisations' members and development of the necessary skills to plan and implement individual and community development social and economic activities.

Efficient and effective local governments require a strong participatory governance system. Such a system cannot be established only by means of reform at the institutional level, but is developed through a mechanism that musters community dynamism for the people's benefit. Community dynamics can be ensured by the people themselves forming local self-governed institutions at the grassroots level to harness the potential of the state and its citizens so as to achieve the objective of sustainable social and economic development. Local government can serve as a catalyst to assist community organisations in harnessing their potentials as well as a link between them and other development partners.

The experience of the programmes supported by UNDP, which has been working with local governments in the area of social mobilisation, has shown that a systematic and process-oriented social mobilisation approach needs to be adopted to ensure communities' participation in building community social capital for effective and sustainable local development for poverty reduction at the village level. The Programme's experience has also shown that the local government at village levels, being closer to the people, is able to play a crucial role in supporting the citizens in harnessing their potential by initiating the process of social mobilisation.

Since local government plays the role of a support organisation and creates an enabling environment for local people to take the lead in undertaking the process of social mobilisation, the peoples' involvement in identifying and prioritising the development projects promotes peoples' participation which is a necessity for good governance.

It is important to note that community mobilisation can be ensured only if citizens see an incentive to participate in organising themselves into community organisations. Possible incentives could be economic returns that are directly beneficial to the members of the household or social incentives that benefit the entire community. Therefore, the local government has to work out

various ways to make governmental and non-governmental resources available to meet the needs of the community organisations that they are not able to address from their own internal resources. Such resources could be made available from the local government's budget, grants, donors, state budgets, or credit from financial institutions. Strong partnerships between local government bodies, community organisations and non-government organisations should be established as the first step towards achieving this end.

In summary, social mobilisation helps to:

- Promote sustainable organisations for development, helping people to enhance their capacity to receive and use and also to work together for household and community initiatives.
- Establish a working relationship between the community, local government, and other development partners.
- Ground a system of participation, transparency and accountability which are the factors that help individual citizens feel that they have a voice within the organisation.
- Generate the feeling of democracy at grassroots level by allowing citizens to take collective action to counteract undemocratic actions of the state or local government.
- Gain control of the development of the villages by the citizens who select, plan, and carry out projects that benefit their community.
- Help communities to develop social cohesion and social capital that can be used to provide support for the most needy members of the community.
- Help to give the most needy members access to capital for solving their economic and social problems through a process of internal capital generation.
- Reach the poor and disadvantaged groups in the villages and empower them to continue their own development.
- Enhance collective creativity as more people are encouraged to be involved in finding solutions to common challenges.
- Generate compromises and consensus that in turn foster a free exchange of ideas and a democratic culture.
- Improve the quality of public products and services using feedback from citizens.
- Generate a commitment to the community from all the actors involved as the proposals and directions for the future do not derive from the authorities alone.
- Increase the satisfaction of citizens as they feel that their ideas, needs and perceptions are taken seriously by authorities *i.e.*, improved responsiveness to citizens' needs.

A case study: a local development initiative supported by the Community Mobilisation Process

Background

The government of Albania is giving top priority to support for decentralisation and the development of an effective and democratic system of local governance to yield a positive impact on regional and local development. Accordingly, the new Constitution promulgated in 1998 places emphasis on decentralised local governance, followed by approval of the National Strategy for Decentralisation and Local Autonomy in 1999 and the Law on Organisation and Functioning of Local Governments in 2000. In 1998, the government became a signatory to the charter of local governments of the Council of Europe and also became a member of the Congress of Local Governments in Europe. These measures are the initial steps taken by the government to pursue and implement policies on decentralisation and local governance that conform to the norms and practices established by the Council of Europe.

Local government in Albania is organised at two levels. At the first level, Albania has a clear political and administrative delineation of boundaries for its 304 communes and 65 municipalities. At the second level, Albania no longer has 36 districts but 12 regions that have regional councils. The regional councils' members are mayors, commune chairpersons and other representatives of those elected at the municipal and commune levels.

There is, in general, a good understanding and strong support of government, prefecture, regional council, municipality and commune authorities for decentralisation and strengthening of local governance in Albania. The response of the donor community is also positive. There is firm recognition that strengthening local governments will indeed result in improved human security, effective public and private services, increased levels of development and improved livelihoods. Thus, there is a positive attitude or environment for decentralisation and strengthening of local governance. There is also a growing realisation that implementation of decentralisation and local governance policies is weak, and that building the capacity of local authorities to undertake their responsibilities, with the participation of their communities, is a high priority.

These opportunities will provide a strong basis for supporting and strengthening local governance in Albania, UNDP in partnership with other donor communities such as the Norwegian Government, the SOROS foundation, the United Nations Volunteers Programme Special Voluntary Fund, the Arab-Gulf Fund and the UNDP Thematic Trust Fund responded to the critical priorities of the government in supporting the on-going process of decentralisation by

strengthening the democratic system of local governance and by implementing a pilot Local Governance Programme in three regions of the country.

The UNDP-supported Local Governance Programme adopted a multi-sectoral oriented regional and institutional approach to local development. Community driven development through the process of social mobilisation was used as the main vehicle for creating an enabling environment for a dynamic two-way partnership between the local authorities and the communities. In doing so, the system of local governance and development has been people-centred and is in accord with the principle of subsidiarity, an essential feature of the European Charter of Local Self-government.

The next section of this chapter presents the results achieved by the UNDP programme which focuses on strengthening self-governing community-based organisations at the municipality and commune levels as the entry point to fortify democratic governance and local development**.**

The main thrust of the community mobilisation process is its focus on social mobilisation to bring the community of people together for the common benefit of its citizens. By urging the local people to form community organisations, the programme helped to promote development through their own and other resources, and to actively participate in decision-making processes that affect their lives and surroundings. With unity as their primary strength, people not only improve their livelihood but they also move towards self-empowerment, self-sufficiency and self-governance.

By following a participatory process of consultation with the members of households, the programme supported the efforts of citizens of villages to unite and form their own CBOs – composed of men, women or mixed – and helped them to become involved in the development process by creating self-governing institutions. The strength, commitment and cohesiveness of the CBOs have been proven to be the essential factor for properly implemented and managed development projects.

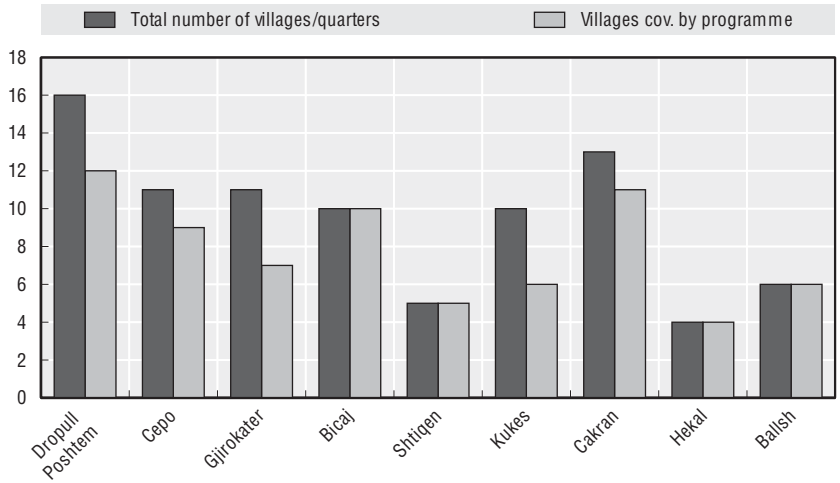
As a result of the consultations and orientation, the village citizens organised meetings and decided to form their own CBOs within the village for the social and economic development of the village dwellers.

As a first step, the CBOs developed their own rules and regulations, which have provided the basis for their functioning as self-governing institutions at the grassroots level, and have elected a Chairperson and Manager to govern the groups.

Villages covered in the pilot communes and municipalities

In a period of 30 months, a total of 70 villages/quarters (out of 86 villages/quarters) have been covered by the programme in 6 communes and 3 municipalities, and have initiated the process of Social Mobilisation.

Figure 8.2. **Programme coverage (villages)**

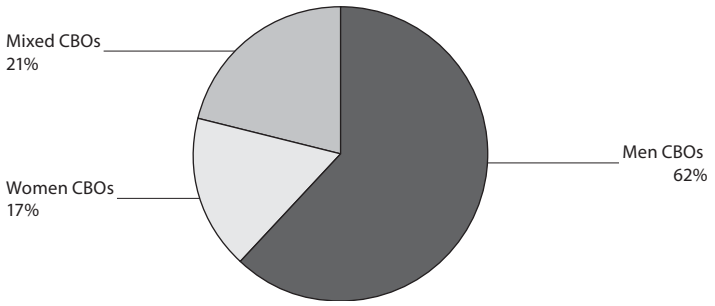


Number of CBOs established and functioning

A total of 126 CBOs have been formed and are functioning as self-governing organisations in the pilot communes and municipalities. The CBOs are now potent organisations for development by helping people within the villages to work together toward community improvement initiatives.

Out of 126 CBOs, 78 organisations are composed of men, 22 are composed of women, and 26 are mixed CBOs. The total number of CBO members equals 3 349. Male members account for 76% of the total while female members comprise 14% of the figure.

Figure 8.3. **Number and type of CBOs**



Savings generated by the CBOs

CBOs are encouraged to initiate small saving schemes to generate group assets for their own development purposes. To generate capital through a small amount of savings is a difficult initiative, especially in poor villages. Despite the difficulty, members of the CBOs started saving activities by depositing their contributions in a savings account during their regular meetings. Meetings were also held on a needs basis to discuss and establish concrete plans to solve their problems.

The capital generated through savings is planned to be used to finance micro-enterprise development at the household level. The CBOs can lend money to members at a rate that satisfies local credit needs, and at the same time contributes to CBO savings. The CBO members in all three pilot regions have already saved a total of 2 469 550 lek ($24 500) to be used for their self-development activities.

Community projects planned and implemented by the CBOs

The Micro Capital Grant (MCG) scheme is used as an incentive to increase communities' participation by taking the lead in the identification, prioritisation and implementation of small projects. The most important element in the project implementation is that MCGs are matched by cost contribution from the municipality and the communities. This has also helped to build trust between the local government and the citizens.

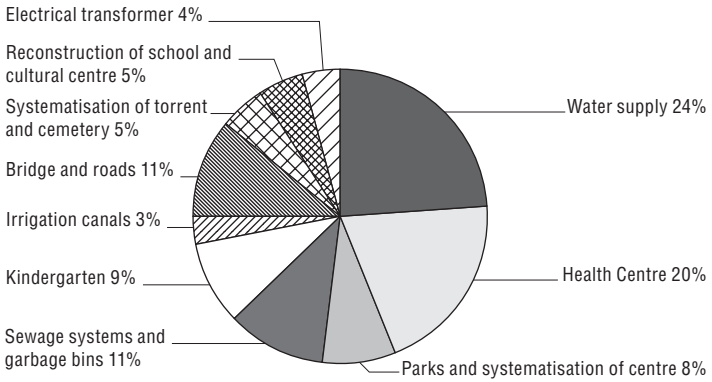
In all, 74 projects have been planned, prioritised and implemented by the community members in a period of 30 months.

The total cost of the community projects completed by CBOs is $1 775 800. They have benefited a total of 16 500 households of the pilot communes and municipalities (9). Of the total cost, 28% was borne by the local government and the community and the rest, 72%, was mobilised from the grants of donor organisations.

Major concentration of MCG projects

Most of the projects prioritised and implemented by CBOs are directly linked with the Millennium Development Goals (MDGs). Drinking water, green environment and sewage projects are related to MDG 7 on environmental rehabilitation and sustainability. These projects constitute about 51% of the total number of the projects implemented. Rehabilitation of health centres is related to MDG 4 and 5 on decreasing child mortality and improving maternal health, respectively. The systematisation of the canals and road schemes relating to MDG 1 on poverty alleviation constitutes about 25% of the projects implemented.

Figure 8.4. **Concentration of MCG projects**



Cost sharing of the projects

The projects implemented with donors' funds are instrumental in supporting the local government in achieving the MDG targets. Cost sharing and matching funds from other partner organisation have been well accepted and integrated in the implementation of the projects.

Table 8.1. **Financing the MDG targets**

Region	Norwegian government	Other donors (SOROS, UNDP)	Community	Commune/ Municipality	Total
Gjirokaster	273 680	169 699	58 328	151 332	653 039
Fier	195 173	175 829	31 663	81 659	484 324
Kukes	210 933	240 453	142 736	44 222	638 434
Total	679 786	586 071	232 727	277 213	1 775 797

Lessons learnt from Albanian experience

- Social mobilisation will be effective if it is institutionalised within the local government which has put a decentralised system of governance in place. Moreover, the success of community-driven development depends on the role of the catalyst which provides guidance to the community, the support organisation which creates the enabling environment, and the facilitator who helps in mobilising the resources and institutional support to sustain the whole process. Experience has shown that local governments (elected) which are accountable to the people can play all these roles effectively provided their capacities are enhanced to the required level.

- Participatory programming and budgeting at the local level are new concepts that need to be fully internalised by the elected authorities, as well as state officials at the local levels. To achieve this end, more focus should be given to the provision of regular substantive training in participatory planning and budgeting. Such training should cover the mobilisation of people in planning and decision making on local development initiatives, linking the plan with resources available at the local level, the means of generating more resources at the local level, and budgeting and accounting procedures.
- Community people are ready to take responsibility for local development efforts but they need to be guided and supported by a local change agent that could be local self-government, an NGO or a CBO. Closer ties between the community, local government and with local NGOs are essential.
- The concept of ownership is crucial. It is effective in mobilising development resources in rural areas. Unless the partner organisations internalise and institutionalise the participatory approach at all levels, it is unlikely that a sense of ownership can be inculcated.
- Through the involvement of the communities in planning and implementing development efforts, the number of people willing to work within the project framework has been increasing in the pilot communes and also in non-pilot villages/communes. Communities of the non-pilot communes in the pilot regions have started approaching the CBOs and UN volunteers for technical assistance in developing similar CBOs in their villages. The demonstration effect of the CBOs in pilot communes has helped the non-pilot communes to establish similar CBOs to work for the development of their communities.
- Having successfully planned and implemented social infrastructure projects of their choice and for their needs, the community organisations have begun to realise the need to implement economic (income generating and production oriented) community projects in partnership with the local government, the private sector and UNDP.
- The formation of CBOs at the grassroots level in partnership with local government bodies has helped to develop good working relationships between the community people and local government. This is evidenced by the micro capital grants projects planned and implemented by the CBOs and local governments in the pilot communes and municipalities.
- The involvement of the community people in making decisions on planning and implementing projects at the village levels has enhanced transparency and accountability for funds at the local level.
- In mobilising community organisations, facilitators should always be aware of the risks of creating monopolies or structures that could exploit other

community members or neighbourhoods or initiatives being captured by local elites. Promoting good governance is hence essential throughout the social mobilisation process. Civic norms and values as well as effective leadership are essential elements in building CBOs for empowerment and participation in governance.

- In working with the communities, it is important to engage all stakeholders (government, civil society and private business entities) and to work with the majority population (men, women, youth, minorities etc) as well to promote changes in attitudes of discrimination and mutual dislike and reinforce social cohesion in the community. It is therefore necessary for capacity building efforts to target all these actors.
- The formation of self-governing community organisations of men and women representing the majority of the households at the village level has provided an institutional platform for local empowerment, the development of social capital and harmony, peace and human security.
- Organisation of regular meetings of the community's people will result in the preparation of community development plans, including the establishment of small and medium scale enterprises. These community development plans will be linked to and form the basis for participatory development planning at the local government unit levels.
- Generation of local capital in the form of savings and credit schemes and the community's contributions through partnerships to development projects identified in the community development plans will be the basis for sustainable development of micro-finance and micro-enterprise schemes at the local level.
- Last but not least, the development of CBOs into sustainable self-governing institutions is not an easy task. Empowering the rural poor and enabling them to take increasingly greater development activities into their own hands is a time consuming process which requires considerable professional support. If shortcut methods are used to develop self-governance at the grassroots level, the sustainability of the organisations concerned will be in question. Support to the established organisations needs to be continued until they are fully self-sustaining.

Conclusion

In conclusion, the key messages to the development partners of Central and Eastern European countries include the following:

- There is a need to look at local development and democratic governance in a more holistic manner and facilitate linkages and partnerships of all relevant stakeholders.

- Local development initiatives should integrate civic participation from the very beginning of conceptualisation to final evaluation of the programme.
- All development partners should have a common understanding of the goals and principles of social mobilisation and its importance in local development.
- Formation of community organisations should lead to higher degree of participation by the local people in organised form in the decision-making process for local development, whence better local governance.
- Mobilisation and formation of CBOs is expected to lead to more effective local development programming and implementation management and needs to be directly linked to the utilisation of resources available at the local government levels.
- It is important to stress that the critical role of social mobilisation is to ensure effective participation of civil society, including the poor, isolated and vulnerable members of society, in development processes and to create more responsive local government. Such efforts help to ensure accountability, transparency, and equity in planning and public management practices.
- Whilst the principles of social mobilisation apply universally, the approaches and methods used must be country-specific to achieve maximum impact.

ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 9

Institutions, Governance and the Development of Entrepreneurship in Central and Eastern Europe

by
David Smallbone

Although the specific policy priorities for entrepreneurship development vary between individual economies, key underlying themes are the importance of institutional development and capacity building and the development of a market-oriented system of governance, over which governments exert a key influence. In some countries an appropriate and effective institutionalisation of small business policy is still one of the main preconditions that need to be fulfilled before productive and sustained private sector development can become embedded. In others, more should be done to unleash the potential role of regional and local authorities, both in promoting entrepreneurship and in facilitating its development, in view of the fact that it is at the local level that policy and institutions touch entrepreneurs most directly.

Introduction

This chapter is concerned with the importance of institutions and governance as an influence on the nature and pace of entrepreneurship development in Central and Eastern Europe,[1] whilst also noting, where appropriate, relevant experience in mature market economies. The emphasis is on issues relating to governance, policies and practices relevant to processes of starting and developing businesses, in which both formal and informal institutions play a key role.

Public policy and governance can influence most of the contextual factors that bear on the demand for entrepreneurship, as well as the supply of entrepreneurs in the longer term. The term "governance" is a very versatile one, referring to the exercise of power in both a corporate and a state context. This particular chapter focuses on the latter interpretation, embracing actions by executive bodies, assemblies (such as national parliaments) and judicial bodies. Governance has been defined as "conscious collective action extending beyond government deploying, for example, the capacities of businesses, community groups and academic institutions" (Hart, 2003a). Governance is concerned with the rules, procedures and practices affecting how power is exercised. These issues are central to the democratic process, because they influence the legitimacy and effectiveness of institutions, which as the third section of this chapter demonstrates, can have major impact on entrepreneurship development.

The development of entrepreneurship has been a key element in the process of social and economic transformation in the EU's new member states of Central and Eastern Europe, particularly during the transition period. The contribution of entrepreneurship includes the generation of jobs, the emergence of new activities, introducing greater flexibility in the economic system, as well as to innovation in some cases. It also contributes to changes in the behaviour and patterns of thinking of people, oriented towards greater initiative, self-reliance and responsibility.

The dynamic growth of entrepreneurship after 1990 generated considerable demand for institutional change, focusing on four main areas: firstly, a legal infrastructure appropriate to market conditions; secondly, the creation of a legal framework to facilitate the development of entrepreneurship; thirdly, the creation of commodity, capital and labour markets. In addition, in some countries a business support infrastructure

conducive to the creation and development of new and small enterprises has been developed, although in most cases qualitative improvements are needed in order to increase its effectiveness. Some of these issues are discussed later in the chapter.

The second decade after the start of the transformation process is an appropriate time to reflect on some of the emerging policy, institutional and governance issues affecting private enterprise development in former socialist economies, since an appropriate and effective institutionalisation of policy is one of the main pre-conditions for private sector development. Whilst emphasising that setting up, operating and developing businesses results from the creativity, drive and commitment of individuals, rather than as a result of government actions, the conditions that enable and/or constrain entrepreneurship are affected by the wider social, economic and institutional context, over which the state has a major influence.

The state has an important role to play in fostering entrepreneurship by removing (unnecessary) obstacles to enterprise creation; establishing a facilitating environment for private sector development; and contributing to the development of appropriate market institutions, as well as influencing their behaviour (Smallbone and Welter, 2001a). Within the context of an overall strategy for entrepreneurship development, one of the key roles for the state is to develop a well co-ordinated relationship between the various actors involved in promoting and regulating enterprise creation and development at the national, regional and local levels. In this regard, the coherence of the policies, actions and behaviour of institutions at different levels is an important element in the institutional framework.

Entrepreneurship and government policy

In considering the relationship between the development of entrepreneurship and government policy, a key point to stress is the variety of ways in which government can affect the nature, extent and pace of small business development in an economy. As a result, when considering the question of policies to support SME development, it is necessary to consider the implications of a range of government policies, institutions and actions for the operating environment in which businesses can develop, rather than just focusing on direct interventions that are specifically targeted at SMEs. One reason why this is important is because any benefits accruing from the latter may be more than outweighed by the negative effects of other government policies and actions and those of state institutions. This applies in mature market based economies as well as those at various stages of transition, although the transition context typically adds further dimensions.

In this context, the following types of policy have previously been identified (Smallbone and Welter, 2001a): firstly, *macroeconomic policy*, since the macroeconomic environment affects the willingness and ability of entrepreneurs (and potential entrepreneurs) to invest, particularly in projects that may take some time to produce a return; secondly, the *costs of legislative and regulatory compliance*, which can fall disproportionately heavily on smaller enterprises; thirdly, t*ax policies***,** including both the total tax burden but also the cost of compliance that can be affected by the frequency with which changes are made to the tax regime and the methods used for tax collection; fourthly, the i*nfluence of government on the development of market institutions***,** such as banks and other financial intermediaries, business support and training organisations; fifthly, the *influence of the government on the value placed on enterprise and entrepreneurship in society,* which in the long terms is affected by the curriculum and methods of teaching in the education system (at all levels), but also by the stance of government towards business and property ownership and the behaviour of politicians and government officials in their dealings with private firms; and lastly, *direct intervention*, which is designed to assist small businesses to overcome size-related disadvantages**.**

In a liberal market view, such intervention is justified on the basis of demonstrated market failure, such as the effects of a collateral-based approach to lending by commercial banks on the supply of finance for new and small firms. However, in a context where a market, from a small business perspective (*e.g.,* for finance or advice/consultancy), may be underdeveloped or still emerging, such intervention may have a pump-priming role in helping to build capacity in the market. Indeed, one might suggest that if the aim is to move towards a market based system, the contribution to market building is one of the essential criteria against which any proposed intervention should be assessed.

Whilst each of these policy areas are applicable in mature market as well as in transition and emerging market economies, the key underlying factor in a transition context is the extent of the commitment of government to market reforms. This is demonstrated through actions with respect to the shift from public to private sector ownership; the extent to which there is price liberalisation; and the role of government with respect to the creation and effective operation of market institutions.

In this context, the role of good governance and market-oriented institutions becomes an essential feature of the reform process, if the development of productive entrepreneurship is to be encouraged and sustained, enabling the SME sector to achieve more of its potential contribution to the process of social and economic transformation. This can be illustrated with reference to a commonly recognised issue in countries where SME policy has sometimes been declarative in nature, leaving an

implementation gap between the stated policy and the practice. There can be various reasons for this, but a lack of clarity with respect to *responsibilities,* a lack of *accountability* for actions, combined with procedures that are less than *transparent* can all contribute. All are elements of good governance practice, which for the purpose of this chapter, specifically refers to practices that encourage productive entrepreneurship and the establishment and development of SMEs.

Transitional environments with major institutional deficiencies

Before focusing on the emerging market economies of Central and Eastern Europe, it may be helpful to emphasise the important role of institutions in relation to entrepreneurship development by considering environments with major institutional deficiencies. Evidence from empirical surveys in former Soviet republics, such as Russia, Belarus and Ukraine suggests that many enterprises have been set up, survive and sometimes even grow *despite* government, because of the entrepreneurship of individuals, which is reflected in their creativity in mobilising resources and their flexibility in adapting to hostile external environments (*e.g.,* Chepurenko, 1994; Peng, 2000; Smallbone *et al*., 2001b; Yan and Manolova, 1998). The problem is that in these situations the number of firms remains small and their contribution to economic development in terms of jobs, innovation and external income generation rather limited. Thus, in situations where market reforms have been slow or only partially installed, the institutional context becomes a critical factor, since government still has to create the framework conditions for private sector development to become embedded and sustained.

In such conditions, the types of entrepreneurship that can be identified, and the enterprise strategies adopted, are heavily influenced by the external environment (Peng and Heath, 1996; Peng, 2000) in general, and the institutional context in particular (Welter and Smallbone, 2003). In this regard, institutional theory offers a suitable interpretative frame of reference, since it emphasises the role of external political, economic and societal influences on individual behaviour (North, 1990). North understands institutions to form "the rules of the game in a society", which assist in reducing uncertainty and risk for individual behaviour as well as the transaction costs connected with entrepreneurship. They include formal institutions, such as political and economy-related rules and organisations, but also 'informal institutions', which refers to codes of conduct, values and norms that "come from socially transmitted information and are part of the heritage that we call culture" (North, 1990).

In this context, an institutional framework which is adequate for entrepreneurship consists of the "set of fundamental political, social, and

legal ground rules that establishes the basis for production, exchange, and distribution" (Davis and North, 1971). Examples of relevant formal institutions in this regard include the legal framework and the financial system. Fundamental rules, such as private property rights, are a major influence on the nature and extent of any entrepreneurial activity, whilst day-to-day economic and political decisions, together with unwritten rules, determine the actual scope for the behaviour of entrepreneurs and their actions. In transition economies where transformation has made limited progress, the lack or inadequacy of effective formal and informal institutions that are appropriate to emerging market conditions, and the predominance of old (*i.e.,* unchanged) informal rules and incompatible formal and informal institutions, assist in explaining certain characteristics of entrepreneurship and enterprise behaviour.

As a result, the inadequate and often hostile institutional environment in countries where market reforms have been slow or only partially installed can play a major role in constraining small business development. In Belarus for example, the very slow pace of privatisation, combined with an increase in the regulation of small enterprise activity after 1996, forced many small firms into liquidation and others into operating abroad in Poland, Russia, the Czech Republic, Latvia and the Ukraine (Smallbone and Welter, 2001c). By 1997, the effect of an increasingly hostile regulatory stance on the part of government towards the private sector resulted in 54% of all registered enterprises becoming illegal or driven out of business because of new registration rules (Zhuk and Cherevach, 2000). Methods used to restrict entrepreneurship included additional requirements for enterprises to obtain licences and a more rigorous approach by state officials (*e.g.,* tax officials) towards private firms than towards state enterprises.

In many transition countries with slow reform progress, the *legal framework* is still the main barrier for the development of small business and entrepreneurship. Creating an adequate legal framework involves laws relating to property, bankruptcy, contracts, commercial activities and taxes, but it also involves developing an institutional framework with the capacity to implement it, with major implications for staffing. In practice, in a Belarussian context, specialised economic courts; a private legal profession and effective enforcement mechanisms are lacking for the most part, with a typical lack of adequate personnel in government administration. The reasons are low public sector salaries combined with a lack of education and training opportunities, which prevent their proper implementation. In addition, frequent changes in tax regulations and other commercial laws require a constant adjustment of knowledge by small business managers as well as by those in government administration.

All of this results in time lags and a rather uncertain attitude, or even arbitrariness, on the part of public officials regarding law enforcement, which is not helped by a typical lack of specificity in the drafting of laws. Fundamentally, these institutional deficiencies reflect a lack of political commitment to facilitate private enterprise development. Belarus may currently be one of the worst examples, but the issues exist to varying degrees in most of the other former Soviet republics. Political considerations with respect to the enforcement of laws can aggravate the situation, resulting in the fostering of old networks between former state-owned firms and government. In some transition countries these networks seem to become one of the major problems impeding the establishment of independent juridical institutions and the enforcement of a legal framework required for market economies and thereby discriminating against small businesses.

Another major barrier to the development of entrepreneurship in transition countries where market reform has remained slow is the *financial infrastructure* (Smallbone and Welter, 2001c). While stock exchanges developed quickly in the more advanced transition countries, in most former Soviet republics, national risk capital markets are virtually non-existent and the banking system is still highly inadequate (Zecchini, 1997). Banks under central planning were mere accounting agencies without an active role in the financial transactions of households or enterprises. In less advanced transition economies, the majority of banks still experience difficulties in mastering the task of guiding savings toward capital investment in private enterprises, especially small businesses. The extension of credits to small businesses has also been hampered by the fact that newly created or privatised banks often face liquidity constraints, resulting from insufficient equity capital provision, inherited liabilities from the central planning era or from massive repayment delays. In addition, banks have typically followed conservative strategies with respect to the financing of private enterprises.

As a consequence, most banks in less advanced transition countries, such as Ukraine and Belarus, lack a willingness to finance small businesses, which is reinforced by a lack of expertise and know-how with this new clientele, as well as a shortage of collateral on the side of the enterprises. In these circumstances, informal institutions and practices may compensate for some of the deficiencies in the formal market institutions, although not without implications for the types of strategies adopted by entrepreneurs to set up and develop businesses (Peng, 2000).

All these factors can contribute to a negative attitude on the part of small businesses toward government and regulations, which was a common phenomenon in the early years of transition particularly. It typically results in the widespread use of types of enterprise strategy, which represent an adaptation by entrepreneurs to the specific set of environmental and

institutional conditions that pertain. As is evident from empirical survey data (*e.g.,* Smallbone *et al*., 2001c; Welter *et al*., 2000), entrepreneurs often cope with an inadequate institutional framework through "evasion" strategies (Leitzel, 1997), which allow private entrepreneurship to survive in an environment where government considers private businesses to be mainly a source of tax revenue and where inadequate public law enforcement leads to arbitrariness and corruption. Typical evasion strategies include the combination of legal and informal production; setting up a "fictitious" enterprise; and cash payments to employees, which are undeclared to the tax authorities. A further example is diversification into unrelated activities, which can be an attractive development path for successful entrepreneurs who are keen to avoid being publicly noticed as being too successful.

Frequent changes in the tax system, combined with a prohibitive tax level, unpredictable behaviour on the part of state officials in applying tax regulations, and inadequate access to external capital encourage entrepreneurs to use evasion strategies in order to reduce profits and tax payments with the underlying objective of preserving the capital base of their enterprises. For example, evidence drawn from a study of employment behaviour in Russian small businesses indicates a predominance of unofficial payment strategies to workers in order to reduce social security contributions (Welter *et al*., 2000), which is confirmed by the results from other surveys (*e.g.,* Frye and Shleifer, 1997; Hendley *et al*., 2000).

Feige (1997: 28) characterises such actions as the "legacy of non-compliance", which dominated most of the tolerated and non-legal entrepreneurial activities in Soviet times. Due to frequent changes in commercial laws, entrepreneurs perceive the external legal environment as a major constraint on their entrepreneurial actions, consequently reacting to, or anticipating, constraints with evasion behaviour. Weakly specified regulations combined with inadequate law enforcement encourage corruption, not only when registering a company, but also in everyday economic transactions. Thus, an inadequate legal framework results in enterprise behaviour, which although rational from an individual entrepreneur's point of view, is non-productive from the economy's standpoint (Welter and Smallbone, 2001). This is because it diverts resources that could otherwise be put to productive use, into dealing with some of the unnecessary costs associated with an institutional context in which the framework conditions for sustainable entrepreneurship have still to be established. Such behaviour reflects insufficient formal institutions (laws, courts, etc.) to regulate business activity as well as inconsistent and inadequate informal rules to assisting law enforcement. Both of these lead to mistrust on behalf of entrepreneurs, state officials and society more generally, thus resulting in a potentially vicious circle.

As a consequence, in conditions that pertain in countries such as Belarus and Ukraine, policy needs to focus on improving the overall institutional framework for entrepreneurial activity in order to facilitate the development of productive entrepreneurship (Baumol, 1990) and minimise unproductive forms of entrepreneurial behaviour. Improving the quality of laws and regulations is a key element in establishing the framework conditions that are necessary for economic and democratic development. Regulations that are overly burdensome, complex or impractical may reduce business competitiveness by contributing to higher administrative and compliance costs, as well as to a diminution of the rule of law when non-compliance becomes rife.

Institutions and SME development in accession States

The continued development of entrepreneurship is crucial to the process of European integration. In the case of the EU's new member states in Central and Eastern Europe, entrepreneurship has been a key element in the process of social and economic transformation during the transition period, facilitated by administrative and legal reforms and some degree of institutional change. In the case of Cyprus, Malta and Turkey, the issues focus on the need for institutional capacity building to facilitate the development of more knowledge-based enterprises to complement the traditional emphasis on small and family businesses.

Institutional capacity building is perhaps the most challenging aspect of the reform process, and one that is central to the continued development of entrepreneurial capacity in these countries, because of its potential impact on transaction costs. It involves not simply legal and administrative reforms and the reform of institutions relevant to entrepreneurship, but more importantly behavioural change in those institutions. Relevant institutions include public bodies such as regulatory and tax authorities; licensing and registration offices; private sector institutions, such as banks, accountants and other professionals involved in providing business support; development agencies; as well as self-governing bodies, such as chambers of commerce.

Existing regional and national disparities within the EU will widen considerably after enlargement, posing a challenge to policy for EU coherence and social inclusion. This underlines the importance of implementing the recommendations set out in the White Paper on European Governance, particularly those relating to strengthening the role of regional and local governments and their communities in economic development (Commission of the European Communities, 2001). This draws attention to the potential importance of bottom-up initiatives, which may create the most effective milieu for entrepreneurship development. It means that there is a need for

institutional capacity building at the local and regional, as well as at the national level, if the contribution of entrepreneurship to local/regional development is to increase. In some countries (*e.g.,* Estonia), the issue is associated with a need for a reform of local government and a strengthening of the role and experience of local authorities in local economic development. However, there is also a need to examine the influence of soft factors, such as the level of involvement of local entrepreneurs in the process, and the skills and capacities of local government in this area.

Hence, whether or not entrepreneurship is able to achieve its potential contribution to increased economic convergence and greater social cohesion depends, in part at least, on strengthening the institutional and policy context in candidate countries. Strengthening the institutional environment is particularly important for the development of knowledge-based entrepreneurship, which is increasingly being viewed by policy makers as a key generator of growth, social and economic change, and improved competitiveness.

In the EU's new member states, the process of accession has contributed to institutional development and administrative reform. This can be illustrated with reference to Estonia, which represents a country where considerable progress has been made in terms of institutional development and regulatory reform with respect to enterprise development, in contrast with some of the countries referred to earlier in the chapter. Although a very small country, Estonia is an interesting example, not least because it was formerly part of the Soviet Union.

Following independence in 1991, government policy in Estonia has been underpinned by a free market philosophy and a commitment to the institutionalisation of private ownership and market reforms. Rapid privatisation meant that by the end of 1996, most large enterprises had been sold, with attention turning to the utilities, such as energy, telecommunications, railways and ports. Since 1991, Estonia has also had a very liberal trade policy in which trade barriers and tariffs have been largely abolished. This has led to a growth in exports on the one hand and to an inflow of duty free imports on the other. It has also contributed to Estonia's success in attracting foreign investment, which has been an important enabling factor contributing to the success of its economic reforms and the structural transformation of the economy. As a result, on most indicators of market reform, Estonia scores highly in comparison with other Central and East European countries and former Soviet republics. For example, based on EBRD assessment, by 1999, 75% of GDP was contributed by the private sector (EBRD, 2002).

During the initial phase of transition, government was responsible for administrative and legal reforms, which made it possible for privately owned

enterprises to develop, although for a time the continuous nature of these changes contributed to an unstable and uncertain business environment. It also took some time to completely revise the tax system, which meant that the development of small private enterprises was initially constrained by the remains of a tax regime inherited from the Soviet period. At the same time, until recently, direct measures to support small business development in Estonia were noticeable by their absence, with the role of government best characterised as one of limited intervention, focusing instead on establishing the framework conditions to facilitate productive, private enterprise development.

The development of an appropriate institutional framework is an important part of the process of market reform. In general, the institutionalisation of business support includes the development of institutions on three levels: macro-, meso- and micro-level (Welter, 1997). At the macro level, responsibility for enterprise support in Estonia has been centralised under the Ministry of Economic Affairs and Communications, with the aim of making more effective use of the resources available for enterprise support, whereas prior to 2000, a total of five Ministries were involved in enterprise support, directly or indirectly.

Considerable progress has also been made in developing the institutional framework for enterprise development at the *meso level*. This includes the banking system, which, now largely under foreign ownership, has developed a range of financial products similar to those available to enterprises in a mature market economy. It also includes a number of unions, associations and chambers, established by special interest groups mainly on the basis of voluntary membership. Some of these, such as the Chamber of Trade and Commerce and specialised sector-based organisations have been the main source of support for businesses in the process of exploiting foreign markets particularly. In 2000, the public business support infrastructure in Estonia was reorganised in an attempt to make it more efficient, transparent and accessible. Seven foundations together with the Tourist Board, under the administration of five different ministries, were integrated into two new organisations, namely Kredex (the Credit and Export Guarantee Fund) and Enterprise Estonia, which has responsibility for implementing public business support measures.

At the *micro-level*, institutional development has focused on the development of a network of business development centres that originated with foreign donor funding in the 1990s. Previous evaluation had identified a number of weaknesses in the donor-financed network, including poor relationships with local authorities and other relevant institutions (such as banks), and limited impact within local business networks. Other problems identified included the ongoing dependence of these centres on subsidies, the poor advertising of their

services, and the fact that their activities had been mainly limited to dealing with start-ups (PHARE Report, 1999), leaving established businesses not well provided for. As a result, the business support network has recently been the subject of reform, both to improve the quality and effectiveness of services delivered to small businesses but also to improve the administration, management and cost effectiveness of the support institutions.

Although the small size of the Estonian economy, combined with the opportunity to exploit historic ties with Nordic neighbours has presented Estonia with potential advantages over many other former Soviet republics, the pace of change has been impressive. Considerable progress has been achieved with respect to the institutionalisation of small business policy.

Some governance issues

Principles of good governance

In this section, some of the practical governance-related issues are discussed that can affect the nature and pace of SME development. Within the European Union, the White Paper on European Governance provides a useful set of guiding principles with respect to the debate about good governance for SMEs, at a national as well as at a European level (Commission of the European Communities, 2001). A key theme in the White Paper is the need to improve the effectiveness and legitimacy of institutions, although to achieve this requires the framing and implementation of better and more consistent policies, involving civil society organisations with state institutions in the process. It also involves improving the quality of legislation to make it clearer and more effective.

More specifically, the EU White Paper identified five key principles underpinning good governance:

- *openness*, which means that institutions should operate in an open and accessible manner.
- *participation*, throughout the policy chain, from conception to implementation.
- *accountability,* with clearly defined roles for institutions in the legislative and executive processes, with each institution explaining and taking responsibility for what it does.
- *effectiveness,* emphasising that policies must be effective in delivering what is needed on the basis of clear objectives and assessment of future impact.
- *coherence, i.e.,* of policies and actions, as well as between policies.

The influence of impending accession to the EU is impacting on the policy process in candidate countries. This can also be illustrated with reference to Estonia, where the recent publication of a national policy document for SME development represented a significant step forward in

strategic thinking, with related measures and responsibilities for implementation. Moreover, linking strategic policy objectives to specific action plans, which are tied into the budgetary process, represents a positive step towards overcoming the implementation gap that is a common feature of small business policy in a transition context.

Dialogue with entrepreneurs

One of the key principles of good governance with respect to the development of entrepreneurship and SMEs is the establishment of dialogue and co-operation between the state and representatives of entrepreneurs, with respect to different stages of the policy process. The creation of a facilitating environment for business development requires the effective participation of representatives of entrepreneurs and SME owners in policy formulation, implementation and evaluation. In addition, mechanisms for assessing conditions for business development and for measuring the impact of different policy tools should also be created and effectively implemented. In this regard also, effective communication between government and entrepreneurs is crucial.

The effective institutionalisation of policy with respect to entrepreneurship needs to incorporate the partnership principle. In mature market economies, self-governing, self-regulating organisations act as professional intermediaries in the process of dialogue between government and entrepreneurs, in order to ensure that the interests of businesses are taken into account in the decision making of public authorities at different levels. The lack of recent tradition and experience with this type of self governing organisation in the new EU members states of Central and Eastern Europe makes this a policy priority as far as building institutional capacity is concerned.

Although the membership negotiations in most candidate countries involved consultation with entrepreneurs' organisations, such methods are not embedded in everyday policy practice and there are also doubts about their effectiveness. In the case of Poland, for example, all social partners have been blamed for this deficiency, for reasons that include: firstly, insufficient familiarity with procedural aspects of preparations for negotiations; and secondly, insufficient knowledge about integration processes themselves and negotiations connected with them. In practice, it might be suggested that differences in the level of knowledge between government and non-governmental organisations seriously limit the possibility of conducting consultations based on partnership principles. Consequently, social partners and non-governmental organisations in new member states of the EU are typically insufficiently prepared to undertake discussions on the most important issues concerning them,[2] reflecting a more fundamental weakness, namely their lack of resources.

At the same time, it needs to be recognised that creating appropriate organisations is not a sufficient condition for the views and interests of entrepreneurs to be adequately represented in policy development. To achieve this requires a degree of regulation of these organisations in order to avoid excessive fragmentation, together with a programme of training and capacity building to assist them in developing an effective lobbying function. It also requires a willingness on the part of entrepreneurs to participate actively in representative organisations, although this is a problem not confined to transition, or emerging market economies.

One of the factors influencing the nature and extent of the contribution of entrepreneurship to economic development, competitiveness and increased social cohesion is the extent of empowerment of the role of small to medium-sized businesses (and entrepreneurship in a broader sense) within the economic system. However, whilst SMEs may be typically well embedded in their communities and employing local people, this is not always reflected in their level of engagement with formal institutions of governance. Small firms can be a difficult to reach group for consultation purposes, for various reasons. In this regard, Hart (2003) refers to firstly, the lack of time and energy on the part of entrepreneurs for activities that are not directly connected with their businesses; secondly, a lack of information about the possible benefits of participating; and thirdly, doubts about whether any policies resulting from their contribution can be implemented quickly enough to make a difference to their particular venture. As a consequence, it is inevitable that only a small minority of entrepreneurs typically become involved directly in the policy process, through representative organisations. Mobilising entrepreneurs to become involved in policy making is not easy, even if policy makers have a will to do so, although this is a problem that is not confined to transition or emerging market economies.

Encouraging and facilitating the development of entrepreneurship is an important part of strengthening the basis of a democratic society, through building up the middle class. Moreover, increasing the involvement of entrepreneurs within the democratic process is an important element in the institutionalisation of policy, which is an essential part of the process of reform of the system of governance. Although more advanced in some candidate countries than others, this aspect of the process of democratic reform still has some way to go, not least because of the absence of any recent tradition of self-governing organisations in these former centrally planned economies.

Better regulation

A key policy issue, which can be used as a litmus test for the effectiveness of the wider system of governance, concerns the effect of administrative and regulatory barriers on the establishment and subsequent development of enterprises. This is a subject that is much debated, in mature markets as well

as in transition and emerging market economies. One of the key roles of government in a market-based system is to create an environment in which private sector business can flourish and thereby make an effective contribution to generating employment and economic development. At the same time, the state also has an important regulatory function to ensure that business operates within certain rules that seek to balance the need to encourage and promote enterprise with a need to protect wider social interests and the public good. Establishing an appropriate balance has been the subject of considerable debate in mature market economies, with some emphasising the need to minimise government regulation and control of business activity by the state (*e.g.,* Bannock and Peacock, 1989), whilst others remain less convinced of its necessarily harmful effects (*e.g.,* Storey, 1994). However, in a transition context, establishing an appropriate balance is doubly difficult because of the lack of any tradition of the state as a regulator of business activity.

Regulation covers "the full range of legal instruments and decisions through which governments establish conditions on the behaviour of citizens or enterprises" (OECD, 1994). In this context, it is important to recognise that compliance with regulations and other statutory requirements involves a cost for business, which includes the opportunity costs with respect to the resources devoted to compliance, as well as any direct money costs. As a result, minimising the regulatory burden on business to the level that is necessary for the protection of the public good is a key element in government policy designed to encourage entrepreneurship and private sector investment.

The removal of unnecessary administrative burdens on business must be seen as part of a wider process of regulatory reform that aims to improve the environment in which business is conducted, in order that its potential contribution to economic growth and job generation may be fulfilled. Improving the quality of laws and regulations is a key element in establishing the framework conditions that are necessary for economic and democratic development. Regulations that are overly burdensome, complex or impractical may reduce business competitiveness by contributing to higher administrative and compliance costs, as well as to a diminution of the rule of law when non-compliance becomes rife.

In this regard, the foundation of the rule of law is based on a mutual respect for the legitimacy of regulation by both government and citizens. Rather than viewing regulations as tools by which government directs its citizens, they should be seen as a means of limiting the power of the state by closely defining it. Such a view is based on a democratic principle of "co-operation" between government and its citizens, rather than an "authoritarian" style of regulation, which transition economies have experienced in the past.

It should be noted that regulations are part of a wider regulatory system that includes processes and institutions through which regulations are developed, enforced and adjudicated. Apart from the regulations themselves, the regulatory system includes processes of public consultation, communication and updating. In taking initiatives to remove administrative barriers, the aim should be to improve the quality of regulation, both in terms of individual regulations and the regulatory system as a whole. This raises the question of what constitutes "good" regulation and the criteria by which it might be assessed. Drawing on good practice experience from a number of member states, the OECD (1994) identified the following quality standards for the regulatory system as a whole as well as for individual regulations, including:

- Coherence, consistency and balance between competing policies
- Stability and predictability of regulatory requirements
- Ease of management
- Transparency and openness
- Consistency and fairness in implementation
- Adaptation to changing conditions (OECD, *op. cit.*)

During the last 10 years or so, the management of regulation has become a priority of EU institutions, reflected in the drive for better regulation, which involves impact assessment, consultation, and *ex-post* evaluation of regulatory tools and institutions. The key underlying aim has been to improve the quality of legislation and make governance more transparent, responsive and accountable. One of the main innovations has been the use of Regulatory Impact Assessment (RIA), which involves an explicit commitment to systematic, *ex-ante* assessment of the possible implications of proposed new regulations, combined with ex post monitoring and review of regulations introduced, reflecting wider objectives of better law making and better regulation. In this regard, Metcalf (2003) has emphasised that the value added of impact assessments depends not just on their intellectual elegance and completeness but also on how they actually work in practice, emphasising the importance of management quality.

Although the issue of regulatory burdens can affect the development of all businesses, it can be a particular barrier during the start-up period, when entrepreneurs face many other demands on their time, in a context where time and money resources can be particularly scarce. All this affects the transaction costs, which in turn have implications for competitiveness, both domestically and internationally. This is currently recognised as a key policy issue in the EU, which is reflected in a benchmarking exercise conducted by the European Commission in the field of the administration of start-up

procedures (Centre for Strategy and Evaluation Services, 2002). The study concluded that member states have made considerable progress in improving the process of administration of start-ups, through the use of, for example, Single Access Points and statutory response times; switching from authorisation-based systems to systems based on self-certification; reducing the number of licences, approvals and procedures; enhancing the involvement of users through the use of the Internet to provide information; reducing the scale and complexity of the documentation required to start a new business; and reducing the level of mandatory costs. At the same time, the report also identified scope for improving the administration of start-ups in a number of areas, particularly with respect to the performance of so-called discretionary activities, such as completing a business plan and obtaining finance, although these only affect those enterprises that actively seek external finance.

Following the review of the registration practices and procedures in different EU member states, the European Commission recommended single contact points or one-stop shops between businesses and public authorities at all levels. The aim is to avoid the necessity of potential entrepreneurs needing to trail from one administrative office to another to complete different registration documents (*e.g.,* for tax, social security, business registers, etc.) at each location, often with much of the same information. A single contact point for business start-ups can play an even more important role if it becomes a focus for all the formalities that have to be complied with during the life of a business (such as change of address, transfer of ownership, permits and licences).

Related to the single contact point (or one-stop shops) is the single registration form, which will gather all the information required by any part of the administration to register a new enterprise. The advantage of such a system is that the information necessary for registration purposes only needs to be supplied once. Public administrations should be encouraged to share information and to make greater use of available databases and information technology.

The issue of better regulation is especially important in the case of the EU's new member countries. This has been recognised by the European Commission in its CC BEST initiative, which shows that although the regulatory and administrative framework in these countries has improved significantly, progress varies between countries although administrative simplification is a priority in all of them. Governments sometimes fail to acknowledge that heavy administrative procedures hit smaller companies disproportionately, which can provoke their flight into the informal sector. A particular challenge is the need to simplify legislation, whilst, at the same time, adopting the *acquis communautaire*. The main focus of the simplification process is the reduction of the time and cost of registration and licensing, with

one-stop shops for administrative procedures a welcome development.[3] At the same time, there are still unresolved questions, such as what consultation mechanisms could help governments to "think small first"? And what are the most cost-effective ways of informing the business community of changes in legislation?

It can be argued that an entrepreneurial society is one where legal, administrative and institutional processes and procedures facilitate ease of exit for entrepreneurs, as well as ease of entry. From an economic perspective, ease of entry and exit can influence the mobility of factors of production between less and more productive uses, thereby influencing the degree of flexibility and adaptive capacity of an economy. However, it may also contribute to the development of an enterprise culture through influencing the extent to which exiting from a business venture is necessarily considered to represent failure. This is explicitly recognised in a UK's recent competitiveness White Paper, "Tackling Fear of Failure", which includes a review of personal bankruptcy laws, aiming to devise means of reducing the stigma of failure and to help honest failed businessmen re-start in business as soon as possible. Germany also recognised this problem by introducing a revised insolvency law, which allows the discharge of residual debts for enterprises.

Strengthening the role of regional and local authorities

The development of entrepreneurship in most transition and emerging market economies typically varies considerably between regions and localities, as indeed it does in most mature market economies (*e.g.*, Reynolds *et al.*, 1994). This emphasises the importance of the promotion of and institutional support for, entrepreneurship at the local and regional levels. This in turn raises questions concerning the respective responsibilities of authorities at different levels; the co-ordination of state and regional support programmes; the establishment of appropriate lines of demarcation of responsibility; and the need to take steps to avoid unnecessary layers of bureaucracy and duplication of effort. There may also be a need to build institutional capacity at the regional and local levels, which may be dependent on a wider process of institutional reform. For example, in Estonia, there is a need to reform the county and local government structures, neither of which have the capacity or resources to effectively engage in regional policy. There are 250 different local authorities, ranging in size from Tallinn (with 400 000 inhabitants) to small islands with a handful of people.

Local government reform can help to provide a basis for the development of effective central-local and public-private partnerships, that are necessary if the EU's new member states are to maximise the opportunities for accessing EU Structural Funds in the future. At the same time, there is a need to

systematically take into account the interests of entrepreneurs, at every level, when adopting basic decisions with respect to entrepreneurship promotion and support.

Conclusions and key policy issues

Although the specific policy priorities for entrepreneurship development vary between individual economies, key underlying themes are the importance of institutional development and capacity building and the development of a market-oriented system of governance, over which governments exert a key influence. In countries, such as Ukraine, Belarus, Moldova and the Russian Federation, an appropriate and effective institutionalisation of small business policy is still one of the main preconditions that needs to be fulfilled before productive and sustained private sector development can become embedded. This also refers to the potential role of regional and local authorities, both in promoting entrepreneurship and in facilitating its development, in view of the fact that it is at the local level that policy and institutions touch entrepreneurs most directly.

At the same time, developing effective institutional arrangements for the governance and support of small businesses in the economy is a challenge shared by all countries. The state has an important role to play in fostering entrepreneurship by developing a strategy for removing obstacles to enterprise creation, for establishing a facilitating environment for private sector development and contributing to the development of appropriate market institutions, which are an important part of the business environment in a market economy. In this context, the appropriateness, effectiveness and overall quality of the *legislative and regulatory framework* is likely to have a greater impact on the development of the small business sector in the long run than direct support measures that are specifically aimed at helping small businesses. Moreover, the negative effects of an inadequate and poorly implemented legal and regulatory framework can impair the development of legitimate private sector activity at the expense of a burgeoning informal economy. Additionally, strengthening the legislative environment can be a highly cost-effective strategy for stimulating and promoting entrepreneurship, particularly when government resources are limited.

In new member states of the EU priority must also be given to the development of effective business support networks, since the competitiveness of SMEs depends on them being able to extend and supplement their base of internal management resources and knowledge, by drawing on external inputs. Active promotion of entrepreneurship at the regional and local levels is also required, as part of an enterprise-focused

regional policy. Although the pace of development of the small business sector in core regions in many candidate countries has been impressive, there is typically a need to take steps to stimulate entrepreneurship more widely.

Other policy priorities in new EU member states, with implications for institutional development, include the development of effective national innovation systems. The development of an institutional infrastructure to support technology transfer and facilitate innovation in SMEs (*e.g.,* innovation centres, technology parks, science parks) has been a feature of economic development in most EU states during the last 25 years, although in new member countries, such initiatives have a much shorter history. However, as the experience in western Europe demonstrates, whilst supply side initiatives (such as innovation centres or science parks) may be a necessary condition for nurturing new technology based enterprises, they are not a sufficient condition for the development of such enterprises. Hence, another policy priority is to increase the level of involvement of higher education institutions in developing links with the business sector in order to increase the supply of technical entrepreneurs.

Many of the governance issues facing transition and emerging market economies, as far as entrepreneurship and SME development are concerned, are associated with defining and rendering operational the role of the state in an emerging, market-based, democratic system. Whilst this can present particular challenges associated with attitudes, experiences and legacies inherited from previous times, it is important to recognise that many of the issues are not confined to transition countries.

One example is the development of an effective business support infrastructure for SMEs, which is approached in different ways in different EU member states, reflecting different historical traditions and political contexts. In countries with a strong liberal market emphasis (such as the UK), state involvement in this area is usually justified as a response to the failure of market forces to provide access to the information, advice and training that they need if they are to be competitive and contribute to economic development. However, in circumstances where markets hardly exist, or are seriously underdeveloped, it is particularly important that any interventions in this area contribute to the development of the market, rather than crowding out market-based solutions. This was the rationale behind the subsidised consultancy offered by the Department of Trade and Industry (DTI) in the UK in the 1980s, under the so-called "Enterprise Initiative". Focused on SMEs that had not previously used paid consultants, the scheme provided a number of days of subsidised consultancy from accredited sources, thereby introducing an element of quality control over consultants used by participating firms, as well as helping to pump-prime the demand side of the consultancy market.

Another issue with respect to the development of a publicly funded business support system is the need for it to be customer-oriented. Although the allocation of public resources to support for private enterprise development must ultimately be justified in terms of the potential public benefits and welfare gains to the economy as a whole, it is important that the support services offered to businesses be customer-oriented and delivered by organisations and individuals that are able to focus effectively on customer needs. In this regard, the lack of agencies with strong links to companies was identified as one of the current weaknesses in the Polish system of export promotion and support to SMEs, which together with fragmentation on the supply side, makes it difficult for SMEs to find their way through the system to obtain the assistance they require. As in many other post-socialist countries, the approach to managing export support programmes in Poland appears legalistic and institutional rather than customer driven. In a comparison with the Netherlands, a Dutch technical adviser suggested that rather than an emphasis on having spending targets within the rules (Netherlands), in Poland the priority of staff is to administer the rules (Smallbone, 2003).

Finally, when considering policies to encourage and support enterprise and small business development in emerging market economies, it is important to keep in mind that ongoing critical debate exists within most mature market economies about policy approaches and priorities and the effectiveness of government intervention with respect to small businesses (*e.g.,* Curran, 2000; Gibb, 2000). In this regard, some of the current policy debates in mature market economies are applicable in economies at earlier stages of market development and vice versa. What is the appropriate role of the state in relation to market forces and market institutions in supporting SME development? What is the role of universities and higher education institutions in relation to the development of entrepreneurship? How much do policy makers really know about the support needs of the enterprises and entrepreneurs that their policies purport to address? Such questions are currently being debated in EU countries, including the UK, yet they are basic questions, which indicate the limited extent to which policy practice is based on real knowledge and robust evidence of the needs of entrepreneurs, rather than on the assumptions of policy makers and the political agendas of their masters. These remain priority issues for policy makers to varying degrees, in most countries.

Notes

1. Part of the chapter draws on a paper jointly authored with Dr F. Welter ("Institutional Development and the Policy Context for Entrepreneurship in the Transition Economies of Central and Eastern Europe and the Former Soviet

Union", World Conference of the International Council for Small Business, ICSB, Belfast).

2. Social partners, *www.ukie.gov.pl*.

3. Report on the Candidate Countries' Measures to Promote Entrepreneurship and Competitiveness, SEC(2001) 2054, Volume I, p. 23.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 10

The Experience of Public-private Partnerships in Financing Entrepreneurship in Eastern Germany and Poland

by
Holger Kuhle

Public-private partnerships (PPPs) bringing together local authorities, the financial sector and non-profit organisations to optimise financing schemes are efficient ways to foster entrepreneurship locally. PPPs provide support mechanisms that are simple, easily accessible by small businesses and tailored to their needs. For the public sector, the partnership with the private sector thus achieves high leverage. It also allows limited public funds to be used more efficiently, essentially matching micro-lending for entrepreneurs, mainstream SMEs and entrepreneurial growth companies with guarantees. The public sector further contributes through improving the legal framework to facilitate fundraising and lending by micro credit institutions. However, PPP is a governance tool that requires strong local leadership from the public sector, which should be seen as a facilitator and catalyst.

Introduction

The development of programmes by local and regional authorities to support innovation financing is a relatively recent phenomenon. This may appear to be paradoxical, but it is true. One of the main reasons why local economic development is receiving increasing attention is globalisation. Globalisation involves, in the first instance, the mobility of money. As national borders become less important, national finance markets are becoming even more integrated into the competitive pressure of foreign markets so that the pressure on local domestic banks increases.

The new changes in the manner in which banks will be allowed to assess their risks will in future make it harder for banks to provide loan and risk capital for investment in start-up or growth firms.[1] Several reasons can be cited for the overall tendency of declining public budgetary funds during the same period. The public sector has been increasingly forced to set overall strategic objectives for finance provision and supervision at the local level. Even the financial transfers from the central government to sub-national levels of government are often conditional; meaning that they can only be disbursed for specific purposes. Transfers from the central government appear to be the easiest way to ensure a flow of money to the local treasurer.

The administrative procedures for accessing funds and reporting on their use are cumbersome. Sometimes, for example, accounting procedures need to be changed, expenditures classified, special accounts set up, and so forth. All of this increases local administrative costs and consumes scarce resources. In more general terms, grants may also serve as a sweet poison and undermine abilities and efforts to mobilise local resources. However, the capacity not only for companies but also locations – cities and regions – to stimulate existing potential as well as to support the emergence of new endogenous potential depends to a large degree on the respective financial resources. The greater the financial resources, the greater is the potential for local governments to invest in local infrastructure, enhance the attractiveness of a city as a place to do business and foster endogenous potential. However, the question is how such aims are to be achieved today. What financial instruments are available to local authorities?

Local policy and credit provision for SMEs

Recent scientific publications and political reports provide an idea of the importance of private financing of a multitude of investments that result in

the economic and social development of rural and urban areas (inner-cities, including areas of strong immigrant concentration, near suburbs, brownfields) but are undervalued by private financing.[2] These publications outline certain government-supported strategies which have encouraged small-scale investments in these areas. For example, local policy could prod banks to do more for the target groups concerned via the respective supervisory bodies – this would correspond to the practice in the United States (Community Reinvestment Act, CRA).[3] One can also provide incentives for banks to grant loans, particularly by reducing the elements of risk (the guarantee banks in Germany offer 60-80% and in turn are provided with support through counter-guarantees from the federal government, DtA). StartGeld offers an 80% release from liability, while a portion is covered by the European investment fund (EIF) or by means of fixed processing fees (in the case of StartGeld these amounts to 500 euros per loan).[4] Neither of these variants results necessarily in improved support systems, and may even lead to profit taking effects among the corresponding banks. Above all, however, these incentive systems do not function for really small credits (less than 20 000 euros) and, in addition, are aimed only at the founders of new businesses. One could also collect complaints, evaluate them and request that the banks provide proposals for a solution. This corresponds to the British way of doing things (Financial Services Authority, FSA). And, finally, one can specifically promote special-purpose organisations and funds to direct financing to small enterprises by the government. In this fashion it would be possible to offer new credit products and reduce the unit and risk outlays to the benefit of the financial institutions through grants and support systems geared toward local requirements. In particular, private capital could thus be mobilised and integrated into the financing of specific local requirements. The integration of private financing instruments in this way remains essential due to the chronic and growing shortage of public sector financing.

The mechanisms that underpin local financing tools in Poland and Eastern Germany demonstrate that both the public debts of locally committed authorities and flexible private financing on a global scale can be made compatible within the framework of local private-public partnerships.

The Polish example of the local "Guarantee Schemes" of the National Economic Bank, the Bank Gospodarstwa Krajowego – BGK, and the Berlin experience with a model of a micro-lending fund from the regional public Investitionsbank demonstrate that sources of financing (national, regional and local authorities, banks), financial tools (grants, loans, equity, etc.) and indirect support (incubation, mentoring, etc.) constitute elements of the same local financial development value chain: each local situation and company requires a different solution depending on individual growth prospects and the respective stage of development. The challenge for both public and private

sector providers of financial resources is how to ensure that the different elements of this chain are integrated and work together effectively. Both examples are innovative because overall European financing tools for innovation at the regional level are still a long way away from having integrated financial supply chains. The reasons for this include:

- Imperfect knowledge among local authorities, SMEs, investors and intermediaries about the available financing opportunities.
- Insufficient willingness to invest:
  - Poor knowledge of investor and entrepreneurial requirements among local authorities.
  - Weak management and financial systems within local authorities seeking financing for entrepreneurs as a whole.
- Difficulties for local authorities in enlisting private financing because they lack the collateral that banks require.

Thus there are several "gaps" in the provision of financing, so that the public sector has considerable scope for action, either by:

- reducing the risk for private sector investors (*e.g.*, through guarantees), or
- using public sector funds to increase the supply of certain types of finance.

The Polish local guarantee scheme of the National Economic Bank BGK is an example of the first mentioned type of action. This scheme is designed in response to the local economic environment, where micro-firms predominate, and where job creation has been a priority for local authorities. In all, the fund has succeeded in generating thousands of new jobs – a significant contribution to regional employment. The local focus of the guarantee schemes is an important reason for its success, because both the providers and the beneficiaries are local, while trust plays a greater role in decision-making.

Within the framework of the "Equal Credit Project" Investitionsbank Berlin developed new financing models for micro-credit, combining public and European money with private volunteer work. This is an example of the second type of action mentioned above. The project pioneered the use of structural funds for revolving loan funds which fostered financial engineering techniques for achieving sustainable use of European financial assistance. The use of professionalised and certified volunteer work by client-supporting mentors and experts for co-financing also represents a further innovation.

Both cases represent models for optimising local financing schemes. They are based on specific regional environments and – in various combinations – bring together local authorities, the financial sector and non-profit organisations. In order to act, public sector institutions need to be clear about what problems they are seeking to address in the financial value chain

as well as the desired outcomes. Without a clear vision of this kind, support schemes are liable to be fragmentary and their impact diminished.

Reducing the risk for private sector investments – the case of a Polish guarantee scheme

Experience has shown that the best results in SME financing are achieved when the public sector works with markets and acts as a catalyst to encourage their development. The increasing risk awareness of banks has led them to expand the use of internal ratings of SMEs; a move which will gradually lead to a rating culture where SMEs need to signal their creditworthiness to the banks, regularly discuss their credit standing and deliver timely information. Thus, to overcome the persistent gap in early-stage financing it is necessary for the public sector to continue to work with the private sector. Most regions in Europe have programmes and institutions that aim to overcome the gap in early-stage SME financing caused by high risk and high overhead costs. Guarantee instruments that are widely and easily available and which share the risk between the private and public sectors effectively address the difficulties experienced by SMEs in getting bank loans. Micro-lending can provide start-ups with decisive assistance, and loan guarantees should be used efficiently in order to promote this. The use of regional and local financial intermediaries and national programmes makes it possible to tailor financial instruments to the various types of financing, thus providing additional leverage to programmes targeted to the financing gap in early-stage SME financing. The experience gained with EU financial instruments shows that loan guarantees are a very efficient way to use limited public funds and directly address the problems of insufficient collateral and intangible assets. Efficient public support mechanisms need to be simple, tailored to local conditions and accessible. This can only be achieved by using local banks and guarantee funds as intermediaries – as is the case with the Polish example of the National Economic Bank (BGK) financial instruments.

This public bank, which pursues cross-border operations, acts as a financial institution behind the scenes: it has no branch offices. It maintains a guarantee fund created by law which includes both government and EU funds. Since the beginning of 1990, economic restructuring in Poland has been supported by the EU in both technical and financial terms, primarily on the basis of the PHARE programme. Initially, the primary purpose of PHARE was to support the restructuring activities of the various economies and create normal market economy conditions. In the countries which were the most advanced in the process of economic and structural transformation – namely countries which applied for EU accession – the principal purpose of PHARE was to support their economic integration into the European Union. In the meantime, Poland has been integrated into the financing of the structural

funds through its membership of the European Union. The guarantee funds which have been earmarked throughout Poland on the initiative of the BGK are divided into a total of sixteen regional funds, *i.e.*, one per region (voivodeship). The guarantee funds made available in the individual voivodeships with federal government resources by the BGK are supplemented with regional funds. Private resources from the capital market are also included on the initiative of the individual voivodeship. The total amount depends on the demands at local level within the region, the so-called *powiaty*. The guarantee fund only becomes available to small and medium-sized enterprises at the level of the respective district, *i.e.*, at the direct local level. There are more than one hundred local "distribution units" within the sixteen regional funds which make the SME guarantees available.

As regards their formal legal status, the local "distribution units" are corporations founded on the initiative of the local authorities of the various districts. The local authorities have to raise the required capital deposit for establishing a corporation and on this basis register it vis-à-vis the voivodeship as a financial intermediary which issues the guarantees that the local enterprises need in order to receive loans from private banks. The BGK has the right to be a member of the supervisory board of the local corporation. Moreover, the local corporation is only recognised as a contracting party by the BGK if the prerequisite standards are satisfied and the prescribed rules of management observed. This includes minimum capital adequacy and process technologies.

The guarantees can be used by companies which lack the collateral demanded by the bank for granting a loan. This applies both to founders of new enterprises as well as existing companies. The maximum guarantee from the fund may cover at most 60% of the loan amount. While the regional fund does not seek to turn a profit, the entrepreneur pays for the privilege of being able to take advantage of the guarantee, and is charged 1.2% of the sum which is to secure the funds. At the same time, the enterprises are provided with the advantage that they not only receive a loan, but that it is less expensive and the enterprise's rating by the bank is raised, thereby increasing its chances of acquiring additional financing.

It is the local corporation which is established on the initiative of the local authority that concludes contracts with the commercial banks in accordance with the respective requirements of a company for a guarantee. At the same time, it is the local authority that specifies the local requirement for use of the BGK guarantees obtained at the regional level vis-à-vis the voivodeship. Thus the initiative comes from the local level. In this manner the use of federal government or regionally earmarked guarantee funds is provided for in a fashion that is not only customised, but oriented toward local conditions. Above all, the local management body for granting guarantees ensures non-

bureaucratic accessibility for the enterprises. In addition, direct routes to the lending bank are provided for the entrepreneur. The banks' practices in extending loans are no longer oriented perforce toward local interests given the general stipulations involved in current loan rationing and in accordance with the overriding principle of corporate ratings. They are in fact faced with local intervention that offers a possibility of compensation that both fits in with banking logic and engenders the mobilisation of local private capital.

It is in this general context that hundreds of local guarantee schemes were founded. Public funding makes it possible to offer long-term guarantees on favourable terms to micro- and small firms by eliminating the barriers facing small innovative companies. As a rule, these include:

Limited access to financing

- SMEs tend to have limited assets, making it harder for them to obtain long-term loan financing.
- Small firms are perceived to be more risky than larger ones (for example, they have higher levels of late or non-payment of instalments and higher failure rates).

Higher financing costs

- SMEs are less able to negotiate good terms for their financing.
- They are generally less well-informed about various financing options.
- They require smaller loans/investments, which are proportionately more expensive.

One example covering several BGK guarantee schemes is currently available in the Polish region of Warmia and Mazury.[5] The local scheme was designed in the light of the local economic environment, where micro-firms (1-9 employees) predominate, and where job creation has been a priority of the local authorities. In general, the voivodship has developed a strategy based on the growth of a specialised tourism sector as the main policy instrument for countering major restructuring problems which have become manifest in this rural and outlying region. The tourism sector SMEs are therefore the main target group for the horizontal facility in this region. This means that the scheme has a very broad focus – guarantees are not restricted to innovative firms, but are also available to firms seeking to add value their current activities.

In the region of Warmia and Mazury each individual guarantee has had a fairly limited impact in terms of the investment generated, creating approximately 1.5 jobs per company and covering an average loan value of about 16 000 euros. However, the fund as a whole has succeeded in generating 916 new jobs – a significant contribution to regional employment.

Using public sector funds – a micro credit scheme in Germany

In the EU Commission report "Micro credit for small businesses and business creation: bridging a market gap" (Directorate-General Enterprise, 2003) the authors concluded that insufficient supply of micro-loans is a major issue when the founders of businesses are unemployed persons, women or belong to ethnic minorities. Supporting the supply of micro-loans is therefore not only an issue of entrepreneurship and economic growth, but also of social inclusion. Banks often look at micro-credit as a high risk low-return activity due to the high failure rate and overhead costs. Although the situation varies between the Member States, banks usually are not active enough in micro-lending. In 1998, the Senate of Land Berlin mandated Investitionsbank Berlin (IBB)[6] to implement a new small loan programme for business start-ups targeted at unemployed people as part of the Employment Policy Framework Programme (ARP). The loans are interest-free and in the beginning had a five year grace period; hence proper evaluation of the repayment rate is not yet available.

In analysing an evaluation study of the Berlin ARP small loan programme it was realised that the demand for micro-credit has yet to be met and that particular target groups should be approached and included in a better fashion. In order to make this happen and also to minimise risk, there should be a system of supporting measures for borrowers of small loans, tailored towards their individual needs. Moreover, fund allocation has to be approved by the regional authorities for each year, with budget restrictions interrupting the programme. In addition, existing micro-enterprises, co-operatives and people with a CV as an artist were unable to access the existing loan programme. Thus, IBB participated in the EU pilot project EQUAL CREDIT, aimed at stimulating regional development and job creation through micro-enterprise start-ups. The project, with partners from eight regions, developed new financing models for micro-credit and business support measures, combining private, public and ERDF-money and thus pioneering the use of European Structural Funds for revolving loan funds.

To complement the existing ARP small loan program for unemployed persons, Equal Credit provided and mediated supporting measures. IBB got in contact with several local organisations to implement a network of existing measures of business support (especially those which are free of charge for the entrepreneurs) through its associate partners. IBB loan officers, who decide on and deliver loans of up to 15 000 euros within the ARP scheme, choose borrowers that have already received a loan or at least a confirmation. These clients were borrowers who would have also been selected even without Equal Credit, but whose risk of failure was higher due to a certain lack of experience, *e.g.*, in business administration, legal matters, marketing,

languages, etc. As the default rate in IBB's ARP scheme is not insignificant, Equal Credit was able to show that support measures can have an impact on success and expand the target group reached.

The Berlin Equal Credit regional project functioned and continues to function as a pilot project for designing a revolving micro-credit fund covering Berlin, building on the existing ARP small loan programme. IBB organised round-tables joined by the representatives of banks, NGOs and local authorities in preparation for this fund during the course of Equal Credit. At the end of the project a comprehensive concept for a revolving micro credit fund was put into effect. The key innovations include:

- private-public partnership, combining private with public and Structural Fund money;
- a revolving fund for the sustainable use of Structural Fund money beyond 2006;
- a combination of small loans with a comprehensive toolkit of accompanying business support measures tailored towards the individual needs of specific target groups (mentoring, experts, qualification, common infrastructure, *e.g.*, common marketing tools such as "market of cultures"); and thus
- expansion of the target group to include more excluded people (from access to finance) – network of volunteer mentors and experts ("*Gründerengel*").

While a coalition agreement of the Berlin government and a resolution by the Berlin House of Representatives have requested a micro-credit fund for Berlin, the political decision-making process has yet to be finalised. Thus it is only a model at this time. It is becoming clear that the initial elements only will be adopted in Berlin and that the granting of micro-credits will be incorporated into a fund for SMEs from which larger loans are also granted. Apart from this process, the EQUAL CREDIT project led to the goal of establishing a fund for a future integrative micro-lending scheme. The micro-loan programme is thus intended to combine the financing of business start-ups and micro-companies by means of loans with individually adapted support measures. The programme includes loans from EU Structural Funds (ERDF), co-financed capital market resources as well as subsidies from a combination of already existing state-financed programs as well as private donations in kind and in time.

The grants to founders of new businesses serve to finance comprehensive support measures which compensate for disadvantages and individual shortcomings in the record of the respective borrowers. The goal is to ensure the sustainability of the new enterprise and thus to minimise the risk of loss of any loans granted. In addition, the IBB loan officers are supported in their decision-making and when it comes to monitoring. If, for example, a shortcoming on the part of the founder of a new business

enterprise can be compensated for, the decisions made by the loan officers are made easier. However, unsuitable ideas for the establishment of new business enterprises can also be filtered out in time. The support measures include:

- support by mentors,
- further training and services provided by experts, and
- common infrastructures.

The IBB provides the back office resources for management of the entire programme and concentrates on its core business, granting and refinancing loans. The micro-credit program provides loans of up to 15,000 Euros (up to 25,000 Euros in the case of several founders) for business start-ups and micro-companies in the establishment and growth phase. Interest is below the market rate and the overall term amounts to six years as a rule. No collateral is required.

This model which was tested within the scope of the EQUAL CREDIT project thus includes an innovative financing idea that implements the principle of public-private partnership. The public resources which become available through the integration of private resources can be used to better satisfy requirements within or outside the bounds of the loan fund. The total volume of local enterprise promotion is increased through the integration of private resources, while the call on public resources is reduced.

Innovative financing models

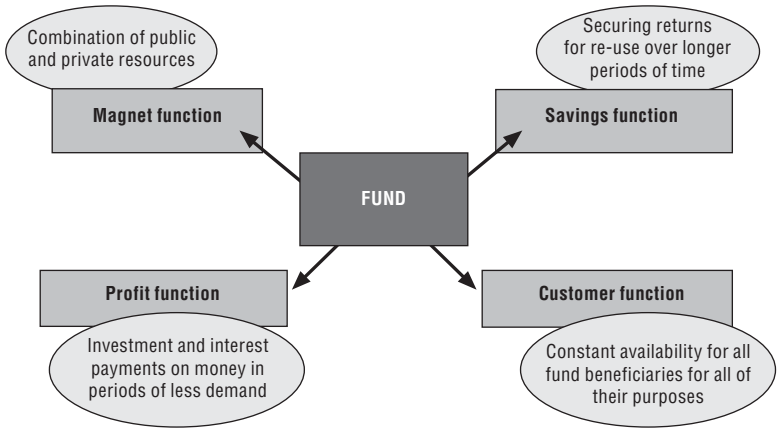
Experience with a number of cases has shown that effective and, above all, long-term, grant of loans, in particular to micro- and medium-sized enterprises can only be realised with the co-operation of various institutions and joint financing within the ambit of a fund. To this end public, private and EU resources are divorced from their administrative connections (*e.g.,* their annual parameters) and combined with each other in a closed system of aid. Through common management, an optimised set of rules and the jointly administered financial envelope, the fund provides for uncomplicated support of the enterprises, oriented toward their respective requirements while at the same time ensuring efficient use of time, money and materials. Those who are willing to establish new business enterprises are no longer sent through an unco-ordinated, vague consulting environment which is not co-ordinated with the respective financing possibilities; on the contrary, the fund ensures that a heretofore inadequate range of recruitment, financing, support and infrastructure support is made available and co-ordinated. Were such co-ordination to only take place via placement and consultations within the scope of a "virtual fund", it would be expensive and imperfect because harmonisation of the regulations is only possible in a closed system of aid.

Financing gaps resulting from annual earmarking of budgetary appropriations or even budgetary freezes are also avoided. The resources in the fund for founders of new business enterprises are available over the entire term. The fund ensures that funds flow back for re-use over a longer period. Finally, unused funds do not have to be paid back in periods of less need. On the contrary, they are invested and bear interest and thus provide the fund with a profit for fund beneficiaries in times of greater demand.

In the fund model inspired by the EQUAL CREDIT project for Berlin public funds are used to finance measures in the public interest. It is a political question of compensating structural deficits and regional disparities caused by market distortions providing equal opportunities. The fact that the market and the competition are relatively unconcerned by the needs of socially disadvantaged founders of new business enterprises must be compensated for through enhanced support, consulting and training as well as infrastructure measures. The bank concentrates on its core business, granting and refinancing loans. By combining public and private funds which contribute to minimisation of the risk – not least for the founders of new businesses as well – the bank can take part in the success or failure of both riskier ventures and the establishment of even the smallest new businesses. Furthermore, the micro credit programme mobilises private, low-cost commitments from so-called "Founder Angels" in the form of donations of time and materials. In this case non-monetary performance through honorary mentors are recorded as an element of monetary value and can be defined as a form of co-financing for purposes of EU funding. The fund takes over quality management and the certification of the voluntary services.

For regions in EU member states or candidate countries it is interesting to note that the Commission of the European Union has expressed considerable interest in the innovative employment of Structural Fund resources,[7] i.*e.*, replacement of the previously techniques of grant promotion by new financial instruments. The EU has promoted its support for the establishment of micro-credit and investment funds in recent years as a component of "financial engineering" with the aim of local development and the creation of new jobs. The primary interest is in the sustained employment of EFRE and ESF resources in revolving funds beyond the current promotional period. In addition, funds enhance the opportunities for raising private money for the purpose of co-financing. On the one hand, this is designed to increase the efficiency of the employment of such funds through greater leverage; on the other hand, the structural fund resources should be available for supporting measures beyond the current promotional period via returns *e.g.*, from revolving funds. The leverage of the structural funds can also be used to integrate additional partners into the promotional instrument such as the European Investment Fund (EIF) in order to spread the risk.

Figure 10.1. **Advantages of a fund model**



Conclusion

The analyses of the Polish and Berlin examples, embodying the presence of local promoters and investors of various sizes, demonstrates the significance of local public policies for financial promotion of the local economy, including private finance. Failure by local leaders to make this happen not only underscores their inability to optimise the leverage effect of targeted public investments, but also the less than optimal economic and social effects of ordinary public services. Without using both public and private financing of these resources to leverage private finance, local economic development transfers public monies to promoters, but this does not revive collapsed local markets, although these markets remain the only guarantee of sustainable local economic development.

The problems of finance facing local economic development are to a large extent structural and require long-term solutions involving the public sector. The Polish guarantee fund experience shows that even under more favourable conditions, *e.g.* in the booming Warsaw region, early-stage venture capital investments continue to be dependent on the participation of the public sector. However, the role of the local public sector should be seen first of all as a facilitator and catalyst, in order to invite the banks, driven by interest rate policy, to exercise more openness and communication. Both examples recognise that, the public sector should set the overall strategic objectives for providing finance and that supervision should be at that level. But management of the financial tools should be carried out on a commercial basis.

The Polish and Berlin experience shows that risk sharing between public and private sectors in a partnership between banks and SME development institutions is an efficient way of alleviating the financing problems facing SMEs. Simplicity and accessibility of support mechanisms must be one of the overriding goals of local economic development policy. The need to promote entrepreneurship on a wide front, taking on board both entrepreneurial growth companies and mainstream SMEs, requires financial instruments that are defined broadly enough to be used for various purposes in line with changing market requirements, such as financing second chance entrepreneurship or transfers of businesses. There is a need to develop markets and work in partnership with the private sector to achieve high leverage. The consistent message from entrepreneurs is that their key task is to run a business, not to deal with bureaucracies. They do not have time for targeted specific programmes that require top-heavy procedures and long processing delays. From the viewpoint of the beneficiary, the simplicity of dealing with their customary bank but getting the benefit of local, regional, national or European public participation is invaluable.

In developing more targeted public sector action in local economic development SME finance, the need is to use limited public funds efficiently, *e.g.,* matching micro-lending for entrepreneurs, mainstream SMEs and entrepreneurial growth companies. It can be effectively promoted through guarantees and by improving the legal framework to facilitate fundraising and lending by micro credit institutions. Micro lending programmes should aim to be sustainable so that public sector support can gradually decline. Co-operation between micro-finance institutions and business support service providers should be encouraged. Guarantee schemes enable banks to provide micro credits because both the risk and the capital requirements are lower.

In local public-private partnership, managed funds are an efficient way to provide loans and loan guarantees because they can use banks to lend further to SME borrowers. Public sector instruments can have both credit and guarantee components, or micro-loans can be provided without collateral. However local authorities in particular should pay attention to balanced distribution of the risk among public-private partnerships. For example, the public assumption of risks and guarantees need not be inflexible. Otherwise, the commercial bank has clearly less incentives to provide quality support to the borrowing enterprise. Other dynamics are possible if public authorities are to take over such bank risks: individual commitments reducing over time. Far more radical, but nevertheless worthy of examination would be performance-based remuneration of company consultants and financiers.

The overall goal should be to encourage private investors to provide the bulk of the financing necessary for local economic development, and in so doing, fulfilling goals of economic equity (small business creation, local hiring)

and social equity (greater home-ownership, education). In spite of considerable experience, *e.g.,* the Polish and Berlin examples, the local finance approach is not yet well established in Europe. Most of the financing for local development, especially in peripheral areas, remains largely public, and so is best administered in large units. As a result, it has been essentially reserved for large national operators or more and more global-market-driven commercial banks, and the difficulty of optimising the local micro-economic effects of public aid and private investment persists.

Notes

1. The Basle Committee on Banking Supervision is currently deliberating on these changes; the New Basle Capital Accord (also known as Basle II) has been due for publication since the end of 2003. Basle II is scheduled for implementation in member countries by 2007.
2. See *La bancarisation des nouveaux marchés urbains*, by Kent Hudson and Crédit Municipal, Economica, Paris, 2004; and Jacques Donzelot's remarkable comparative study of US and French urban policies, *Faire Société*, Seuil, Paris, 2002.
3. *Cf.* Evers, J., "European Regulation for Socially Responsible Banks? Learning the Lessons from the US American Community Reinvestment Act", *Banking and Social Cohesion*, C. Guene and E. Mayo (eds.), 2001, p. 266-277.
4. *Cf.* Evers, J., "Ein internationales Benchmarking für moderne Wirtschaftsförderung", *Die Sparkasse*, 02/2002, pp. 64-68. and Evers, J. and T. Fisher, "Finance for Local Development: New Solutions for Public-Private Action, Handbook for Public Authorities", in English, Italian and French, London and Florence, 2001, in English and Italian as a (hardcover)] book, Hamburg 2001.
5. The Warmia-Mazury region is part of Euroregion Baltic and covers an area of 24 200 square km and is home to about 1.5 million inhabitants. It is situated in the north-east of Poland, bordering the Russian Federation province of Kaliningrad. The capital Olsztyn is situated 220 km from Warsaw and 190 km from the port of Gdansk. The region has three major towns – Olsztyn, Elbag and Elk.
6. IBB is a public agency owned by Land Berlin and was established in 1994 as part of a widespread policy of fostering technology-based innovation. This was needed in order to counteract the decline of the industrial base and the high level of unemployment in the city following reunification. Its overall aim is to promote economic activity within the region, especially in small and medium-sized enterprises (SMEs). In this respect, IBB provides and manages public innovation funds. Several principal programmes also include offering management support in a wider sense.
7. The legal basis for incorporation of EU Structural Funds into regional development measures is formed in particular by Council Regulation (EEC) 1260/1999 of 21 June 1999 with general regulations on the structural funds and Commission Regulation (EEC) 1685/2000 of 28 July 2000 with implementation instructions for Council Regulation (EEC) No. 1260/1999 with regard to the eligibility of expenditure of operations co-financed by the Structural Funds. Several of these provisions include, among other things, the conditions for use of structural funds in innovative financial instruments. As regards Rule 8 of Regulation (EEC) No. 1685/2000: On the basis of the general regulation No. 1260/1999 this regulation contains

implementation instructions for the eligibility of expenditure of certain operations co-financed by the Structural Funds. Apart from regulations for the definition of eligible types of expenditures and payments, financing expenses and costs for the purchase of real estate, Rules 8 to 10 contain stipulations for the eligibility of "financial engineering" instruments. Thus Rule 8 contains regulations on the eligibility of venture capital and credit funds.

ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 11

Community Development Banking to Foster Entrepreneurship: A Comparison between Experiments in Hungary and Poland

by
Željko Šević

Non-government assistance programmes to finance entrepreneurship are particularly suited to the situation of transition economies, as they support the development of efficient markets and the building of social capital. A publicly sponsored network of development banking institutions would promote small business development, assist in the development of entrepreneurial skills, and provide special assistance to disadvantaged areas. It would help by making small business finance more accessible and connected with the provision of necessary advice and assistance. The institutions would be publicly capitalised, but run locally by non-profit organisations in collaboration with local governments and the private sector. Direct involvement of banks is required to supervise performance. While community development banking cannot solve all the problems of initial entrepreneurial finance, it can help to narrow the gap and tackle market failures.

Introduction

Social transformation, although necessary, incurs a cost that many societies are not ready to bear, and the population is not ready to support a venture into uncharted waters. Equally at a micro level, when an individual enters into a new enterprise he or she enters uncharted waters where many challenges await. A person ready to undertake the activity and face the challenges is called an entrepreneur. Developed Western societies were more or less made by the entrepreneurs of their time. In Central and Eastern European Countries the situation is somewhat similar. After many years of Communist rule, these societies have to re-invent themselves and set out on the path of democratisation and creation of a market-oriented economy. As a result of abrupt change and forcible introduction, socialism never matured but rather remained a concept centred around a dominant state, a non-democratic political system and the economics of an inefficient distribution of resources.

With the failure of the socialist concept, many developing countries lost the blueprint which they had tried to follow and, as a distant by-product of changes in Central and Eastern European countries (CEECs), democratisation and social change on other continents, especially Africa and Asia, emerged. All these countries are now in some kind of a transitional process, desperately in need of assistance from abroad, and asking mainly for capital injections from the foreign sector. However, the situation on the world financial markets has changed significantly. With the liberalisation of the economy in former centrally planned economies, many economic agents were allowed to seek funds internationally and the demand for funds increased dramatically. Many countries which baulked at taking up foreign credit (such as Romania) returned to financial markets, interested in raising funds. But in addition to states as borrowers many micro-credit agents attempted to attract additional funds. This makes both sides of the current international financial market even more competitive, amongst borrowers and amongst lenders. Whilst the international market is becoming more competitive for big borrowers and lenders, on the domestic front small and micro-entrepreneurs face a shortage of capital due to adverse conditions. Usually, a small start-up business is not viewed as "economically viable" by classical banks. As they ask for small sums of money, transaction costs are high, and in the final analysis, the banks do not have sufficient knowledge of the creditworthiness of applicants and their

business capabilities and in an increasingly competitive environment, they do not have either the time or willingness to appraise the case of a small entrepreneur, a new entrant into the business world.

The small business "*credit crunch*" was noted as a burning public policy question in the 1960s and the response was the introduction of many government-sponsored schemes aimed at helping prospective entrepreneurs. In countries with an Anglo-American tradition, the government set up an independent agency to deal with the problem, while in administratively-guided economies such as Japan and social-market economies such as Germany and Sweden the programmes were run from within regular government ministries. Continental European countries traditionally prefer fiscal centralisation of expenses and consequently the assistance programmes for SMEs are usually centralised and overseen by the relevant government minister. Although a large number of today's fastest growing companies (such as Microsoft) began as a small business, small and micro-entrepreneurs face serious obstacles in obtaining funds. They are turned down by banks and forced to seek alternative sources of finance, often from private persons. In a similar position are people who are regarded as coming from deprived (underprivileged) areas where bank closures are the rule rather than an unpleasant exception. They have problems in applying for bank credit for their basic needs, since they are not sufficiently "economically viable" to be regular bank customers.

First to deal with this problem was the United States, making it compulsory for commercial banks to reinvest in the community in which they operate. The Community Reinvestment Act of 1977 (CRA, 1977) improved the situation slightly, but did not solve the problem. Finally, the concept of Community Development Banks (CDBs) was developed to tackle the issue. A Community Development Bank (CDB) is, at the same time, a local community policy response to increasing social problems and a bank which follows the same rules as a profit-making banking business. The CDB is the best proof that community action can simultaneously have a social pay-off and generate decent profits. However, the small business credit crunch is not an exclusively US problem, but is a feature shared amongst all *developed* economies, let alone developing and transitional economies. Britain, which has a long history of mutual co-operative credit, has increasingly been paying attention to the delivery of alternative sources of finance, supporting the ideas of micro-credit schemes as a source of financial resources for small business start-ups. This is especially important for neighbourhoods that are inhabited by members of national minorities, neighbourhoods which are as a rule regarded as deprived. A similar idea emerged in other European countries, as the support of small business has been shown to be very important for sustainable growth and small business has proved to be the most adaptable to changes in the

environment, which is a very desirable characteristic in a markedly competitive global economy.

If countries in the developed West face a lack of finance for small businesses, what is to be expected in the countries of Central and Eastern Europe? Certainly not much. Privatisation, as the most important structural change on the road to a market-oriented economy, began with small and medium-sized enterprises, but did not help the regional policy makers to understand the importance of small business. With the liberalisation of the economy and the realisation of regulation requirements, small businesses blossomed in CEECs, but with no or very little help from the State. The state as such was more interested in preparing for the privatisation of public utilities, as that can be a significant source of *extra* public revenue (Šević, 1997). Small business has recently attracted some attention in *advanced* transitional economies (Hungary, the Czech Republic, Poland), but in many respects the public policy response was inadequate, and small business continues to seek finance from many alternative sources of finance, turning to friends and family.

In this chapter we will focus on the problems of defining an entrepreneur, whom we see as a creator of a small and medium-size enterprise (including micro-enterprises that require a special type of financial support such as micro-credit) and an important creator of wealth in the society. Then we will examine what the state and the third (civil) sector can offer and what the possible strategies are for supporting entrepreneurship within a formalised framework. Finally, we look at the different schemes for support to SMEs in CEECs, discussing the feasibility of the CDB model in the wider European context.

The entrepreneur and the SME

Although the terms "entrepreneur" and "entrepreneurship" have been present in business literature for a considerable time, it is very difficult to find or to create one definition on which the theory would agree. Early authors (the 1930s) distinguished several meanings of enterprise: the management of a business unit, profit taking, business knowledge and uncertainty bearing. Economists focused mainly on innovative aspects. Schumpeter wrote in 1949 "the carrying out of new combination we call enterprise" the individuals whose function is to carry them out we call "entrepreneurs" (Schumpeter, 1949). Similarly, Marris and Somerset define entrepreneurship as a "practical creativeness, which combines resources and opportunities in new ways", turning invention into profit (Marris and Somerset, 1971). The entrepreneur can be seen as the owner-manager of a firm (Bannock, Baxter and Rees, 1978), or "the organising factor of production" (Pearce, 1981). Non-economists

usually focus on the specific engagement of resources and socially useful creative behaviour.

Enterprises in a broad business sense can be described (rather than defined) as any business that produces or retails goods, or offers a wide range of business services, including those that provide *financial products*. Definitions of entrepreneurs in Western societies usually focus on the individual, but most developing and transitional economies have been exposed to the late modernisation process, and as such still prefer collectives to a highly developed individualism. This characteristic is usually considered as a remnant of old socialist collectivism, but in our opinion this is not the case. Even countries that pursued a decentralised concept of socialism and allowed a high degree of individualisation, now face the problem that collective categories (nation, local region, etc.) are met with a stony reception by the public. The promotion of national(ism), "creating the others", etc. is politically very appealing and a collective spirit remains the norm, keeping the current political group in power. The concept of common or community action, co-operatives, etc., should therefore not be neglected by any means. But despite the promotion of collectivist concepts the individual entrepreneur is becoming a very important bearer of change. However, a new entrepreneur can be perceived from another perspective as well, but wrongly, in that an entrepreneur, especially a micro-entrepreneur, is seen as self-employed (in private activity), particularly clever and highly independent.

The size of the micro-enterprise poses another problem. Usually, the definition of a small business is stipulated in national law or accounting rules. The definition as a rule has two components: 1) number of employees and 2) size of turnover, or size of fixed assets. The limit by number of employees is usually defined to up to 25 or 50 (Chuta and Liedholm, 1979), and the size of fixed assets should be in the range of USD 50 000 to USD 500 000. Other definitions prefer size of turnover (up to GBP 500 000). Development literature has created a special sub-group of micro-enterprises even smaller in size (up to 10 employees and up to USD 10 000 in fixed assets in the early 1980s). As can be seen, all these numbers are somewhat arbitrary and there is certainly no unique methodology for defining the size and the relative importance of micro-enterprises. Different accounting principles and practices would reveal a fairly wide range of data, all meaningful, but none comparable. A similar problem can be experienced in defining the employed labour force. Some definitions may consider family members as "real employees", while others would disregard them, etc. Often the government itself argues for changes in unemployment methodologies in order to make its statistics more favourable, or even to render past results difficult to compare with current data sets.

The usual mistakes in the study of SMEs are to assume that enterprises have a fixed membership (in fact they may not due to many flexible

employment strategies) or to assume that all SMEs (and micro-enterprises) have a single manager or head; some are better understood as nexus or networks. Another important characteristic of SMEs is that they can move into a different branch of industry quickly, and in a dynamic environment this in fact, often happens. As a result, data collected nationally often cannot be used for international comparative analyses. However, some general characteristics of novice entrepreneurs can be listed. First, at the start an entrepreneur usually tries to keep some kind of old job to secure a monthly income, however small. Often this is reflected in the involvement of a new business in a wide variety of different enterprises in order to make enough working capital to operate easily. Usually, small entrepreneurs are connected closely with their families, whose support is particularly important in the initial phase of business development. It seems that entrepreneurs in CEECs are much more family dependent than in Anglo-American countries. This may be a consequence of late modernisation, or economic difficulties obliging young people to stay in the parental home, as their current income is usually too low for them to afford their own accommodation.

Early studies on small business in developing countries have shown that family labour-intensive firms may have some advantages over out-of-family wage-hired workers. Family-run firms provide long-term training, ensure trust and confidence amongst workers, respond quickly to changes in the economic and political environment, etc. (Benedict, 1968). A small entrepreneur is usually seen as a risk-taker, although there is not enough empirical evidence to support this claim. Strong family ties are usually very helpful even here, as family can be a safety net. Entrepreneurship is seen as a drive for change and advancement, and the question posed is usually: what are the factors that influence entrepreneurial choice and drive? Entrepreneurship is a complex social phenomenon. It is possibly a mild blend of drives, culture, moral values, or even more objective (*quantifiable*) variables such as the presence of market forces and business opportunities. It is really difficult to say what makes a good entrepreneur, but it looks as though a successful entrepreneur requires a combination of 1) innovativeness; 2) curiosity and openness to new ideas; 3) hard and persistent work; 4) orientation towards the future; 5) willingness to save and invest; 6) leadership; 7) acceptance of risk and some would say also 8) selfishness, or even greed. However, the combination of these characteristics may vary considerably from case to case. This explains why entrepreneurship patterns differ across different countries or even different regimes in one country.

SMEs are a very important factor in sustaining changes in transitional economies. They have created a special fully private tier in the economy and are of the utmost importance to supporting the development of that tier, as it generates an environment of efficiency, especially for state-owned enterprises

that are regarded as "too big to fail" and are still, to some extent, protected by the government either directly, or more often indirectly. Polish practice has shown that small firms are able to create new markets, flexible enough to penetrate fully closed markets, employ new technologies, etc. Their dynamism forces the big enterprises to reconsider their efficiency and to think over their development strategies.

One of the problems central to the development of entrepreneurship and SMEs in every country is the accessibility of external finance. While large firms can rely, to a large extent, on retained profits and finance raised externally either on the money or capital markets, SMEs can usually only look towards the banks as a source of external finance. Bank loans are the main, if not the only external source of finance for SMEs. The dynamism of the relationship between financial institutions and entrepreneurs is very important for overall economic development (King and Levine, 1993). An efficient financial sector should be able to fully evaluate entrepreneurs, pool the resources, diversify the risks and value the expected profits from innovative activities. In a changing economy, such as those in CEE, the banking sector is still the best source of finance, given the specific structure of the financial system (Šević, 2003). Banks may be inexperienced in project appraisal procedures, but they are still better developed than the financial markets that are, in any case, even more regulated and in which small entrepreneurs are able to meet hardly any of the requirements for access to funds.

In our view, the role of banks (the banking system) is strengthened by the notorious characteristics that all transitional economies share. The lack of personal savings, the limited supply of venture capital (in-country or from abroad) and general restructuring mean that banks need to work more closely with customers not originating from the former (or still existing) state sector (Šević, 1999). But again, due to scarce resources and the pressure to support big enterprises with a large number of workers, this may make a case for special schemes or even special development institutions. The classical development theory (Oman and Wignaraja, 1991) argued, in the 1970s, in favour of *development banks* (White, 1972) which were to finance the development of the economy, that is, to serve a macroeconomic development function. These banks were state-owned and they worked closely with the central bank and the Ministry of Finance. In some countries where *selective credit* is practised as a monetary policy instrument (Šević and Šević, 1998), the central bank itself had an important development role. But despite the fact that the central bank in developing countries is charged with the function of sustaining both price stability and growth and development (which are usually conflicting targets), it cannot perform the development function successfully in a modern economy without jeopardising monetary stability. Some other alternatives have to be sought. Once again, the macroeconomic aspects of development

are usually in the hands of the government, while some other bodies are in charge of micro-development. In a modern economy, micro-development is also connected with aspects of regional development and the inclusion of a wider community in the development process.

In the former socialist countries, greater participation of local and other communities can be very valuable as all the talents of the community can be used (Murdoch and Marden, 1994). However, the former socialist countries have a particular problem with the public perception of transition which, as a rule, is seen very narrowly as the transition towards capitalism, and individualism. All collectivism, in the popular view, should have disappeared with the fall of socialism. However, there is still enough room for social actions. Social, community action does not mean *state action*. On the contrary, a community action *excludes* the State (the government in the Anglo-American political terminology), and includes independent social forces. However, people in a society that is in transition and at the same time fairly poor have difficulties understanding the concept of social solidarity; they believe that they were mistreated by the state in the past, and consequently feel that now they must evade their duties towards society, which is strangely enough seen through Marxist glasses, as a synonym for the State. Whence we argue that greater *social inclusion* may improve overall social development in former socialist countries.

Rethinking the role of the state in promoting sustainable growth

How is the role of state in economic development defined? There are many different attempts, many historical considerations, but although it has been a hot topic for ages, it is very difficult to give an authoritative outline of the role of the state in economic development and as a promoter of growth. Indeed, is it possible to say what constitutes a good government? Many international organisations (such as OECD) attempt to define good governance in society by stressing the relative importance of social responsibility and accountability, but no one attempts to say what good government is (see: Šević, 2005). In medieval times, it was believed that bad government was characterised by ruin, rape, robbery and murder. In classical right-wing philosophy the government is there to protect a citizen from other aggressive minority groups and allow him or her to live "normally". The concept of "normality" has been usually associated with some kind of "natural order", "natural law" or "natural harmony".

The State has three duties to perform: 1) provide institutions (in the widest sense, establishing the rules of the game); 2) organise income distribution (creating and sustaining the tax system) and 3) promote economic growth (generally increasing the size of the pie which is shared within

society). However, the state may be, on an alternative view, charged to "promote happiness or simply to prevent evil" (Humbolt, 1996). Traditionally, the "supply of institutions" has been equated to Smith's invisible hand, but the neo-classicals who swear by Smith do not really regard institutions as pro-active. They are rather a given variable, beyond societal control. Basic institutions that we associate with the state are the system of property rights and effective and efficient law and order. Anything else the state may provide has more or less ideological connotations. Risk sharing and therefore enforced social redistribution is important for sustaining the stability of the state and society (especially if one sees the state as a form of concentrated society). Finally, combining the set of institutions and putting the state into a societal context can result in a "developmental State". The State that embodies the result must be able to choose the right business for the society, creating a comparative advantage in the right business. These two choices must be appropriately supported by a functioning infrastructure, standards, etc. A developmental state must provide skilled labour and entrepreneurship when or if in short supply. In the early phases of development, a pro-active state can also create a demand within society and this activity can be fruitful.

Sombart in 1913 emphasised the importance of the creative spirit of man and the organisational capabilities of the state (Sombart, 1913). He also pointed out the function of State demand for luxury as a development tool. The State is there to emphasise the importance of education and knowledge in the society. This is not purely normative, but it requires the creation of learned societies, wider access to education, regulation that respects intellectual and other property (definition of property rights, etc.). The establishment of a sound legal system and an effective legal order is also a requirement that strengthens both the society and the role of state within the society. In certain stages of development the State can really be a development tool, especially when it comes to deadlock situations. A high wages strategy, that has the German underlying idea (*Der Mensch und seine Bedürfnisse* – Man and his Needs) led to a situation in which wealth maximisation within the society usually meant maximisation of national wages (and the opposite applies as well). Finally, it leads us to the point that the State can be an entrepreneur and the capitalist of last resort. When there is a lack of entrepreneurship in the society the State must act as an entrepreneur and offer the critical mass that is required for the success of a national development strategy.

A pro-active state develops and treasures new knowledge ensuring that positive systemic effects are present. Ever since the Renaissance, the state has promoted and protected new knowledge and innovation. However, as economic history is perceived only through the definition of classical exchange, the relevance is lost. Instead, focus on production and the

accumulation of social capital is required to appraise the role of the state as keeper of social knowledge and innovation within the society. Emphasising, or rather over-emphasising the importance of perfect markets and perfect competition has led us to view social production through a short-term lens. In the pursuit of the "rational individual" we (the economists) have lost, to a large extent, a sense of collective action. Moreover, in the years of a bipolar world, collectivism was attributed to Communism and in the cyclical witch-hunting manias in the West the promotion of positive collective actions was an unpopular occupation: such actions were seen as destroying the very tissue of individualistic, liberal capitalism, although in fact liberal capitalism has long ago been replaced by "financial institutional capitalism". In systems developed by Leibniz and Wolff there is very little conflict between individuals and the common weal, as the increased knowledge capacity of an individual benefits the society. As Wolff observed, some people collect money, while others collect knowledge. Renaissance scholars appreciated the knowledge, and it was for many of them a starting point. Ignorance was seen as the greatest evil. The state was there to regulate and support positive social enterprises. Unfortunately, the renaissance notion that learning can create development was lost in the classical exchange economy. However, early scholars to a large extent failed to recognise the relative importance of knowledge for different types of entrepreneurial activity. This led to a degree of obsession with industrial development (an over-focus on the manufacturing base). In those conditions our *Homo Feber*, an ancestor of the modern entrepreneur engendered. *Homo Faber*, the innovator and producer, the contrast to *Homo Oeconomicus*, the (free) trader. Classical economics focuses on exchange, accumulation, physical metamorphosis, equilibrium and optimality (Reinert, 1999). In an evolutionary system, no optimality exists, except as a target in the distance (Nelson, 1995). Within this framework, our man can be materialised as *Homo Faber*, that is he (or she) can explore, invent and cumulatively and continuously create (new) knowledge. Through the process of acquisition of knowledge "Man" can better himself (or herself) and passes on the acquired knowledge. In the process of so doing, man must be given a chance to "reinvent" the knowledge, that is to apply the knowledge in a fully innovative way. This is where our modern entrepreneur comes in; leading development, developing new forms of work and improving the knowledge available.

But, again, the modern entrepreneur is not alone! He (or she) has contacts with the society and there is a need for some initial assistance. Assuming that the body of knowledge is present in the society, we are rather interested in looking at the framework, that is analysing what is happening with prosaic material resources, and financial assistance. The classical forms of bank credit and personal debt have been around for ages. However, entrepreneurs are not

usually deemed to be economically viable. A modern society has reinvented venture capital. We say reinvented: high risk financing has existed in the past as well, especially in the times when new daring projects delivered significant societal development in great innovative leaps. For instance, in Ancient Roman times, a form of credit known as the Maritime Loan (*Fenus Nauticum*), brought a revolutionary change to inter-empire trade, when the merchant syndicates supported a captain in his endeavour to launch a dangerous but highly profitable expedition. The members of the syndicate provided funding, but the return of the loan was subject to successful completion of the venture. Today, venture capital is available to cater for the extremely risky entrepreneurial market, but we also need a framework, a programme, etc. for those who are not really in a position to attract speculators. This would encompass those from less privileged backgrounds, but who possess some of the accumulated social knowledge and can contribute to the social capital. This is again the point at which the State comes to the rescue. Different countries design different support programmes. We will look at the very specific American experience of Community Development Banking (CDB), one of the positive achievements of the Clinton administration.

Community Development Banking as such is an entirely American invention, implemented as a policy response to the problem of the credit crunch experienced by the American economy a couple of times during the last few decades. There has been a noticeable decline in the number of independent financial outlets for business, accompanied by a shift in the distribution by size of banks and savings and loan institutions in favour of larger banks, instead of an increase in the volume of funds made available in credits to the economy. Globalisation in banking and financial services has spurred a high level of competition. Competition from large, non-bank financial intermediaries and economies of scale raise the minimum size of the transactions handled by large, diversified financial institutions including commercial banks. These large institutions are most unlikely to be able to meet the needs of small borrowers and small depositors. Practice has shown that this is true. Commercial banks, or rather classical commercial banks, are less able or indeed willing to provide quality financial services for small businesses, or for low-income, low-wealth and deprived households. And practice has shown that the classical banks are reluctant to grant loans to small businesses, which they perceive traditionally as risky, with inexperienced management and without properly established ties with the bank. Small firms are therefore denied loans, and also are unable to establish proper ties with the banking community, ties which are necessary for obtaining loans. The situation is even more difficult as these new firms do not have any market power.

Deregulation of the American financial markets allowed many non-bank financial intermediaries to enter the market. The entry of these new institutions (especially money market mutual funds, see Šević, 1998) tends to support a rise in the rate that has to be paid to attract new deposits. As the costs of attracting funds rise, banks and thrift institutions opt to increase handling fees in an attempt to cover these costs. However, banks have not only increased fees but have also increased other requirements regarding keeping accounts or banking with them in general. There are reports stating that about 34 per cent of households in the US with an income below USD 12 000 did not have deposit accounts in 1993, a significant rise from the 9.5% reported in 1977. One rung higher, 31% of households with an income below USD 18 000 did not have deposit accounts in 1993. Consequently, these households must use cheque-cashing facilities. Most users of cheque-cashing services are low and middle income workers or recipients of social benefits. They also tend to be young and non-white (Caskey, 1993). The fees charged for cashing cheques vary fairly widely, from 1.5 to 15%. The factors that influence the price of a service "are the type of cheque, location and whether the cheque cashing company operates in the state that regulates these activities". As they cannot turn to a bank, less privileged people turn to *alternative* informal institutions, such as pawnshops. In some areas, the interest rate for informal credits can go up to 240 per cent annually. It was estimated that 80% of the "customers" are repeat users, because they lack access to short-term credit provided by banks or credit cards.

Community Development Banks are federally insured and regulated depository institutions that have been organised specifically to provide capital to rebuild lower-income communities. CDBs are also assisted in their tasks by Community Development Loan Funds (CDLFs), and Micro-loan Funds (MLFs). Often micro-loan funds are an aspect of CDBs' activity. MLFs are most often a component of micro-enterprise development programmes that integrate both the economic and human aspects. The individuals targeted by these programmes are usually women, the non-white population and low-income social support recipients. Loans to micro-enterprises range from USD 250 to USD 10 000 to start-up or expand self-employment or micro businesses employing up to five people, normally family members. These programmes have not only significant economic, but also social impact on the community. They are conceived to fight poverty (in the broadest sense), increase incomes, raise self-esteem, stabilise families, develop personal, business and technical skills, create new jobs and role models and finally to speed up the process of community recovery. Micro-loan programmes usually offer additional financial support through co-operation with local banks or credit unions. Micro-loan funds are usually capitalised with grants or loans from charities or

state and federal governments. Sometimes the CRA requirements of commercial banks may be met by channelling money towards this purpose.

Community development financial institutions are charged with: 1) offering credits to low and moderate income people, *small businesses*, and community development projects whose needs for credit are not otherwise being met; 2) providing the necessary technical assistance to borrowers to ensure the success of the loans made and to expand the capacity of borrowers; 3) making credit decisions within their own institutions so that local, regional and state factors, as appropriate, are properly weighted; 4) fostering community-wide economic and social development and 5) enabling disenfranchised individuals and communities to reach self-sufficiency. CDBs were primarily active in small business credit for deprived neighbourhoods and national minorities. These credits were also followed by appropriate technical assistance to different groups and entrepreneurs. This experience helps in developing other support programmes that would improve the overall quality of life in the targeted community (housing, etc.). Small business schemes can also be used towards the purchase of a stake in a small business (that is, equity support). In this way, a creditor will be even more interested in the overall success of a borrower.

Government support is expected to develop in a number of directions :

First, equity capital or the Net Worth Grant programme should be introduced to support the creation of a wide network of CDBs. This programme recognises an important fact that a sufficient level of equity (for for-profit lenders) and net worth capital (for non-profit lenders) is critical to the long-term viability of any financial institution. The small number of CDBs created before 1994 is primarily the consequence of difficulties in raising capital. *Second*, the government should assist in providing grants to cover part of the assistance costs. Specifically, the costs of extending community development loans are higher than the costs of traditional, conventional lending, to a large extent because each loan requires the lender to provide technical assistance to the borrower. This kind of government support can avert liquidity traps for CDBs. Many CDBs in their everyday activities face the challenge of using short-term capital (for non-depository institutions) or deposits to fund long-term projects. *Third*, since CDBs offer technical assistance to their borrowers, human capital development is an important component of the government support agenda. Different types of programmes can be developed to support staff development in CDBs.

The CDBs are increasingly important in serving the development of the whole community, not only in supporting economic advancement. The new, emerging functions also include: 1) a payment system for cheque cashing and clearing, and credit and debit cards; 2) secure deposit facilities for savings and

transaction balances; 3) mortgage financing, home rehabilitation and improvement loans for households, and 4) a commercial banking service for loans, payroll services and advice. Each CDB would offer deposit and savings accounts, cheque cashing services for depositors, the automatic deposit of payroll and government cheques, automatic payments (with customer authorisation) of certain monthly bills, and credit cards (with a small line of credit determined by the customer's credit and deposit history (Papadimitriou, Phillips and Wray, 1993). Despite the initial impression that CDBs are non-profit, charitable organisations, this is not so. CDBs *are for-profit* institutions that target primarily *niche* markets, providing for those who are too small to be served by the traditional commercial banks (Sinkey, 1998) using particular techniques and increasing the chances of enterprise success as they provide technical and other assistance along with the grant of credit. Technical assistance is very important as it increases the general abilities of entrepreneurs and contributes to the overall capacity of human capital in the country.

It is also important to note that CDBs cannot be a major factor in promoting growth and development of the US economy, but they can be (and are) an appropriate public policy response that fills the institutional gap that has widened because of increased competition and high concentration in the banking sector as a whole. As noted above, three new factors have hindered the ability of low-income, low-wealth and often minority residents in certain areas to obtain small business development (usually start-up) credit, namely: 1) increased securitisation of loans (Norton and Spellman, 1991); 2) decreasing numbers of bank branch offices, and 3) the lack of familiarity of traditional banks with communities that are underserved (Minsky, Papadimitriou, Phillips and Wray, 1993). In such a situation, the public policy response must be swift and appealing to the general public. Also, the American concept whereby charities and charitable activities (foundations) play an important role in connecting profitable activities and non-profit community assistance is attractive both to the government and to the public. But can the American concept be (successfully) replicated elsewhere?

Different models for financing SMEs

The problem of financing small businesses development is not only present in transitional and developing economies but also, as we have just seen, in the advanced, developed economies. Most of the problems facing small business development are common to all countries regardless of the structure of the economy or the financial system (Šević, 1996). There is a generally accepted belief that small firms do not have easy access to capital. This claim is also empirically supported. In order to analyse access to capital, one should consider the complexity of a relationship between small firms and

commercial banks. The small firm lodges its application and the first step is to have a bank consider the application. A large number of banks simply do not consider an application submitted by small businesses. If the small business sector is doing well, it is more likely that banks will service small business. As we have already noted, the costs to lenders of business loan appraisal is hardly any cheaper for small loans than for large ones. This high transaction cost poses a barrier to the establishment of a better relationship between banks and small businesses.

Whilst big business banks globally, small business is attracted by a bank's location, regional or geographic scope, etc. It seems that a small firm does not choose a bank for its reputation as a lender to small businesses, but rather because of other convenient features. It is concluded that if a firm applies for a loan to its bank and is denied, then it is most unlikely that the firm will "shop around" and apply to another bank. Access to capital is an issue for firms facing a shortfall of "external" finance. And, as we have seen, small firms are most unlikely to raise finance from retained profit or other "internal sources". An important issue in countries with a well developed banking system is the location of a firm. Usually, firms that have their headquarters in the national capital or regional centres are in a more favourable position to get loans easily, whilst those in remote towns usually lack access to resources. However, a firm in a deprived area is usually able to apply for government-subsidised or supported programmes, or, resulting from a close relationship with the banker, financial sources may somehow be made available. Whilst in developed countries some major trends may be observed at the national level, in transitional countries the best way of analysis is case-by-case. But different transitional countries devote different levels of attention to SMEs and micro-enterprises.

Advanced transitional economies pay more attention to their development whilst others, mainly countries of the former Soviet Union (the Baltic republics excluded), are not yet capable of systematic promotion of small business. The transitional countries of South-Eastern Europe are a specific example of this. Albania, Bulgaria and Romania had highly centralised economies under the socialist regime, and then had, for a while, elected socialist governments that were frightened to implement speedy economic reforms because ostensibly, they were concerned for the social welfare of the population whereas in fact they were trying to protect the inherited nomenclatura privileges. The former Yugoslav republics, now independent states, inherited a fairly decentralised economy in which "deconcentrated social property" dominated. Also, reports on firms in all the former Yugoslav republics have usually been based on ownership structure, rather than size (Bartlett and Hogget, 1996) to an extent such that it was not possible to compare data obtained, or publicly reported. However, there is a logical

explanation for the difference between the situation in the former Yugoslav republics and that in other former socialist countries: from the mid-1960s it was possible to incorporate a small company as a private or (*de jure*) co-operative enterprise, and usually a private firm was a synonym for small business. But by the 1980s, there were a number of private firms which had outgrown the legal constraints that *de jure* were being respected.

The reporting practices remained the same, although it is to be expected that new statistical reporting policies will be implemented, with reference to the size and turnover of the company, rather then to its ownership structure. Since all types of ownership are in all countries and are equal before the law, there is no need for that distinction to be publicly reported. The ownership structure may be important for defining in-company policies and ascertaining the concept of corporate governance that is employed in a company, but it does not affect its size or market power. Of course there are exceptions where the size of a company does not reveal its real market power, due to the existence of some particular political or other ties, beyond the regular market mechanism (Schönfelder, 1998).

Consider the Hungarian case. At the beginning of the transition process, Hungary opted for a moderately fast transition and gradually introduced a market economy from the mid-1980s. Small business development attracted attention in the early 1990s. Due to the restructuring programmes, a large number of jobs were at stake, and it is estimated, according to the Hungarian Central Statistical Office, that over 1.5 million jobs disappeared from 1990 onwards. But in the same period the number of new enterprises increased by a factor of two and a half. In 1995, 1 056 792 enterprises were registered and 1 024 348 or 96.6 per cent had less than 11 employees (CSO, 1995). The ratio remained the same throughout 1997 and 1998. Interestingly from 1995 the number of sole proprietorships was falling, demonstrating that the limited company has become the preferred legal form of business undertaking. In 1997, only 65 per cent of organisations operated as a sole proprietorship, compared with almost 78 per cent at the end of 1994. Also, about 20 per cent of registered enterprises are not active (CSO, 1997). Expecting huge job losses, Hungary promoted a number of different programmes that targeted the working population which potentially could have been made redundant, offering them the opportunity to re-train, upgrade their level of education, acquire new knowledge, etc. This kind of publicly sponsored "contingency preparation" was followed by information on ways to start a new business.

This kind of assistance programme in Hungary has three possible objectives: 1) promoting privatisation (structural changes); 2) assisting existing enterprises to preserve existing jobs and creating new job opportunities, and 3) assisting good enterprises to further expansion and entry into new markets (a kind of export promotion). Classical, traditional

banks are unprepared to support all these programmes on a large scale and still have not developed specific procedures for the assessment of small businesses. They are particularly concerned that the majority of small businesses do not have a long, or indeed any, performance history. Some good examples have emerged, such as the Budapest Bank which tries to establish a lasting relationship with the small business entrepreneurs' community. In a 1993 survey, small business entrepreneurs answered in 70 per cent of cases that their personal finance is an important input into the business either at the beginning or later while in operation. Only some 18 per cent reported using bank credit (CSO Database).

The provider of micro-credit in Hungary is the Hungarian Foundation for Enterprise Promotion, established in 1990 as a quasi-governmental body charged to assist new entrepreneurs and to disseminate entrepreneurial culture. These were fairly broad and responsible tasks, but the Foundation was financially strong enough to "get things moving". At the beginning, the targets were the existing SMEs, with up to 150 employees and net sales revenue of 300 million Forints annually. The instruments used in the campaign were: 1) preferential credits; 2) credit insurance (guarantees), and 3) third-party security and non-refundable credits. It was also generously supported by the EU, through its PHARE Programme. As of 1992, the Programme began to issue grants/credits to newly registered enterprises or those that were in the process of registration (pending recognition of their status as a legal entity). The enterprises were required to have been active for less than two years (24 months), with assets of less than 2 million forints, and sales in the previous year of less than 6 million forints. The number of employees should have been less than 10. The initial credit ceiling was 300 thousand forints, later raised to half a million forints.

The repayment period varies from six months to three years, with a grace period of six months. An applicant must contribute at least 10 per cent, and 70 per cent of the credit must be covered by collateral. Interestingly, the Foundation does not charge any fee. The Foundation is an agency of the central government, but there are also local enterprise centres in municipalities. Hungary, as a country, pays great attention to pro-active, accountable and socially responsible local government (Peteri, 1999). Local enterprise centres throughout the country are in a contractual relationship with the Foundation, but they run their own programmes separately, enjoying almost full freedom of action.

The centres focus their assessment procedures on: 1) the feasibility of business plans demonstrated through realistic cash-flow projections; 2) interview results; 3) sustainability of the project site and 4) collateral. Collateral here is of secondary importance, as the centres focus on the feasibility of the project and the ability of the applicant to complete the

proposed project. By the beginning of 1997, of the 16 990 applicants some 9 333 were granted loans, which gives a rate of successful applications of 55 per cent. Over four billion Forints were granted in these loans. Successful applicants were usually aged between 30 and 39, and interestingly were from cities in the countryside (slightly less then 40 per cent). Almost half of the successful applicants had completed a secondary school education. Despite this success in providing a good support scheme, a number of potential small entrepreneurs still remain outside the reach of these programmes. Positive geographic distribution (an approach not biased towards those located in small towns), cannot hide the fact that the concentration of economic activities is greatest in the capital Budapest. These small credits undoubtedly support the development of small businesses, but other aspects of social development which indirectly influence the overall results remain to be tackled, such as housing, for instance.

Poland tried to establish a similar programme, which was supposed to be locally run. However, an organisation "*Fundusz Mikro*" has recently been established with the idea of extending credit to new start-ups and providing micro-credit to micro entrepreneurs. This NGO is still in its initial phase, but the results reported to date are encouraging. This is of course one of the possible responses to the challenges of a lack of micro-credit. The specifics of these programmes are that they rely on their charitable status and usually depend on at least initial support from abroad, which usually arouses local peoples' suspicion. However, this activity, if endorsed by a large number of people, and seen as an original community action, can achieve significant success.

The theory and empirical studies usually argue that small businesses are not treated favourably. Some research demonstrates that entrepreneurs do not have a particular problem in opening a bank account (the first step in building-up the relationship with the bank), but the going is heavier when it comes to asking for an additional development loan. Research in the Czech Republic (Mladek, 1997) has shown that small entrepreneurs perceive official registration as the most complicated activity (3.338 out of 7.00), while opening a bank account comes at the bottom (1.93), second to registration with the Statistical Office (1.77 out of 7.00). It appeared that getting licenses and a criminal record report are at the top of the list, 2.60 and 2.58 respectively. Those surveyed finance the company's start up with their own money (savings) in 58% of cases. Some 8 % turned to family and friends for a loan, whilst loans from banks accounted for 11%. Only 0.2% of the entrepreneurs surveyed used some kind of public money. Interestingly, no one reported the use of money borrowed on an informal (*alternative*) market, although the option was offered in the questionnaire. But then, if one refers to the size of the bank loans granted, the results are fairly surprising.

The average bank loan approved initially was around USD 480,000, which certainly cannot be regarded as micro-credit. Banks asked for credible collateral, focusing mainly on real estate, premises and plant. However, the firms reporting that they had been turned down when applying for loan finance had sufficient collateral to satisfy the banks. It is difficult to establish why they were refused a loan. Small Czech firms finance their working capital mainly from retained profits (51%), loans from banks (18%), other sources (14%), owners' savings (13%), etc. Credit from suppliers accounts for only 4 per cent. Comparing the samples in the Czech and Hungarian cases, one cannot resist the impression that they are fairly different. Whilst the Hungarian sample is clearly based on micro-business, the Czech one included a number of medium-sized enterprises that boosted good bank results and the size of the average bank credit approved. This is another practical example of the way different countries offer different definitions of the same, or fairly similar things. The lowest common denominator can hardly be found, at the far end.

The usual problem with microfinance has traditionally been reservations on the part of the government, the big banks and big business. Usually, the government was the major source of financing for small businesses. However, with governmental distribution of resources, there is a possible problem with adverse selection and moral hazard. Economic agents may try to influence the manner in which the funds are distributed and reduce the responsibility for the results. The experience of some Asian and Latin American countries in the mid and late 1980s has shown that it is possible to create a sustainable network for micro-financing in these countries, with initial support by the government and donors (here understood not as the major international government-backed programmes, but all those interested in providing the initial capital injection for the micro-financing organisation). Early experience of developing countries (for more see Robinson, 1995) has shown that it is possible to create a sustainable model where the "regular" financial institutions are capable of providing sustainable micro- and meso-credits, without the direct involvement of the government.

However, this requires a clear policy shift, in which the government and the population see microfinance as feasible and desirable in the process of ensuring long-term (sustainable) national economic growth (see: Yaron, 1992a; 1992b). The first step is always to realise that the state-supported subsidised credits are in the long-run unsustainable and counterproductive, especially if they provide finance below the market rate, and do not require the borrower to be exposed to strict market discipline and supervision. It is, however, necessary to change the usually dominant public perception that low-income people are bad bank customers. The experience of the Grameen bank in Bangladesh shows that low-income people can be trustworthy customers, for they perceive a classical business relationship as a personal one and may be

even more appreciative of the effort by a microfinance institution to change the negative perception of banks amongst poor people (see Robinson, 1995 for examples of good practice). The government is expected to provide a sound macro-economic environment with a good regulatory framework. This is pretty much the point at which the government's intervention should cease. Banks as such have to accept that the micro-credit market is a rapidly expanding one, and with the development of entrepreneurial culture within the country it is set to grow even more quickly in the years to come. Therefore, engagement with potential entrepreneurs and innovators is necessary for the expansion of their future business. Historically, banks have used revolving credit as a model to support expansion into uncharted markets (see Šević, 1993; 1999). This type of credit was even used to support national foreign exchange imbalances in the early 1930s by the Bank for International Settlements (Šević, 1993). The revolving credit model allows the bank to monitor a customer's performance and support the customer in the development of his capacities and business. To a large extent, this can also be picked up by the third sector organisations that can target education, training, skills development, etc. (see Robinson, 1995 for some examples).

The development of the CDB model in Europe requires a joint effort by all the stakeholders mentioned: the government, the banking sector (including the central bank and national bank supervisory agency), the third sector (NGOs), and the business sector (indiscriminately defined). Whilst the government's responsibility is to provide stability and national support for the model, the banking sector has to act in a socially responsible way (both responsively and pro-actively), the central bank needs to ensure a sound and robust supervisory model, whilst the business sector should see the benefit of having a solid base of small businesses and lively entrepreneurial efforts for national economic growth and market development. Certainly, the early efforts undertaken in Hungary and Poland that we have focused upon in this chapter have shown what can be achieved when there is good collaboration.

Conclusion: Perspectives for financing social capital

We define social capital as the capacity of society to induce change. This is one of many different definitions of social capital. We believe that the promotion of entrepreneurship in fact strengthens the societal capital. There are no arguments between scholars and development professionals, who concur that small businesses play an important role in developing the economy and sustaining the transition from a socialist centrally-planned to a market-oriented economy. Small businesses also broaden a second tier of the transforming economy, the "pure" private sector. They support the privatisation process, forcing newly privatised firms to compete with them, seeking new solutions, business models, markets, strategies, etc. This is an

invaluable contribution within a changing economy and explains our belief that privatisation of state enterprises will on its own deliver higher economic growth in former Communist countries. There is a need for entrepreneurial excellence, not a re-focus on the exchange framework, in which the part of social capital (understood in material terms) will be redistributed to the new owners. The state may have this function (as we pointed our earlier), but this exercise alone does not deliver a better life and a better society. There is therefore a need to strengthen the focus on enterprises.

The praise by public, academic and professional circles for small business does not *ipso facto* mean that small business does not involve constraints. Both theory and practice (empirical studies conducted by scholars and professionals) have demonstrated that small businesses are at a disadvantage when it comes to applying for a loan. Banks, that is *traditional* commercial banks, are, as a rule, reluctant to grant *small* credits to small, medium-sized and micro-enterprises. They usually hide behind their declared lending policies and strategies, spelling out that the transaction costs for providing small credits are so high that it makes these credits unattractive. Further, banks like to work with a client for a long time before engaging in a pure credit deal. Third, banks are not particularly prepared to deal with entrepreneurs (seen here as people with vision), as brilliant ideas cannot be quantifiable or touchable to serve as a collateral. Fourth, banks are risk-averse when it comes to classical financial instruments. Unfortunately (or fortunately from a systemic point of view), a small business credit/loan will never become an exotic financial instrument. From a bank point of view, there is nothing exotic about granting a small business loan. Banks in CEECs have one additional characteristic, which is that they maintain a close relationship with former or currently state-owned enterprises, and extend credits to them by reason of the government guarantee inherent in most of them. Credits granted to government companies can be indirectly reimbursed through easy access to central bank refinancing facilities. There are many ways to reward banks that adhere to the government's financial policies

This being so, we argue for a publicly sponsored network of development banking institutions, that would promote small business development, assist in the development of entrepreneurial skills, and in the last analysis be able to assist regions and areas that are regarded as *underdeveloped*. Creating institutions that will be a combination of for-profit business and charitable organisation yields a mix that can promote new social values. These institutions would be publicly capitalised, but not publicly run. As a community initiative, they could be run by communities, local governments, etc. A Community Development Banking institution would not be only a bank, but also accompanied by a number of "satellite" structures that would indirectly support the bank's main task of ensuring that a newly funded small

business has all the assistance needed to be successful. Only a successful enterprise repays debt. This kind of programme requires the development of new policy and appraisal procedures, with more voluntary work and involvement of the wider community. This may present a problem in the former socialist countries, where community action can be perceived as unnecessary collectivism.

Generally, Community Development Banking cannot solve all the problems of initial entrepreneurial start-up finance, but certainly it can help in narrowing the gap, making small business finance more accessible and associated with the provision of necessary advice and assistance. Direct involvement of banks in supervising performance and ability to act with early warning, certainly brings a new quality to the bank – the small business relationship, which may sometimes resemble a joint-venture deal. However, one should keep in mind that CDBs are a classical product of the American social environment, and the question is how well they can fit in with the social-market economy that prevails in Continental Europe, which in our view, would certainly need some adjustment in Europe, by both government officials and small business entrepreneurs.

The creation of the financial support network is only one step in a long journey that society must embark on in order to ensure that there is sustainable climate for potential entrepreneurs to be fully understood and supported by society. Creating a climate of understanding and supporting different forms of entrepreneurship is an issue that should be on the agenda of any serious state. In this epoch of the New Economy, the focus on information and strengthening of the pool of knowledge in a society is something that has to be seriously addressed. This is a challenge to a new re-invented state. We believe in the construction of a socially responsible model of CDB in which all the interested stakeholders show respect for each other and work toward the achievement of common aims. The government is to be seen as "an entrepreneur of last resort" (Reinert, 1996, p. 284) that takes a lead in ensuring the accumulation of knowledge that can "spill over" and ensure sustainable economic growth by, supporting local initiatives and partnerships.

The banks are to take the long view and meet the minimum criteria for reinvestment usually set by national laws or central bank instructions, while promoting trust in entrepreneurs as customers and banks as sources of finance for innovators. Entrepreneurs and innovators perceived as respected customers can be a step in the right direction towards securing the financial support for the nascent businesses and underpinning national economic growth. The third (civil) sector can carry out an educational and training task, not only providing potential entrepreneurs with necessary minimum skills, but also educating the population to be supportive of entrepreneurial effort and strengthening the entrepreneurial spirit nationwide as well as the

acceptability of risky decisions that may be taken. Finally, entrepreneurs from low-income regions and backgrounds should be more pro-active and ready to follow their dream and engage more readily in business activities. In other words, the CDB model can work in Europe but in the light of the continent's experience with industrial policy, government policy will have a larger impact than one might normally have expected. But then one should expect that the "hollow State" (see Šević, 2004) might look more to the exercise of its "moral suasion" function and support the civic initiatives more readily, without directly engaging in the processes of economic enterprise. Providing a general framework conducive to the development of micro-financing may be enough, if the other players are in place and there are joint activities in promoting joint tasks. Consequently, the strengthening of the civil society, decentralisation and emphasis on local communities may be a macro-level policy measure that may secure results at micro (finance) level. But, then again, we have learned that in Europe we often look for far too much national policy response that transpires later to require cross-Europe co-ordination – and reconciliation. That time will come with the development of micro-finance model(s) that can truly be called European.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 12

Tackling the Problem of Inadequate Financing for Local Development: The Case of Croatia

by
Dubravka Jurlina Alibegović

Local and regional governments everywhere share the problem of inadequate financing. The main revenue source for financing local and regional development projects is the local and regional budget. The revenue sources for capital projects are limited. The solution for local and regional government is to find additional revenue sources for development projects. Most sub-national authorities are unprepared or unable to take on increased responsibilities for fund raising directed to economic development. In order to tackle this challenge, municipalities and cities must gain the skills and information needed to budget for the current and future years; the ability to understand the impact of borrowing on infrastructure – both annual debt service and annual operational and maintenance expenditures – and the ability to identify, prioritise and plan capital investment. Municipalities and cities facing a shortage of investment capital must be able to identify and analyse technical and financial options and show investors that they have adequate and reliable revenues to meet their debt service obligations.

This chapter explores the role of the local level of government in financing local development projects in Croatia. It explains the present model of financing of local self-government units and, the basic composition of local government revenues and expenditures, and makes an assessment of the strengths and weaknesses of local governments' systems of financing. The chapter then details the potential sources of finance for local development projects. It highlights limitations at the local level of government in financing local development projects. The last section summarises our analysis and offers several recommendations that would lead to improved financing of local development in Croatia.

Present model of financing of local self-government units

Structure of local government revenues and expenditures

Croatia has today a two-tier system of sub-national government. Municipalities, towns and cities represent the local level of government and counties represent the regional level of government. The City of Zagreb has the status of a local and regional level of government.

Following the latest amendments, the territory of Croatia consists of 426 municipalities and 123 towns (cities) at local level, the City of Zagreb and 20 counties at regional level, which makes a total of 570 sub-national units.

Several important laws are the legal basis of the local government financing system.[1] The Law on Local and Regional Self-Government Financing defines sources for financing the operations of municipalities, towns (cities) and counties, various types of taxation, the distribution of funds among the different levels, the tax base, taxpayers, rates, as well as the calculations and forms of tax payment.

Local and regional self-government unit secures revenue through:

- own sources,
- shared taxes,
- grants from the state and county budgets,
- equalisation transfers for decentralised functions, and
- shared revenues,

in addition to

- borrowing.

Local governments' own sources include income from local governments' own property, from county, city or municipal taxes (see Table 12.1), fines, fees, and charges.

Croatian law outlines the distribution of shared revenues between the state and local authorities. Local self-government units are entitled to the revenue from shared taxes and fees collected within their area, at a percentage stipulated by the law. Shared taxes are income tax, profit tax, and tax on real estate transactions (see Table 12.2 and Table 12.3).

The income realised through income tax is distributed in such a manner as to distinguish between municipality and city finances and between decentralised functions in selected public services including education, health care, social welfare and fire-protection, with respect to the special area that a local government unit is part of. A distinct allocation of income tax is provided for the City of Zagreb (47%).

A new distribution of income tax among the state, municipalities, cities and counties was introduced at the end of 2002. It left the share of other shared tax revenues (profit tax and tax on real estate transactions) the same as in the previous year. The share of income tax for municipalities and cities amounted to 34%, increased by the allowance for activities taken over by the units (2.9% share for primary education and 1% for public fire brigades). The share of the state budget in income tax after changes amounted to 25.6%, while the state ceded in full its share of income tax to areas of special state concern, mountainous areas and islands that finance capital projects. The state cedes its share of income tax (25.6%) to municipalities and cities on islands that concluded an agreement on the financing of capital projects of joint interest for the development of islands. Those were mainly water supply and physical planning projects, and the upgrading of transport infrastructure.

Table 12.1. **Local and regional self-governments' taxes**

Municipal, town and city taxes	County taxes
Surtax on income tax	Tax on inheritance and gifts
Consumption tax	Tax on motor vehicles
Tax on vacation homes	Tax on boats and vessels
Tax on idle lands	Tax on gambling machines
Tax on unused commercial real estate	
Tax on unused building plots	
Tax on firm or name	
Tax on the use of public surfaces	

Source: Author's compilation.

The major change in revenue sources for municipalities and counties is the authority to introduce new municipal and city taxes, as well as the possibility of introducing different levels of surtax on income tax[2] depending on the size of the municipality.

The distribution of shared revenue sources between the state and sub-national government has changed. The most significant change is in the distribution of income tax revenues, with a larger part of income tax revenue going to local government units. A special part of income tax revenue is reserved for covering expenditures regarding decentralised functions in primary and secondary education, health care, social welfare and fire protection (see Table 12.2). Local government units that do not have enough resources to finance decentralised functions can draw on equalisation grants for these functions.

The changes described in the financing of the system of local and regional government have focused on one major objective – the transfer of responsibilities in providing part of public services to the local and regional level and at the same time securing revenues to finance the responsibilities transferred.

The amendments to the Law on Local and Regional Self-Government Financing resulted in an increase of the share of public revenues ceded to the municipalities, cities and counties. The share of unconsolidated revenues of local and regional self-government units in GDP increased from 5.6% in 2000 to 7.4% in 2003.

On the basis of available data for fiscal 2003, the respective shares of local and regional budget revenues in consolidated general government budget revenues amounted to 9.40% and 4.67% of GDP. The data show that two major goals of the decentralisation process, greater participation of local and regional self-government in the consolidated general government budget and a more efficient public sector, have not yet been achieved.[3]

The share in the distribution of revenue from profit tax for municipalities, towns and cities is 20%, for counties 10%, and for the state 70%.

Table 12.2. **Distribution of shared taxes**

Shared taxes	Central government budget	Counties	Municipalities, towns and cities
Income tax	25.6% share of income tax for equalisation fund 21%	10% + additional share of income tax for decentralised functions 9.4%	34% + additional share of income tax for decentralised functions 2.9%
Profit tax	70%	10%	20%
Tax on real estate transactions	40%	–	60%

Source: Author's compilation.

Table 12.3. **Additional share of income tax for decentralised functions**

Function	Additional share of income tax, %
Education	
Primary	2.9
Secondary	2.0
Health care	
Health care institutions	2.5
Social welfare	
Social welfare centres	0.4
Old age homes	1.6
Fire protection	
Public fire brigades	1.0

Source: K. Davey, "Report on Fiscal Decentralisation in South Eastern Europe", SEE Ministerial Conference on "Effective Democratic Governance at the Local and Regional Level", Zagreb, 26 October 2004, p. 4.

The share in the distribution of revenue from tax on real estate transactions for municipalities, towns and cities is 60%, and for the state 40%.

Regarding grants, transfers or subsidies, a system of financing community needs has been designed in such a way that grants are used solely as funds to support local self-government units with poor fiscal capacity.[4]

Equalisation grants for decentralised functions are drawn from the state budget to cover public expenses in the area of primary and secondary education, social welfare, and health care and fire protection, which are transferred to local and regional self-government units.

Shared revenues of the state, municipality and city is the revenue from agreed annual concession fees for pumping mineral and thermal water, and for the use of water for the public water supply.

Apart from the aforementioned taxes and grants, local self-government units have numerous other revenues in application of special acts or decisions of representative bodies, such as charges and fees, which are contained in the non-tax revenues of their budget and set forth there.

Viewed as a whole, current revenue accounts for the major share of the total revenues of municipalities, cities and counties. The share of capital revenues amounted to 4.6% in 2003. The share of grants amounted to 14.6% in 2003. The share of tax revenues in total revenues was 56% (see Table 12.4).

The largest share of the tax income of sub-national government units is collected from their share in the distribution of revenues from shared taxes (income tax and surtax on income tax[5] and profit tax). Altogether, it accounts for approximately 50.5% of total revenue in 2003.

Own tax revenues of sub-national budgets amount to only 2.5% of the total tax revenues of towns, municipalities and counties.

Table 12.4. **Total revenues and grants of sub-national budgets, in 000 HRK and %**

Revenues	2002		2003	
I. Total revenues and grants	9 595 090	100.0	10 554 899	100.0
I.A. Total revenues	8 328 336	86.8	9 008 108	85.4
I.A.I. Current revenues	7 830 809	81.6	8 527 776	80.8
– Tax revenues	5 477 139	57.1	5 906 130	56.0
Income tax and surtax	3 863 377	40.3	4 083 336	38.7
Profit tax	1 055 017	11.0	1 244 040	11.8
Property tax	329 418	3.4	315 914	3.0
Sales tax and other taxes	229 326	2.4	262 839	2.5
– Non-tax revenues	2 353 671	24.5	2 621 646	24.8
I.A.II. Capital revenues	497 527	5.2	480 332	4.6
I.B. Grants	1 266 754	13.2	1 546 792	14.6

Note: Data refers to 53 local government units (20 counties, the City of Zagreb and 32 big cities).
Source: Ministry of Finance, 2004. Annual Report of the Ministry of Finance for 2002-2003 Year. Zagreb: Ministry of Finance. Available from *www.mfin.hr/godisnjak*.

Non-tax revenues of all sub-national budgets amount to 24.8% of total revenues and grants. If non-tax revenues are added to the own tax revenues and capital revenues, the share is considerably higher, rising to 31.9% of total sub-national budget.

In the structure of total expenditures of local and regional self-government units, current expenditures amounted to 72.8%. The largest share of total expenditures is accounted for by expenditures for the purchase of goods and services, transfers and labour expenditures (see Table 12.5).

Table 12.5. **Sub-national budget expenditures, by economic classification, in %**

Expenditures	2002		2003	
I. Total expenditure and lending minus Repayments	8 770 288	100.0	10 458 376	100.0
II. Total expenditures	8 680 768	99.0	10 296 246	98.5
III. Current expenditures	6 863 830	78.3	7 617 598	72.8
1. Wages and employer contributions	1 900 678	21.7	2 001 555	19.1
2. Material expenditures	3 270 658	37.3	3 551 369	34.0
3. Financial expenditures	111 620	1.3	75 639	0.7
4. Subsidies and other current transfers	1 580 874	18.0	1 989 036	19.0
IV. Capital expenditures	1 816 938	20.7	2 678 648	25.6
V. Lending minus repayments	89 520	1.0	162 130	1.6
Overall deficit/surplus	824 802	9.4	96 523	0.9

Note: Data refers to 53 local government units (20 counties, the City of Zagreb and 32 big cities).
Source: Ministry of Finance, 2004. Annual Report of the Ministry of Finance for 2002-2003 Year. Zagreb: Ministry of Finance. Available from *www.mfin.hr/godisnjak*.

The strengths and weaknesses of local government finance

The problems of financing municipalities, towns, and counties are complex and call for continual monitoring and analysis, constant adjustment, and proposals for further research.

Two major issues that affect intergovernmental finance need to be pointed out: first, changes in administrative and territorial organisation and second, frequent changes of laws.

Constant changes in administrative and the territorial setup of Croatian territory at local and regional level have made it impossible to evaluate the new approach to the overall intergovernmental finance system.

The existing organisation of local and regional self-government is not efficient in terms of fiscal capacity; this is indicated by the data obtained from budget analyses. Abolishing the autonomy of local self-government units and merging them with neighbouring municipalities and towns, or any other change which would affect the present territorial organisation, is not an approach which should be supported at this time. Before making such a radical change, the existing possibility of connecting municipalities, towns and counties should be drawn on to implement development projects which cannot be financed individually.

The laws that determine various aspects of intergovernmental finance have been modified quite frequently and these frequent changes have also affected local and regional financing in many areas. Such practices create much uncertainty regarding the ability to forecast long-run revenues and expenditures at local and regional level.

Few local government units are able to manage the financial aspects of their development needs using advanced techniques, such as project budget planning methods or the conduct of long-term benefit studies of the local financing strategies. About one third of local government units in Croatia cannot cover current expenditures with current revenues, yet the basic responsibilities to be financed are equal for all local government units. This raises the local and regional government units' dependence on central government transfers to provide the mandatory services: indeed, even the mandatory services may not be provided assuming no sanctions will apply. This means that the financing of local development projects in future will depend on available revenues from the state budget.

Sources for financing local development projects

Local governments everywhere share the problem of inadequate financing. The structure of expenditures in local budgets shows that current expenditures tend to exceed the availability of resources. For reasons of

economic development the structure of expenditures needs to be completely different.

The lack of public funds is the predominant reason for the involvement of the private financial sector in providing local and regional investment and development projects. Apart from the lack of public funds, there are several other reasons for involvement of the private sector in the financing of development projects:

- increasing local and regional needs,
- inadequate structure of local and regional revenues,
- the size of local and regional development projects, and
- limitations regarding borrowing at local and regional level.

Several potential sources for financing local development projects could be tapped. They are reviewed in the following section.

Local and regional budget

The Law on Local Self-Government Financing and the Law on the State Budget govern the drafting, adoption, execution, balance and reporting of local and regional budgets and transfers between sub-national and central government.

Total revenues and grants to municipalities, cities and counties in 2003 amounted to HRK 10.6 billion. In the structure of total revenues, the outturn of current revenues accounted for the largest share. In 2003 capital revenues amounted to HRK 480 million, but their share in total revenues was only 5%. Since capital revenues are derived from the sale of assets that are mostly in the ownership of cities and municipalities, and to a lesser extent in the ownership of counties, their share in budgets of cities and municipalities was higher as well.

Capital expenditures in 2003 were financed not only out of capital revenues, but also from the outturn of current revenues, unutilised funds carried forward from the previous year, and the proceeds of borrowing.

The largest share in total capital expenditures (78% for 2002 and 75% for 2003) was accounted for by expenditures for acquisition of fixed material assets (communal infrastructure, school and health institutions, cultural objects, pre-school institutions, business zones, business buildings, reconstruction and construction of roads, sports and recreation centres, etc.).

Capital transfers accounted for 19% of transfers in total capital expenditures for 2003, 4% up on 2002. They were mainly earmarked for non-profit organisations for non-economy investment, procurement of equipment and procurement of material assets by companies owned by local units.

Local borrowing for capital purposes

There are two methods of local borrowing for capital purposes:

- through loans from financial institutions and other credit institutions, and
- through the capital market (issuance of securities and municipal bonds).

Loans

The most revolutionary change put into effect by the relatively new legislation in transition countries was to give local and regional government power to contract medium or long-term loans for public investment of local interest or to refinance the local public debt. Previously, such investments were financed solely from their own revenues plus central budget transfers, which created difficulties due to delays in approving and transferring funds from the central budget to local budgets. All loans contracted by local and regional authorities are part of total public debt in a country. However, such loans are not the responsibility of the central government, and they must be repaid out of the incomes with which they were guaranteed by local and regional authorities.

Local and regional authorities can contract internal loans with a government guarantee and with the approval of the Ministry of Finance.

The situation in Croatia is more or less the same as in most transition countries. In the absence of capital revenues, and with a view to meeting the needs for financing capital projects, local and regional self-government units were given the opportunity to borrow in line with the provisions of the Budget Law on the Execution of the State Budget and the Instructions of the Minister of Finance.

The Law on the Execution of the State Budget for 2002 and 2003, stipulates that counties, cities, and municipalities may borrow only in the domestic money and capital markets, and that contractors undertaking capital projects are to be financed from their budgets. This is confirmed by the representative body with the preliminary approval of the government.

For the first time in 2003 restrictions were imposed by the decisions on the execution of the budget which stipulate that the operating revenues and revenues from sale of material assets are should equal or exceed the operating expenditures and expenditures for acquisition of material assets, and that the Croatian Government may issue approvals for borrowing of local and regional self-government units not exceeding 2% of total planned expenditures of all local and regional self-government units covered in the financial report.

In addition, the municipalities, cities, and counties may guarantees borrowing by a public institution or company of which they are the founder and majority owner. The guarantee mentioned above is included in the annual

borrowing of the respective unit. The annual liability for loans, guarantees, and other outstanding commitments (arrears) may account for no more than 20% of the own properties of units, and is subject to the approval of the State Audit Office and the Ministry of Finance.

Local borrowing is authorised by budget legislation. Short-term borrowing has aimed to cover cash flow irregularity and must be repaid within the same fiscal year. Long-term borrowing has aimed to finance capital investment expenditures in accordance with criteria to be specified and debt can be incurred domestically.

Local borrowing limits are defined annually in the State Budget Act, which leads to the risk that the framework for borrowing will evolve in an unpredictable manner.

Municipal bonds

Municipal bonds are securities issued by a state, city, or local government. Municipalities issue bonds to raise capital for their day-to-day activities and for specific projects that they may be undertaking (usually pertaining to development of local infrastructure such as roads, sewerage, hospitals etc). Interest on municipal bonds is generally exempt from federal, state and local taxes.

Capital gains however are taxable. Given the tax-savings they offer, municipal bonds are often bought by people who have high tax liabilities. The yields on municipal bonds are often lower than on corporate or treasury bonds with comparable maturities, because of the considerable advantage of exemption from federal tax. In general, municipal bonds are considered safer than corporate bonds, since a municipality is far less likely to go bankrupt than a company.

Some municipal bonds can also be insured by outside agencies. These companies will promise to pay the interest and principal if the issuer defaults. Both issuers and bondholders can carry this insurance, though a bondholder would need to have a large stake to obtain coverage.

There are two common types of municipal bonds: General obligation and Revenue. General obligation bonds are unsecured municipal bonds that are backed simply by the faith and credit of the municipality. Generally, these bonds have maturities of at least 10 years and are paid off with funds from taxes or other fees. Revenue bonds are used to fund projects that will eventually create revenue directly, such as a toll road or lease payments for a new building. The revenues from the projects are used to pay off the bonds. In some cases the issuer is not obligated to pay interest unless a certain amount of revenue is generated.

In the United States, municipal bonds usually come in USD 5 000 par values and require a minimum investment of USD 25 000 in order to get the best price. (*www.investorwords.com /3162/municipal_bond.html*)

There are only a few examples of municipal bonds being issued to raise capital for local development project in Croatia.[6]

Privatisation

Privatisation means the repurchase of all of a company's outstanding stock (the shares of a corporation that have been issued and are in the hands of the public) by employees or a private investor. As a result, the company is no longer publicly traded. Sometimes the company may have to take on significant debt to finance the change in ownership structure. A company might want to go private in order to restructure its businesses (when it feels that the process might affect its share price adversely in the short run). It might also want to go private to avoid the expense and regulations associated with remaining listed on a stock exchange.

Privatisation also means the process of moving from a government-controlled system to a privately-run for-profit system.

The aim of introducing the private sector into the provision of public services is to provide additional resources for financing public programmes for different public services. The concept of privatisation includes participation of the private sector in the construction, ownership, organisation and supply of public services. The concept can be applied to different kinds of infrastructure projects (for example, water supply, wastewater and solid waste, public transportation, etc.).

The private sector has several advantages over the public sector in the provision of public services. The most important is that it may secure resources for the social, economic and developmental needs of a local community without additional financial effort by the community. This means that the local government, with the help of the private sector, will receive additional revenues for public services, supplementing limited local revenues for financing other public needs.

In Croatia the privatisation of companies whose majority owner or founder is a sub-national government unit has now started.[7]

Public-private partnership

A public-private partnership (PPP) is a partnership between the public and private sectors for the purpose of delivering a project or service traditionally provided by the public sector. PPP recognises that the public sector and the private sector have each certain advantages relative to the other in the performance of specific tasks. By allowing each sector to do what it does best, public services and infrastructure can be provided in the most economically efficient manner.

There are several models of PPP, with variations and combinations, that the local authority may turn to for undertaking infrastructure projects:

Build-and-Transfer (BT): A contractual arrangement whereby the developer undertakes the financing and construction of a given infrastructure or development facility and after its completion hands it over to the government, government agency or the local authority. The government, government agency or the local authority will reimburse the total project investment, on the basis of an agreed schedule. This arrangement may be employed in the construction of any infrastructure or development projects, including critical facilities which for security or strategic reasons must be operated directly by the government or government agency or the local authority.

Build-Lease-and-Transfer (BLT): A contractual arrangement whereby a developer undertakes to finance and construct an infrastructure project and upon its completion hands it over to the government or government agency or the local authority concerned on a lease arrangement for a fixed period, after which ownership of the facility is automatically vested in the government or government agency or the local authority concerned.

Build-Operate-and-Transfer (BOT): A contractual arrangement whereby the developer undertakes the construction, including the financing, of a given infrastructure facility, and the operation and maintenance thereof. The developer operates the facility over a fixed term during which he is allowed to charge facility users appropriate tolls, fees, rentals and charges not exceeding those proposed in the bid, or as negotiated and incorporated in the contract, to enable the recovery of the investment in the project. The developer transfers the facility to the government or government agency or the local authority concerned at the end of the fixed term specified in the concession agreement. This includes a supply-and-operate arrangement, which is a contract whereby the supplier of equipment and machinery for a given infrastructure facility, if the interest of the government, government agency or the local authority so requires, operates the facility providing in the process technology transfer and training to persons nominated by the government, government agency or the local authority s.

Build-Transfer-and-Operate (BTO): A contractual arrangement whereby the government or government agency or the local authority contracts out an infrastructure facility to a developer to construct the facility on a turnkey basis, assuming cost overruns, delays and specified performance risks. Once the facility is commissioned satisfactorily, the developer is given the right to operate the facility and collect user levies under a concession agreement. The title of the facilities always vests in the government, government agency or the local authority.

Contract-Add-and-Operate (CAO): A contractual arrangement whereby the developer adds to an existing infrastructure facility which it rents from the

government, government agency or the local authority, operates the expanded project and collects user levies to recover the investment over an agreed franchise period. There may or may not be a transfer arrangement with regard to the added facility provided by the developer.

Develop-Operate-and-Transfer (DOT): A contractual arrangement whereby favourable conditions external to a new infrastructure project which is to be built by a developer are integrated into the BOT arrangement by giving that entity the right to develop adjoining property and thus enjoy some of the benefits flowing from the investment such as higher property or rent values.

Rehabilitate-Operate-and-Transfer (ROT): A contractual arrangement whereby an existing facility is handed over to the private sector to refurbish, operate (collecting user levies in the operating period to recover the investment) and maintain for a franchise period, at the expiry of which the facility is turned over to the government or government agency or the local authority. The term is also used to describe the purchase of an existing facility from abroad, importing, refurbishing, erecting and consuming it within the host country.

Rehabilitate-Own-and-Operate (ROO): A contractual arrangement whereby an existing facility is handed over to the operator to refurbish and operate with no time limitation imposed on ownership. As long as the operator is not in violation of its franchise, it can continue to operate the facility and collect user levies in perpetuity.

Design-Build (DB): The private sector designs and builds infrastructure to meet public sector performance specifications, often for a fixed price. Here, the risk of cost overruns is transferred to the private sector. (Many do not consider DBs to be within the spectrum of PPPs).

Operation & Maintenance Contract (O & M): A private operator, under contract, operates a publicly owned asset for a specified term. Ownership of the asset remains with the public entity.

Design-Build-Finance-Operate (DBFO): The private sector designs, finances and constructs a new facility under a long-term lease, and operates the facility during the term of the lease. The private partner transfers the new facility to the public sector at the end of the term.

Build-Own-Operate (BOO): The private sector finances, builds, owns and operates a facility or service in perpetuity. The public constraints are stated in the original agreement and through on-going regulatory authority.

Build-Own-Operate-Transfer (BOOT): A private entity receives a franchise to finance, design, build and operate a facility (and to charge user fees) for a specified period, after which ownership is transferred back to the public sector.

Buy-Build-Operate (BBO): Transfer of a public asset to a private or quasi-public entity, usually stipulating under contract that the assets are to be

upgraded and operated for a specified period of time. Public control is exercised through the contract at the time of transfer.

Operation License: A private operator receives a license or rights to operate a public service, usually for a specified term. This is often used in IT projects.

Finance Only: A private entity, usually a financial services company, funds a project directly or resorts to various mechanisms such as a long-term lease or a bond issue.

There are several interested partners in PPP. These are: public (especially consumers), building contractors, operators, maintenance services, suppliers, loan capital providers, investors and insurance companies.

Public-private partnership holds the promise of increasing the supply of infrastructure projects and other services without overburdening a country's public finances. An inflow of private capital and management can ease fiscal constraints on infrastructure investment and boost efficiency.

But PPP should be treated with great care. It is by no means certain that PPPs will be more efficient than traditional public investment. PPP can be used to move investment off budget and transfer debt off the government balance sheet, but the government still carries most of the risk and faces potentially large costs that will eventually be borne by taxpayers.

If PPPs are to deliver high-quality and cost-effective services to consumers and the government, there must be adequate risk transfer from the government to the private sector. The quality of services has to be contractually specified so that payments to service providers can be linked to performance and the risk of costly contract regeneration minimised. There has to be either competition or incentive-based regulations (Hemming and Ter-Minassian, 2005).

In Croatia there exist only a few examples of PPP. The majority of them are concession agreements for usage of some infrastructure projects.

External support and aid

An important source for financing of local and regional development projects in Croatia is the proceeds of loans and grants received from the international financial institutions – the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD), the Council of Europe Development Bank (CEB), and the European Investment Bank (EIB).

The IBRD has provided grants for the social and economic recovery project from funds received from the foundation set up by the government of Japan. The aim is to increase social cohesion in the area of special state concern (war damaged areas, undeveloped areas and the islands).

The plan of activities of EBRD in Croatia involves some infrastructure financing, including encouraging the marketing, liberalisation and privatisation of infrastructure services.

The CEB is to finance infrastructure in the areas of special state concern by new loans currently under preparation.

The EIB has a mandate to finance infrastructure projects and private sector development projects in Croatia.

Extra budgetary resources

There are two major sources of extra budgetary funds[8] for financing local and regional capital projects. These are:

- the Fund for Regional Development, and
- the Fund for Development and Employment.

The major activity of the Fund for Regional Development is the stimulation of uniform regional development in the country at large. Revenue sources include the proceeds of: privatisations, the state budget, long-term bonds, loans from financial institutions, bilateral loans, donations, and other revenue sources.

In 2003 a total of approximately HRK 112 million was disbursed by the Fund for Regional Development for capital projects to the areas of local and regional self-government units. Incentives for the development of municipalities, cities and counties are planned within the funds of several ministries. This is mainly for co-financing of development programmes in the area of crafts, agriculture, small and medium-sized enterprises, etc.

The major activity of the Fund for Development and Employment as regards local and regional development is support to county programs that invest own-revenues for employment programs, development of enterpreneurship and construction of infrastructure facilities, as well as help and support in the establishment of business centres, development centres, industrial zones, incubators and technological parks. Revenue sources come from the proceeds of sales of state real estate, privatisation, state budget transfers, and other revenue sources.

Limitations at local level in financing local development projects

There are limitations at local level of government in financing local development projects. Several factors are recognised as major obstacles to local development financing.

The majority of small local authorities in Croatia are unprepared or unable to take on increased responsibilities for fund raising for economic development. This is because these authorities do not employ appropriately

trained administrative staff. In most such small local self-government units, the staff members are responsible for different tasks (financial, legal, technical and other) and they do not have a chance to try to specialise in one business area. Local government officials and professionals lack know-how for assessing real and financial needs and accordingly lack the necessary communication and networking skills. This reflects into the many miscalculations observed in the current activities and planning of development projects. The result is a series of important obstacles to raising funds, especially for undertaking local borrowing for capital purposes.

In order to borrow responsibly, municipalities and cities must have:

- the skills and information to budget for the current year and future years (including both operating and capital budgets);
- the ability to understand the impact of borrowing on infrastructure (both annual debt service and annual operational and maintenance expenditures); and
- the ability to identify, prioritise and plan capital investment.

Municipalities and cities must be able to identify and analyse technical and financial options and show investors that they have adequate and reliable revenues to meet their debt service obligations (Kandeva, 2001).

Sometimes the difficulties stem from a lack of investment capital. The problem lies in the structure of expenditures in local government budgets whereas sub-national government is responsible for covering a wide range of public services.

Recommendations for improving the financing of local development

Local and regional governments everywhere share the problem of inadequate financing. The main revenue source for financing local and regional development projects is the local and regional budget. The revenue sources for capital projects are limited. The solution for local and regional government is to find additional revenue sources for development projects.

Most sub-national authorities are unprepared or unable to take on increased responsibilities for fund raising directed to economic development. One major problem is a lack of investment capital. Several other problems arise because of inadequate knowledge of regional and local administration regarding a need for implementing a clear strategy of regional and local development. The strategy has a major duty to render explicit the roles of the major actors involved in regional and local development.

Capital projects and programs hold considerable promise as ways to mobilise resources to provide results at local level. A clear strategy of regional

and local development is one of the modern approaches aiming to create conditions for testable and balanced development of particular regions of a country, to reduce inter-territorial differences in employment and income and to realise regional and cross-national co-operation and integration. Financial resources for regional and local development should come from the budget but in the near future major financial resources should come predominantly from other sources.

Partnership between central, regional and local government, non-governmental organisations, private sector and all other major actors involved in regional and local development will create useful forms of efficient interaction, such as the participation of representatives of different institutions in the activities, initiatives, and procedural rules for consultations on drafting budgets or planning major capital projects in local areas. The existence of an active network of different actors is indicative of the awareness of the need for joint action and inter-institutional co-operation in revenue raising for local and regional development.

Finding money to invest in infrastructure and other public projects without jeopardising fiscal stability has become a hot topic in many countries seeking to boost economic growth. While looking for innovative ways to expand the private sector's role in providing infrastructure and other services, many countries are also focusing on how to make more room for public spending. The limitations are generated by two fiscal constraints: the overall fiscal balance and gross public debt, which are key fiscal indicators used by the IMF. These two indicators establish links between short-term macroeconomic stability and longer-term public debt sustainability.

The theoretical literature suggests that the poorer regions and local areas spend a larger proportion of their budgets on social expenditures, while their lower revenue base means that their per capita spending on such items remains significantly below that of the richer regions and local areas. There is evidence that the shares of spending on social items and on capital items are inversely related. Richer regions and local areas use their higher revenue capacities to finance more capital spending. Such conclusions have several important implications:

- lower capital spending may influence slower growth in poorer regions and local areas;
- lower economic growth means that the revenue capacities of poorer regions and local areas will continue to lag behind those of richer regions and local areas;
- in the absence of an adequate equalisation system, lower revenue capacities would doom poorer regions and local areas to inadequate social spending and

poor development of human capital, reinforcing the lower growth prospects in the future (Ter-Minassian, 1997).

To perform their major role in co-ordination and promotion of regional and local development, regional and local governments faces three main challenges.

The first is to improve the quality and operational efficiency of local and regional governments at the lowest cost. This implies raising local administration productivity, reducing public costs (central state, regional, municipal and city and other), rendering transparency in local government activities, and actively involving the community and citizens in local government.

The second challenge concentrates on restructuring the relationship between local governments and citizens and acknowledging that citizens are the customers of the local administration. The shift of focus to citizens as clients in the public sector depends upon two principal considerations. First, citizens are users of public services provided by local authorities for which they pay either directly or indirectly through the collection of fees and taxes. Second, any particular public service has a value, price and quality that have to correspond to the needs and requirements of citizens in their capacity as taxpayers and users of these services. Since citizens are clients in the public sector, they have to be protected against possible discrepancies in the "price-quality" correlation.

The third challenge is adjustment of local governments and local administration to the requirements and conditions of economic development of local and regional areas. Thus, it also includes the search for a reasonable balance between the public and private sectors at the local level and the use of private sector methods and approaches in local public management. Public procurement and other forms of contracting are tools of modern local government.

The growing trend to liberalisation, the shortage of funds in practically all budgets and the process of internationalisation are creating new market conditions in the infrastructure of transport, energy, environment and communal services. This means that public-private partnership is the keyword for development at state, as well as local and regional level. The state's control function is coupled to the operational efficiency of the private economy. Practice shows that PPP represent a viable and actively used project financing alternative in cases where the project is of sufficient size and has a high degree of self-financing secured by cash flow and in cases where efficiency improvements can be successfully realised.

The government of Croatia has started the process of decentralisation, moreover retaining it as the principle of its future work in many areas. The

government has continued to express confirmation of its political will to pursue decentralisation. However, no documents presenting a detailed, implementation-level programme have been approved that set forth the objectives, work out the methods, impose concrete tasks, define who would be responsible, propose deadlines and provide yardsticks for performance measurement for the achievement of the aims of decentralisation (Jurlina Alibegović, 2004).

Finally, counties, towns and municipalities in Croatia should take advantage of the opportunities to co-operate, particularly having in mind the joint realisation of development projects for which individual local self-government units do not have adequate financial resources, but may benefit mutually from the project results. There is much benefit to be expected from enhanced co-operation between municipalities, cities and counties in order to achieve common goals and to increase the revenues necessary to finance local functions, as well as to collect more funds for investment in joint capital projects, and as a result, to improve their credit standing.

Notes

1. The Law on State Budget, the Law on Local and Regional Self-Government Financing, the Law on Execution of the State Budget, the Decree on the Mode of Calculation of Equalisation Grants for Decentralised Functions, the Decree on Budget Accounting, the Rules on Budget Accounting and Chart of Accounts, the Rules on Financial Reporting in Budget Accounting. In addition, the local units also have to abide by other special regulations relating to various areas of public spending.
2. The rate of surtax on income tax: municipalities may levy up to 10%, towns with a population below 30 000 inhabitants may levy a surtax of up to 12%, cities with over 30 000 inhabitants may levy a surtax of up to 15%, and the City of Zagreb may levy surtax of up to 30%.
3. The share of revenues of local and regional government in the total revenue of the consolidated general government in Croatia is much lower than in other transition countries. While in Croatia the share in total revenues of local government is 9.40%, this share in other countries is: 20.8% in the Czech Republic, 26.7% in Hungary, 28.8% in Poland, 22.1% in Estonia, 25.0% in Latvia and 22.8% in Lithuania (Ebel and Yilmaz, 2002).
4. For more details on grant system and equalisation grants in Croatia see Jurlina Alibegović (2004).
5. After the amendments to Law on Local and Regional Self-Government Financing in 2001 extended the possibility of the introduction of surtax on income tax to all municipalities and cities until the end of 2003, the number of local self-government units which introduced of surtax on income tax rose to 198 municipalities and cities.
6. The county of Istria was the first example of a local bond issuer in Croatia. Recently the City of Zadar has begun to issue municipal bonds to raise funds for specific development projects.

7. Debate on the process of privatisation of communal and other companies owned by the City of Zagreb started several years ago. But the City of Zagreb is owner or founder of more than 20 companies.
8. Revenues and expenditures of both Funds are now the part of the State Budget.

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ISBN 978-92-64-03851-6
Local Innovations for Growth in Central and Eastern Europe
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Chapter 13

Fostering Local Development in Bulgaria: The Need of Fiscal Decentralisation

by
Desislava Stoilova

Although local authorities in Bulgaria have been assigned various responsibilities over the past 15 years, state transfer flows toward municipal budgets have not increased in the same proportion. Only a degree of local financial independence and fiscal decentralisation can contribute to the development of a favourable investment climate and foster sustainable development. A gradual delegation of taxation power to local authorities as well as the development and adoption of a stable legal framework for the principles and mechanisms of the intergovernmental transfer system would contribute to greater financial independence of municipalities.

Introduction

The purpose of this chapter is to study the current framework of local development financing in Bulgaria, and suggest solutions for some of the impediments, constraints or gaps in regulations that presently exist. As a result of purposeful effort, the current system of revenue assignment in our country is closer to the European standards, and therefore to the objectives of local finance reform. Despite the undoubted achievements in the scope of fiscal decentralisation, some challenges and constraints persist. Analysis is focused on the main revenue sources at the local level, estimated in the context of European accession process. Promoting local own-revenues, as a basic pillar for financing municipal budgets requires constitutional amendments, intended to foster local tax authority and fiscal autonomy. At the same time, the intergovernmental transfer system is a crucial mechanism for horizontal and vertical fiscal equalisation. Introducing municipal borrowing as an attractive and flexible tool for supporting municipal investment projects implies setting up a new institution in Bulgaria, namely the municipal credit market. Solving the problems that local governments face in common and fostering interaction contributes to development of a favourable investment climate, and allows municipalities to undergo a transformation to become the main organisers of the public productive capacity within their jurisdiction and, as structural units, heralds of sustainable development and growth of national importance.

Fiscal decentralisation and local governance

During the last fourteen years, Bulgaria has undergone a process of gradual political, administrative, and financial decentralisation. The process of smooth transfer of power and responsibility for public functions from the central to the local level started in 1991, when the Local Self-Government and Local Administration Act was adopted. According to this Law, Bulgaria has two tiers of sub-national administrative government – regions and municipalities. The region is an administrative unit of the central government, which comprises several neighbouring municipalities. It performs three main functions: to manage state property located on the regional territory, to monitor the compliance of local decisions with the law, and to implement state policy at local level. In addition to the controlling functions, mainly intended to combat and curtail corruption, the regions are supposed to foster

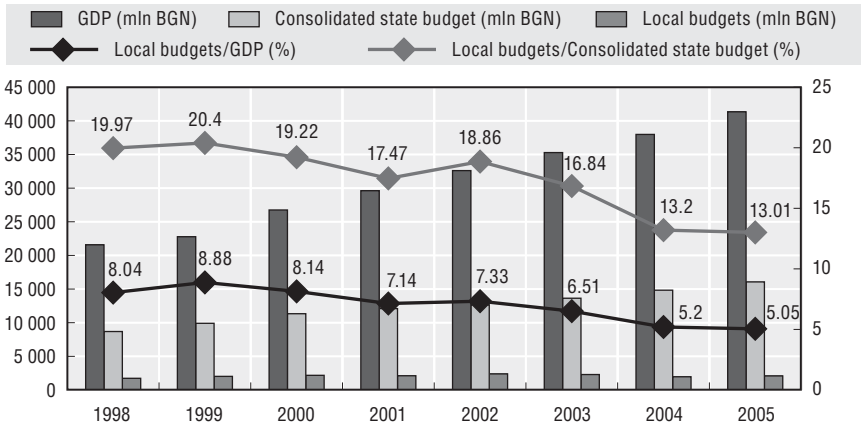
local development and to encourage municipalities to unite to work together on large-scale projects. Despite the fact that the regions co-ordinate national and local interests, they do not perform executive functions. As mediators between the central and local authorities, regions do not enjoy financial autonomy, and do not provide public services to the population. Regional government is performed by regional governors and administrations and financed from the central budget. The budget of the regional administrations accounts for 0.1% of the consolidated public expenditures and 0.04% of the general domestic product (GDP).[1] Presently there are 28 regions. They were established in 1999 by splitting up the 9 regions, which existed at that time.

According to the Constitution, the municipality – a legal entity – is the only tier of local self-government in the country. It has the right of ownership and an independent municipal budget, which must be used for serving the local population's interests. The bodies of local government – municipal council and mayor – are elected directly by the local population every 4 years. They determine and implement municipal development policy. Despite the fact that Bulgaria is a small country, with a territory of approximately 111 000 km^2, 264 municipalities exist at present. Although the legal possibility for dividing or merging of municipalities exists, their number varies little. The main features of Bulgarian municipalities are as follows: average territory is approximately 422 sq. km, average population is approximately 30 000 people, and average number of settlements is approximately 20.

In fact, gradual decentralisation results in growing local self-governance and ever-increasing responsibility for the municipalities to meet rising demands of the population, ranging from transportation to cultural events and leisure. Local authorities are also assigned some state mandates in the fields of education, health care, and social assistance. Municipalities are partially responsible for services related to cultural advancement (local libraries, museums, and theatres), environment protection, housing construction supervision, and some economic activities. They are fully responsible for the local utilities such as water supply, sewerage, heating, gas supply, construction of local roads and streets, urban development and infrastructure. One of the main achievements of the fiscal decentralisation process in Bulgaria is the clarification of the respective responsibilities of the central and local authorities, defined by the State Budget Acts for fiscal years 2003, 2004, and 2005, as well as their applications. Moreover, according to the legislation in force, when municipalities are assigned to undertake a state mandate, the central government must provide appropriate grants.

According to recent data, Bulgarian municipalities provide up to 30% of public sector services in the country. At the same time, regardless of the financial stabilisation and economic growth achieved during the recent past, the share of, local budgets in GDP has been reduced to 5.05% in 2005 against

Figure 13.1. **Bulgaria: Basic macroeconomic and budgetary indicators**



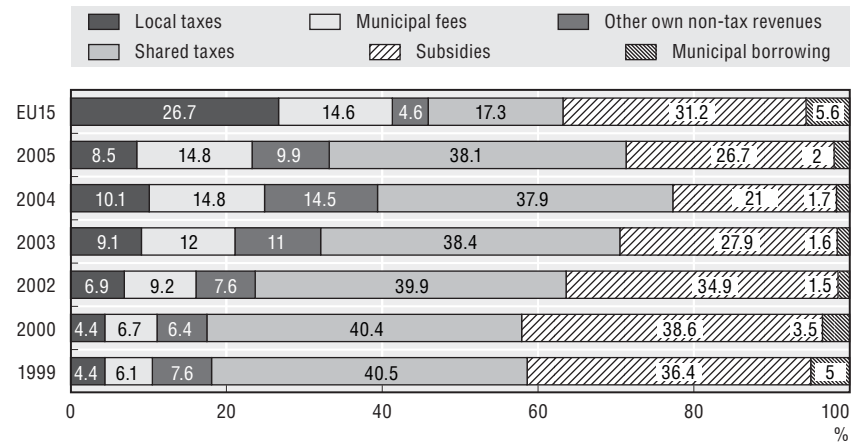
Note: BGN is the abbreviation of Bulgarian currency. The Currency Board has fixed the exchange rate at 1.95583 BGN per euro.

Source: The Ministry of Finance and own calculations.

12.3% in 1991, and 8.9% in 1999. The same clear downward trend can be observed in the local budgets' share of the consolidated state budget.

To a large extent, this is due to the fact, that although local authorities have been assigned various responsibilities, state transfers to municipal budgets have not increased significantly, and so have tended to decline in real and relative terms. Moreover, by virtue of the current legislation, municipalities are restricted to influencing the local revenues.

Figure 13.2. **Municipal revenue assignment (% of total local revenues)**



Source: Ministry of Finance Database and own calculations.

It can be seen that the local revenue structure in Bulgaria comprises several standard components, namely own-source revenues, intergovernmental transfers, and municipal borrowing.

Local own-source revenues

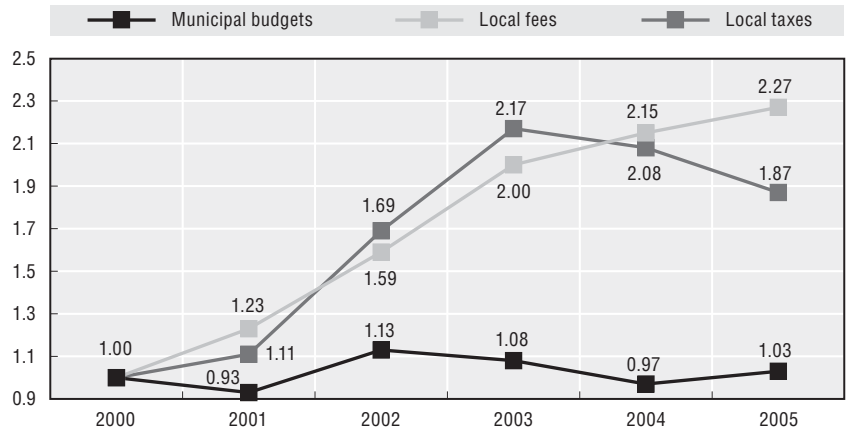
Basically, local own-source revenues include local taxes, municipal fees and other local revenues, mainly from municipal property management, such as rents, sales, concessions, fines and interest. According to the recent data, local own-source revenues have tended to increase gradually, from approximately 10% of total municipal revenues in 1997 toward almost 40% in 2004. Obviously, this is an important step toward fiscal decentralisation and real local budget independence. It can be viewed as a satisfactory result, having in mind that the central governmental level covers the totality of state-delegated activities. However, in order to define and discuss the significance of local taxes accurately, it is useful to clarify the system.

Actually, Bulgarian local governments do not have the power to determine the type, the rate or the base of local taxes. In fact, the only reason for calling them "local" is that they are stated in the Local Taxes and Fees Act. Property tax, motor vehicle tax, inheritance tax, gift tax, and tax on the purchase of real estate and movable property, which are recognised as local taxes, are entirely regulated by the central government. In terms of modern public finance, if local governments do not have any say in the "design" of the local tax, that tax should not be considered as a local tax, but as a special transfer, based on the location of taxable property.[2] Thus, reviewing the elements listed, up to 75% of the municipal budgets are formed by transfers and are determined directly by the central government.

Because the Bulgarian Constitution now prohibits municipalities from fixing the local tax base and rates, they are allowed only to receive the local tax proceeds. This regulation conflicts with article 9.3 of the European Chart of Local Self-Government, signed by the Republic of Bulgaria in 1995. Consequently, there is an urgent need to find political consensus for constitutional amendment, intended to delegate real tax power to local governments, because local tax autonomy can only be gained through full local governmental control over the tax levy.

At the end of 2002, in line with the Fiscal Decentralisation Programme, the Local Taxes and Fees Act was amended and local authorities were assigned full legal rights to determine the base and size of local fees by application of the cost-recovery principle, as well as to implement local social and economic policy by providing appropriate tax exemptions to certain taxpayers. Actually, this legislative amendment is an extremely important achievement in the field of fiscal decentralisation reform.

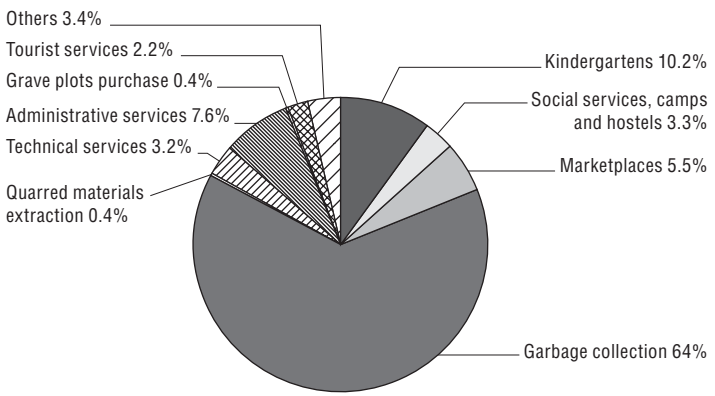
Figure 13.3. **Rates of local taxes and fees proceeds increase in comparison with local budgets increase**



Note: The proceeds in 2000 are used as a base.
Source: The Ministry of Finance of the Republic of Bulgaria and own calculations.

According to the available data, local fees form a gradually increasing share of the local revenue base, with an average relative share in own-source revenues up to 38%, ranging from 6% to 60% in any particular municipality.[3] Since the start of fiscal decentralisation reform, the proceeds of local fees have more than doubled. Over the same period, municipal budgets rose by only 3%. One of the main reasons for this growth is that in accordance with the cost-recovery principle, local fees have to be calculated as prices of public services, and must cover the full prime cost of local service provision. It should be pointed out that the growth potential of local fees has not been

Figure 13.4. **Local fees structure in FY 2004**



Source: The National Association of Municipalities in the Republic of Bulgaria.

reached yet, so that an additional expansion in the size and proceeds of local fees can be expected in the medium term.

Besides local taxes and fees, local authorities can rely on revenues from local property management. Given the current scarcity of financial resources in the public sector, and the limited local tax base, a possible solution for promoting local fiscal autonomy is the efficient use of municipal property by establishing municipal companies and public-private sector business partnerships. Improvement of local capacity in the field of property management can foster the expansion of municipal own-source revenues and influence considerably the quantity and quality of local services.

Intergovernmental transfer system: Financial dependence of local governments

Intergovernmental transfers as specific financial flows from the central to the local governmental level have two basic forms: revenue sharing and grants. The main purpose of the transfer system is to "soften" vertical and horizontal fiscal imbalance, and compensate local governments for financial disparities and spillover effects.

Actually, the intergovernmental transfer system in Bulgaria plays the dominant role in financing local governments. Governmental transfers form the dominant element of municipal revenues – up to 60% in recent years. Due to the gradual decline in their relative share in total local revenues, from 90% in 1999 to 76,3% in 2002, and 59% in 2004, the Bulgarian intergovernmental transfer system is approaching the European standards. Although there is no absolute rule, it is accepted that local fiscal autonomy is properly secured when local own-source revenues compare in amount to the governmental transfers. From an economic and financial point of view, the dominant role of the transfers allows local governments to be compensated for vertical imbalance, horizontal imbalance and spillover effects, but from a political and institutional standpoint, such a proportion gives the central government more political and financial control over the local level than is acceptable in a modern revenue assignment system.

The intergovernmental transfers in Bulgaria are not competitive and comprise shared taxes and state subsidies. The most important shared tax is the personal income tax. It used to be shared among the State and municipalities in a 50:50 ratio. Since the beginning of 2003 personal income tax has been classified as an entirely municipal revenue, intended to cover delegated state responsibilities at the local level. However, significant interregional disparities are inescapable because personal income tax is progressive, collected by withholding at source, and the tax base is unevenly distributed, favouring the richest local governments. For this reason, certain

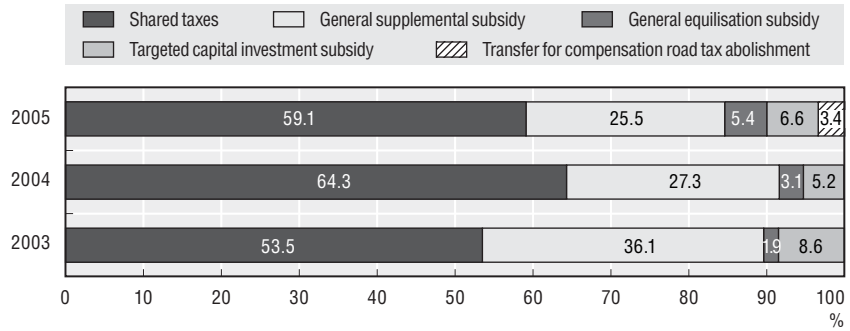
normative expenditure standards for delegated state activities have been developed and, concomitantly, the shared tax proceeds of any particular municipality have been limited to the amount of these standards.

In addition to the shared personal income tax, Bulgarian municipalities can count on three types of state subsidies: general, targeted, and extraordinary. According to the legislation in force, a general subsidy is provided to municipalities without restrictions. It is unconditional, so no strings are attached to the use of the money. Target subsidy is conditional. It is provided for a preliminary set of purposes, usually for social assistance, health care, ecological recovery or capital investment projects. Extraordinary subsidy is an unconditional, unplanned financial flow, granted to municipalities in a difficult financial situation.

Total intergovernmental subsidies are allocated based on a formula which is set forth in the Annual State Budget Act. Since its introduction in 1993 it has been changed almost every year. Basically, the formula takes into account the expenditure needs and revenue capacity of the local governments. The *general supplemental subsidy* is calculated by a "gap-filling" method, as the difference between the full cost of all state mandates imposed on municipal budgets, and the amount of the shared tax revenues. Actually, the general supplemental subsidy plays an equalisation role as well, and compensates for the uneven distribution of the personal income tax base. The right to receive a *general equalisation subsidy* is extended only to a municipality whose proceeds from local taxes in the previous fiscal year have been under the average local tax proceeds at the national level. This governmental transfer brings the revenue capacity of the below-average municipalities up to the national average level. The annual equalisation transfer pool must equal at least 10% of the total municipal own-source revenues in the previous fiscal year. The *targeted capital investment subsidy* is a very important financial flow, because a wide range of infrastructure capital investments and ecological recovery projects is assigned to the local governments. It is allocated on an ad hoc basis and seems to bear no relationship to the general subsidy criteria. The *extraordinary subsidy* is an unconditional, unplanned financial flow, granted to the local governments in the course of the fiscal year, based on vague criteria and generally aimed at supporting municipalities in a difficult financial situation.

The structure of intergovernmental transfers in fiscal 2003, 2004 and 2005 is presented in the figure above. Obviously, the main transfer flow is the personal income tax, whose significance has been tending to increase, especially in the last few years. Another visible point is the substantial growth of the equalisation subsidy which, however, has relatively little influence, because of the dispersal effect – up to 240 municipalities (90% of all municipalities in the country) were subsidised in 2004. Although the target

Figure 13.5. **Intergovernmental transfer system**

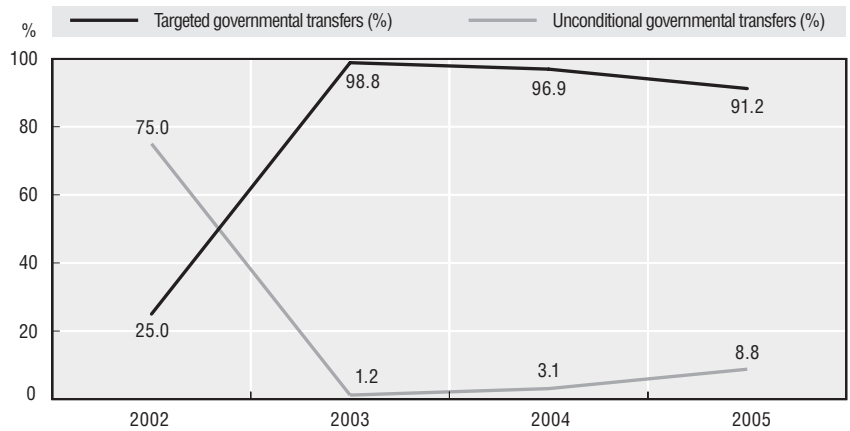


Source: The Ministry of Finance and own calculations.

subsidy for capital investments seems to remain almost unaffected, it is one of the most debatable points in the transfer system. The lack of a clear mechanism for its allocation is one of the fundamental challenges in intergovernmental fiscal relations. It is still unresolved.

A more alarming problem in the system is the obvious centralisation of the recourse to transfer funds, which has been clearly visible during the last three years. Contrary to expectations and logic, shared tax revenues and the general supplemental subsidy have been transmuted into strictly targeted funds, so that since 2003 up to 90% of the intergovernmental transfers have been targeted.

Figure 13.6. **Intergovernmental transfer structure**



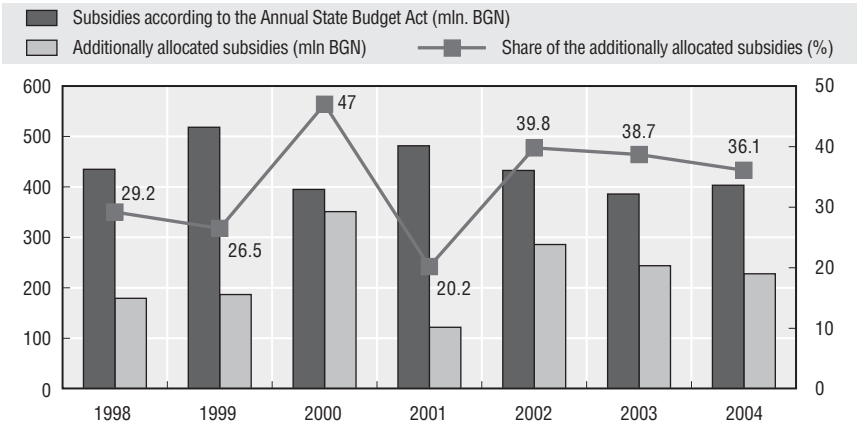
Source: The Ministry of Finance and own calculations.

Actually, the favourable change in the proportion between own revenues and governmental transfers mentioned above mainly reflects the significant reduction of delegated mandates – 130 million BGN in recent years – rather than a considerable increase in local own-source revenue. Moreover, according to the most recent legislative amendments, at the beginning of fiscal year 2005 one local tax, namely road tax, was abolished. In order to compensate local governments for the ineluctable fall in tax revenues, the Annual State Budget Act for fiscal 2005 provides for a special governmental transfer. Such an approach can be considered as a regression to the earlier highly centralised intergovernmental financial relations.

A really important issue regarding the scope of the intergovernmental transfer system is the inaccurate planning of the transfer flows, and as a consequence, the additional reallocation of funds among the municipalities. According to the available data, the relative share of additionally allocated funds, during recent years has absorbed up to 35% of the total governmental subsidy. This practice is a step back from the fiscal decentralisation concept, since it ignores both the allocation formula and normative criteria.

Actually, depending on transfers would not be a problem for local governments, but reliance on "ad hoc" or strictly centralised funds could undermine effective budgetary decision-making at the local level, while fostering a strongly political determination of intergovernmental resource allocation. Moreover, the lack of longstanding and stable legislation on the scope of intergovernmental transfer allocation is a cause of unfairness, unpredictability, and instability of local finance, and renders the local budgetary process opaque.

Figure 13.7. **Additionally allocated subsidies**



Source: Ministry of Finance and own calculations.

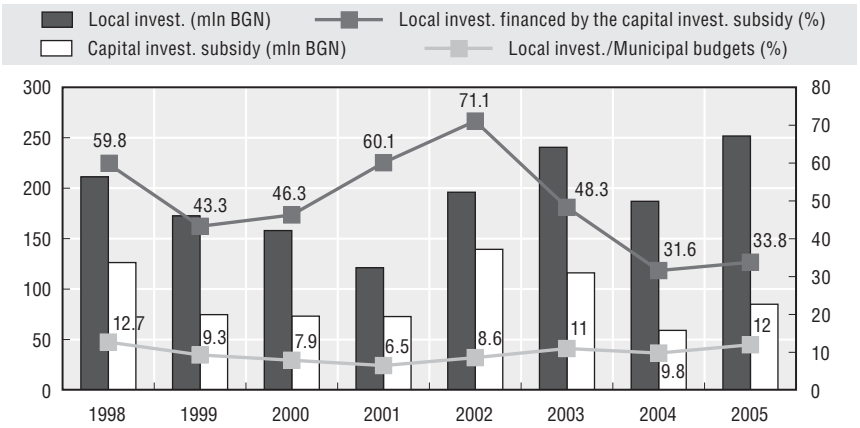
Municipal borrowing and local investment financing

Since the transition, investment spending by Bulgarian municipalities has been extremely low and insufficient to meet the economic and development needs of local governments. Obviously, municipal investment expenditures have recently absorbed a relatively moderate share of local budgets. These outlays are mostly for the delegated state activities; actually targeted state investment subsidy is the main source of local investments financing. Although local investments tend to increase, the fiscal year 1998 level (12.7%) has not yet been reached; moreover, the upward trend was interrupted in 2004.

At all events this share does not compare favourably with other CEE countries such as Hungary (18%), Poland (more than 20%) and the Czech Republic (more than 30%). At the same time, available sources for investment financing are quite limited and consist mainly of targeted capital investment subsidy and revenues from sales of municipal property. Local governments could not rely only on the State for important municipal investment needs and one of the most alarming trends is the increased use of sales of municipal property as a source for local investment financing, in parallel to a decrease in of local own-source revenues. The scarcity of capital funding sources for local infrastructure projects during the transition period has been due to the lack of an appropriate legal framework defining the scope of local borrowing capacity. For this reason municipalities have only limited experience in raising and managing funds.

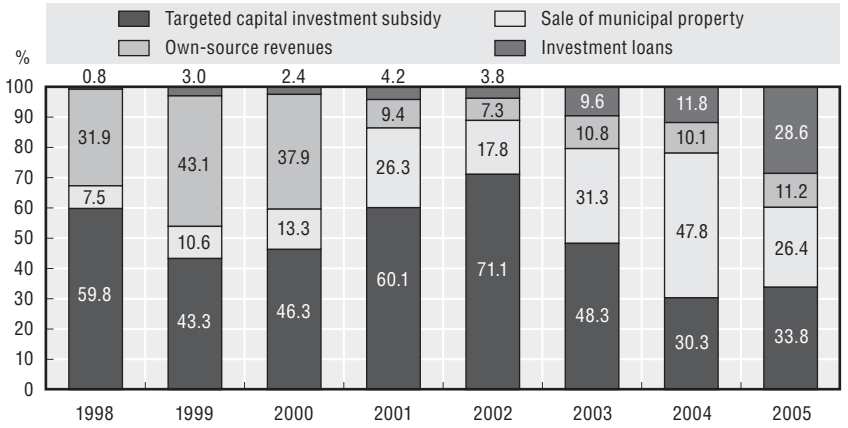
Instead of selling municipal property, and consequently reducing own-source revenues, local governments could use borrowed funds in order to

Figure 13.8. **Local investments relative share in municipal budgets**



Source: The Ministry of Finance and own calculations.

Figure 13.9. **Sources for local investment financing**



Source: The Ministry of Finance and own calculations

finance local investment projects. The advantages of local borrowing as a source for investment financing can be summarised as follows:

- Inter-temporal and inter-generational equity.
- A closer relationship between those who benefit from the investment project and those who pay for its completion, which supports optimal resource allocation.
- Benefits from the acceleration of local development accruing from the borrowed funds quite often exceed the cost of debt service.
- A reduction of operational costs due to the fact, that expenses related to borrowing are often lower than the costs of maintaining the old infrastructure for longer. If local infrastructure is too old it will be more profitable to borrow funds and build new and more reliable facilities, instead of repairing them. The benefits are higher reliability, as well as savings in the cost of repairs and the employment of service staff.
- Access to the grants from European and other development funds is one more rationale for borrowing, specific to Central and Eastern European countries. There are several investment grants available to local authorities, subject to the condition that the borrower must provide matching funds usually equal to at least 25% of the total project costs (as in the case of SAPARD, PHARE or ISPA projects). Borrowing can be a useful tool for increasing local capacity to apply for these development grants.

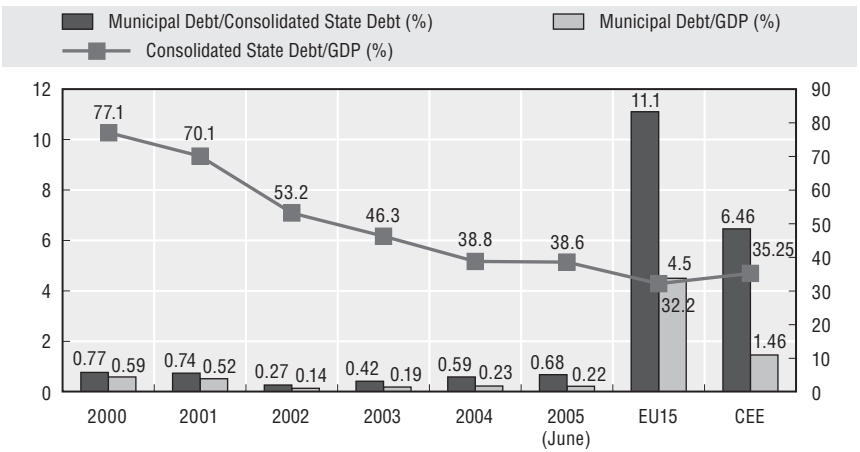
The conclusion is that there is a considerable need to improve, rehabilitate and extend local government infrastructure and networks, and to repair essential buildings and equipment. This effort cannot be implemented

without increased access to capital markets and improved local government ability to repay such borrowing.

However, local budgetary deficits and debt are part of the consolidated state deficit and debt. Because of the forthcoming accession to the European Union, public debt in Bulgaria is limited by the legislation in force[4] to 60% of GDP, in accordance with the Maastricht criteria. Moreover, the central government has the legal right to propose a cap on municipal debt, should consolidated debt exceed the proportion approved. Fortunately, this is not a problem at this time. Thanks to the purposeful efforts of the last few years, consolidated state debt has been gradually reduced to 38,6% of GDP – a level comparable to the European standards. At the same time, the local debt level in our country is negligible by comparison with its level in the developed countries, and even in some of the former socialist countries. Obviously, local debt potential has not been reached yet, so that in the medium and long term context, an increase in the recourse to debt instruments at local level can be expected.

Under the legislation in force,[5] the borrowing sources available to Bulgarian municipalities are the issue of municipal bonds, loans from banks and other financial institutions, interest-free loans from the central budget, and inter-municipal loans. Basically, borrowing is not a significant local source of funds, and its relative share in the total local revenues has not exceeded 1-2% in recent years. Moreover, local debt has been reduced from 157.9 million. BGN in 2000 to 88.4 million BGN at end 2004 – a decrease of almost 55%. In practice, the best part of the borrowed funds has been used by

Figure 13.10. **Public sector debt indicators**



Note: Debt indicators for Central and Eastern European countries comprise data for the Czech Republic, Poland, Slovakia and Hungary.

Sofia (the capital city) and the largest municipalities. At the same time, small and medium size local authorities are short of funds for capital investment, especially in local infrastructure. Due to the lack of an appropriate legal framework, they have not enjoyed the same access as the other participants who have operated in the capital markets for a long time. For this reason, adoption of the new Law on Municipal Debt, which entered into force in June 2005, is one of the main achievements in this area. In order to achieve strong fiscal discipline, the law limits municipal annual debt service to 25% of own-source revenues plus the annual equalisation subsidy. Despite its restrictive role, this statement is not an obstacle. To the contrary, it is an important guarantee against municipal default and a vital precondition for fostering the growth of a market in municipal credit.

Conclusions and issues for consideration

- The degree of fiscal decentralisation in Bulgaria is below European standards. During recent years, municipal budgets' share in the consolidated state budget has been substantially reduced to 13-14%, and no more than 5-6% of GDP has been redistributed through the local budgets. In comparison, the average levels of the specified indicators in the European countries are more than double these values.
- The basic parameters of local revenue structure are comparable to the prevalent European model. Municipal own-source revenues have increased gradually, from approximately 10% of total municipal revenues in 1997 to not far short of 40% in 2004. Obviously, this is an important advance towards fiscal decentralisation and real local financial autonomy.
- At the same time, local tax revenues are tending to decline. In order to foster local financial autonomy, it is necessary to expand the local tax base. Possible approaches that could be recommended: update the property tax base or delegate new local tax revenue sources.
- Municipalities do not enjoy real tax authority. In the OECD classification, local taxes in Bulgaria are defined as a special kind of governmental transfer. In the context, a gradual delegation of taxation power to the local authorities is an absolutely necessary and urgent task.
- Development and adoption of a stable legal framework for the principles and mechanisms of the intergovernmental transfer system is a precondition for stable, predictable, and transparent local revenue allocation. The ability of the central government to neglect the normative methodology and allocate additional subsidies during the fiscal year at will must be ended.
- Development and adoption of an appropriate framework for regulating capital investment subsidies is necessary. A gradual transition is required to

a model of financing, based on robust investment projects that municipalities can refer to in order to apply for targeted subsidies, applying competitive principles, from the national investment fund.

- A clear distinction is required between local operations and capital budgets, as a precondition for achieving municipal creditworthiness.
- The Law on Municipal Debt now in force must be followed by development of a municipal credit rating system, as a base for fostering development of a market in municipal credit.

In conclusion, hard and purposeful efforts have brought the revenue distribution system in Bulgaria closer to the European standards, and therefore to the objectives of local finance reform. As can be seen from the discussion above, there are many achievements, but also many challenges in the fiscal decentralisation process. The conclusions and recommendations summarised here are aimed at helping local governments to solve the totality of the problems they face. Only real local financial independence can contribute to the development of a favourable investment climate, and allow municipalities to transform themselves into the main organisers of public production facilities within their jurisdiction, as well as structural units, heralds of sustainable development and growth of national importance.

Notes

1. Ministry of Finance Database in *www.minfin.bg*.
2. See Working Party on Tax Policy Analysis and Tax Statistics of the OECD Committee on Fiscal Affairs, 1999.
3. See *www.narmb.org/database*.
4. The State Debt Act, published by the State Official Journal, Issue 93/2002, Art. 10 and 11.
5. The Municipal Budgets Act, published by The State Official Journal, Issue 33/1998, Final Additions and Amendments in Issue 107/2003, Chapter 8.

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ISBN 978-92-64-03851-6
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Chapter 14

Fiscal Autonomy and the Incentives to Stimulate Business Growth and Efficient Public Goods Provision: The Case of Belarus

by
Irina Kolesnikova

The structure of revenue sharing between the various layers of governments affects the public sector's incentives for providing infrastructure for private business development. The recent experience of Belarus has been that any change in local government's own revenues is almost entirely offset by changes in shared revenues. Local governments are unable to benefit from an increase in the local tax base and, therefore do not see any interest in expanding it. This situation leads to stricter business regulation and lower growth compared with a system with greater fiscal incentives, and has a negative effect on the efficiency of local provision of public goods. A reform of the existing financial system for local governments is required to provide some degree of autonomy for local self-government, with the aim of enhancing local governments' capacity to finance local development.

Introduction

The history of the New Independent States shows that as national states were established centralised tendencies prevailed. The Republic of Belarus is no exception. The centralised assignment of public functions and firm control of the central government over service delivery and the financing of local development projects coincides with a low level of own-source revenues. Only a small percentage of municipal budget revenues (usually about 6%) is defined and collected by the local government. Revenue-sharing practice exists but it is highly discretionary. A specific sharing ratio is adjusted to individual needs and the vertical imbalances of local government budgets and changes every year. Moreover, any change in a local government's own revenues is almost entirely offset by an opposite change in shared revenues. Local governments are unable to benefit from an increase in the local tax base, and, therefore, lack a revenue incentive to expand the tax base. According to a recent study (Zhuravskaya, 2000) weaker fiscal incentives lead to lower efficiency in the provision of public goods, because a bigger portion of public expenditures is wasted.

The Belarusian economy faces the challenge of raising allocative and administrative efficiency in the public sector. In this regard, smoothly functioning fiscal relations between central and sub-central governments are of great importance (Joumard and Kongsrud, 2003). In principle, decentralisation can make governments more accountable, allowing a better matching of resources to preferences. It may also introduce competition across jurisdictions and thus raise public sector efficiency. However, shifts in expenditures towards higher decentralisation will not achieve the expected benefits without a concurrent shift in control towards localities over how much revenue local governments can collect.

This chapter argues that inefficient intergovernmental relations are a possibly important reason for the apparent disinterest of the majority of Belarusian municipalities in financing and promoting local development projects. In particular, the chapter provides evidence that the structure of revenue sharing between central, regional and local governments affects governments' incentives to foster business growth and to provide public goods efficiently.

The strength of fiscal incentives is gauged by a binomial indicator of the presence (or absence) of crowding-out of changes in own revenues by changes

in the shared revenues of local budgets. I then estimate how the change in the strength of fiscal incentives helps to predict variations in the provision of public goods and the formation of private businesses.

This approach rests on the theory of "market-preserving federalism". Contributors to this literature *(e.g.* Oi, J994; Montinola *et al.,* 1995; Qian and Weingast, 1997; and Jin *et al.,* 1999) argue that this type of federalism induces a strong positive relationship between local revenue and local economic prosperity, thus providing local officials with incentives to foster that prosperity. In contrast, the chapter shows that the system of intergovernmental relations in Belarus represents a model that can be called "market-hampering-federalism" since the local revenues are independent of local economic prosperity. Vesting central and regional administrations with the "authority to regulate local revenues made local governments heavily dependent on said administrations". There is a vertical imbalance between the distribution of revenues and expenditure responsibilities: during recent years, regional central governments have controlled a disproportionately high share of resources. Such a situation hinders real autonomy for local self-government and requires reform of the existing financial system.

Our investigation proceeds as follows. The next section presents some organisational details of the Belarusian governments and evaluates the degree of decentralisation. The following section contains some basic correlations between variables describing fiscal incentives of localities and the outcomes in the provision of public goods. The final section concludes.

Fiscal relations across government levels

Belarus is a unitary state. There are formally four levels of government. The top three levels are formally authorised to collect their own revenues and make decisions on expenditures. The lowest tier is a branch of the first tier, local governments, and is directly subordinated to them. This chapter studies only the first tier of local governments in Belarus and we will refer to them as local governments. There are 6 regional governments (middle-tier level) and 117 district governments (first tier level).

The principal law governing the financial system at the local level is the 1991 Law on local government and self-government in the Republic of Belarus and the 1998 Law on budget system and extra-budgetary funds of the Republic of Belarus, in which sources of tax revenues of local budgets are determined. However, according to these Laws and subsequent amendments and addenda, development of local self-government in Belarus is not matched by a transfer of genuine fiscal autonomy to the local level. Local governments form their own budgets, but their revenue autonomy is very limited. As collections from local taxes and non-tax revenues can cover only a small portion of local

spending needs, the resulting vertical imbalance is covered by the Republican and middle-tier governments by assigning variable rates of share of taxes to localities and allocating grants. In 2004, about 24 per cent of local budget expenditures were financed by grants (transfers, subsidies/subventions) from higher level budgets. Grants and shared taxes at rates changed annually totally accounted for roughly 70% of local budgets. As the rates keep changing from year to year, local governments are unable to forecast the amount of revenue they will have available, and in effect bear no responsibility either for how they form and execute their budgets, or for the quality and quantity of services provided to the public.

Local expenditure responsibilities

In Belarus more than one third of total public spending is at local level. However, the responsibilities for expenditures of different levels of government are poorly defined. *De facto,* local governments are responsible for providing some basic public goods, including pre-college education and most health care. They also provide garbage collection, local public transportation, some police protection, local road maintenance, etc. The largest expenditures have been expenditures on education, health care, and public utilities; in 2004, these constituted 27%, 23%, and 12% of local expenditures, respectively.

Finally, local governments subsidise loss-making enterprises. While local budgets are the recipients of significant current transfers from the Republican budget, they also provide significant subsidies in their own right. Indeed, the subsidies that they provide to public enterprises – for general support and to cover losses – are at least twice as large as those provided by the Republican level. These subsidies constituted 25% of local expenditures. "Other subsidies" are a significant portion of local subsidies. Local governments also provide direct transfers to the population, although they are not large by comparison with subsidies.

Local revenue sources

Local revenues consist of *own* and *shared* revenues. Local own revenues consist of: 1) various ad hoc local taxes, including license and other fees, and various surcharges and fines; and 2) non-tax revenues, which mostly come from municipal property leases, profits from municipal enterprises and privatisation. The components of shared revenues are 1) taxes shared with upper levels of government, and 2) transfers (grants) from upper levels of government. The relative importance of different sources of local revenues in Belarus is described in Table 14.2. As noted above, the revenue sharing arrangements in Belarus are frequently changed and budget funds of local governments are independent of their efforts to raise additional own revenues. The portions of shared taxes and the amounts of transfers are not

Table 14.1. **Indicators of fiscal decentralisation in Belarus**

	Sub-national government spending (share in general government spending*)		Sub-national government revenues			
			Share in general government revenues **		Attribution of tax revenues as percentage of total tax revenue ***	
	1999	2004	1999	2004	1999	2004
Middle-tier governments	17.1	21.1	23.1	27.0	27.1	29.2
Local governments	35.7	36.9	23.5	23.4	20.3	22.4

* Excluding the transfers to other levels of government.
** Excluding transfers received from other levels of government and including tax sharing arrangements.
*** Including tax sharing arrangements.

determined on the basis of a fixed formula, and vary both over time and across localities within a single region. Regional authorities set target levels of expenditures for localities depending on minimal standards. They come to about 230 euros per resident; of this, health care amounts to nearly 80 euros per resident/year. These targets serve as a foundation for the amounts of shared revenues to be allocated to each locality. Regional officials estimate the "needed level of expenditures" for each local government in the region, and the total amount of funds that is to be distributed among the localities in the form of shared taxes and transfers. The regions then negotiate the actual amounts of transfers and shared revenues with their localities. This system gives local governments no incentive to maximise localities' own revenue because additional local revenues are almost entirely taxed away by the regional authorities.

The impact of fiscal incentives on business growth and the efficiency of provision of public goods

In this section, we test a proposition that the strength of governmental fiscal incentives can influence local support for business growth and the efficiency of the provision of public goods.

We assume that if fiscal incentives are strong, *i.e.,* if an increase in the local tax base results in a nearly equal increase in budgetary revenues, then governments bear financial costs in terms of forgone taxes when they over-regulate or restrict business. In contrast, if fiscal incentives are weak so that the local government's ability to increase its marginal revenue by increasing its tax base is close to zero, then budget revenues are not affected by changes

Table 14.2. **Composition of expenditures and revenues of an average locality's budget**

	1999	2004
Number of localities with information on current expenditures and revenues	107	117
Expenditures (in %)		
1) Education	26.1	27.2
2) Health care	24.3	23.1
3) Subsidies to housing and enterprises	23.3	25.3
4) Subsidies to utilities	15.4	12.1
5) Administration	1.6	2.2
6) Others	9.3	11.1
Revenues (in %)		
A. Shared revenues	90.8	89.9
1) Republican and regional taxes	70.7	65.5
2) Transfers from the regions	20.1	24.4
B. Own revenues	9.2	9.9
1) Local taxes	5.1	6.3
2) Non-tax revenues	4.1	3.9

Notes: Republican government taxes include profit tax, VAT, personal income tax, and excise tax; regional taxes include property taxes, charges for natural resources, trade taxes, and other regional taxes; non-tax revenues include privatisation proceeds, revenues from municipal property leases, and other non-tax revenues.

in governmental policy towards business. Economically unjustified political intervention into business, such as excessive regulation, adversely influences entrepreneurial activity and lowers the governmental tax base. In a system with stronger local fiscal incentives, one should observe more benign regulation, and higher growth compared with a system with weaker fiscal incentives. In addition, stronger fiscal incentives should lead to higher efficiency in provision of public goods, because a smaller portion of public expenditures is wasted.

It should be noted that regulatory authority over private business in Belarus is concentrated at the local level. Local governments are responsible for licensing and registering firms. Local authorities also rent out space to businesses and establish most regulations and fines. For example, health, fire, and other inspectors are subordinated to local government's offices and are financed out of local budgets.

We use a unique panel data set of localities over a period of 5 years. It contains detailed budgetary data on expenditures, revenue sources and tax shares for shared taxes. This data set includes 117 districts in 6 regions of Belarus for the period 2000-2004. The panel is unbalanced, but we have at least

3 years of data for each locality. The data are provided by the Ministry of Finance of the Republic of Belarus. Data on outcome measures of public goods provision and the number of businesses in the districts were provided by the Ministry of Statistics and Analysis.

We use two measures of outcomes associated with the provision of public goods: the infant mortality rate and the percentage of school children who must attend school in the evening due to overcrowded schools. These measures were chosen because they seem likely to depend on the quality of public goods provision, and they are directly related to government choices for which data are available. Health literature establishes that the availability of primary care in the first days of life is, on the one hand, a direct function of outlays on primary care and, on the other hand, an important determinant of infant mortality. In addition, the availability of schools in Belarus is also very closely dependent on current local government expenditures. There is a paradoxical situation: the number of schools per child is very high in Belarus relative to most developed countries, but the percentage of students who attend schools in the evening due to overcrowded schools is also very high. This is because many existing schools, a legacy of the Soviet welfare state, are closed. To open these schools, local governments would need to undertake (unsubstantial but necessary) renovations financed by capital outlays from the local budgets. Thus, we consider health care and education expenditures as public expenditures corresponding to the outcomes of public goods provision described above.

Table 14.3. **Outcomes of public goods provision and new business formation**

	2000	2004
Infant mortality (deaths per thousand births)	10.7	10.2
Children attending schools in the evening (% of total)	11.5	14.3
New business formation (number of firms, thousand)	1.2	0.4

To test our preposition we use a variable that measures the strength of fiscal incentives of the local government (incentives proxy). This is very simple proxy for fiscal incentives: it is equal to zero if changes in shared and own revenues are of opposite sign; otherwise, the incentives proxy is equal to one. An incentives proxy equal to zero is an indicator of weaker fiscal incentives and an incentives proxy equal to one is an indicator of stronger fiscal incentives. Tax bases for shared and local taxes in a locality are highly positively correlated, both being functions of the level of economic development in this locality. So, if shared and own revenues shift in different

directions (*i.e.,* the incentives proxy equals zero), then there is some crowding-out of changes in own revenues by changes in shared revenues and the local government is not financially independent of the regional government. The variable new business formation is the number of newly privatised and newly opened businesses in the locality.

We report some basic correlations presented in Table 14.4. Annual changes in shared and own revenues are negatively correlated with a correlation coefficient of -0.47 significant at the 1% level. The incentives proxy is positively correlated with the new business formation variable (correlation coefficient is equal to 0.17 significant at the 10% level) and outcomes of public goods provision: infant mortality (the correlation coefficient is equal to –0.11, significant at the 10% level) and unavailability of schools (coefficient equals – 0.06 not significant). The signs of all these correlations are as implied by our proposition.

Health care expenditures per capita are negatively correlated with infant mortality, while education expenditures per capita are negatively correlated with unavailability of schools. This provides evidence that these outcomes of the provision of public goods are indeed related to local government policies.

Table 14.4. **Pair-wise correlation coefficients**

Change in own revenues	Change in shared revenues	–0.47* (0.00)
Total budgetary revenues	Incentives proxy	–0.05 (0.44)
Total expenditures per capita	Incentives proxy	–0.03 (0.73)
New business formation	Incentives proxy	0.17**(0.06)
Infant mortality	Incentives proxy	–0.11**(0.06)
Unavailability of schools	Incentives proxy	–0.06 (0.33)
Infant mortality	Health care expenditures per capita	–0.21* (0.00)
Unavailability of schools	Education expenditures per capita	–0.16*(0.03)

Notes: * and ** denote significance at the 1,5 and 10% level, respectively. P-values in parentheses.

Thus, the results of the correlations analysis support our propositions. The negative correlation between annual changes in shared and own revenues means that fiscal incentives of local government in Belarus are very weak. A crowding-out of changes in own revenues by changes in shared revenues gives local government no incentive to encourage the growth of private business in order to boost own tax revenues because local governments in Belarus simply can not raise revenues at the margin. The strength of fiscal incentives in localities is positively related to the number of newly formed businesses in the region. In addition, weak fiscal incentives have implications for how efficiently public money is spent at the local level. The measures of the outcomes of public goods provision are positively affected by the strength of

incentives. These results support the view that with weaker fiscal incentives local governments spend money less efficiently.

Conclusion

One of the problems Belarus faces is the structure of its inter-governmental relations. The main finding of this chapter is that local officials have not been given sufficient responsibility for their decisions on expenditures and have not been granted the right to raise their own revenues. The chapter provides some evidence that revenue sharing relations between local and regional governments hinder local governments' incentives to provide infrastructure for private business development. In addition, it shows that the fiscal dependence of local governments on the regions has a negative effect on the efficiency of local provision of public goods.

Vesting central and regional administrations with the authority to regulate local revenues has made local governments heavily dependent on said administrations. Such a situation hinders real autonomy for local self-government and calls for reform of the existing financial system. This reform should seek to ensure stable revenues for local budgets by restricting the latitude of Republican and regional administrations in disposing of the revenue sources assigned to them and bring certainty to the fiscal status of local government. Otherwise the administrative regions will replace local self-government.

It should be noted, that under existing conditions a transition to alternative forms of financial support to municipal services is of great importance for Belarus. In particular, the public-private partnership can provide a broad umbrella which can shelter and protect the public interest while creating investment potential and added value from the private sector.

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ISBN 978-92-64-03851-6
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ANNEX

About the Authors

David J.A. Douglas is Professor of Rural Planning and Development in the School of Environmental Design and Rural Development, University of Guelph, Canada. In 1985 he was Director of the University School of Rural Planning and Development, after ten years in management consulting and five years in regional development policy and planning, Province of Ontario. He conducts his research, teaching and practice in Canada and Europe, and in other international contexts (*e.g.,* China, Iran, Indonesia, Pakistan, Japan). His main expertise is in rural and smaller community development, governance, local government, and regional economic development policy and planning.

Irena Đokić is an economist specialised in urban management. She works in a multi-disciplinary team in the Spatial Economics Department at the Institute of Economics, Zagreb. Her research covers local and regional development in Croatia, management and development of units of local and regional government, planning and programming at national, regional and local level and institutional capacity building. In the last few years her research has focused on the problem of urban brown fields.

Sylvain Giguère is Deputy Head of Local Economic and Employment Development (LEED) at the OECD. As part of his responsibilities he leads a multi-disciplinary work programme on employment and governance which seeks to improve policies and practices on labour markets, skills, migration and economic development in the context of globalisation and policy interdependence. Sylvain co-ordinates LEED's programme of work, oversees the LEED Directing Committee sessions, and heads the OECD Forum on Partnerships and Local Governance. He studied economics at UQAM and Queens' University in Canada and holds a PhD (econ.) from Université Paris 1 (Sorbonne).

Vladan Jeremić is the Director of the Regional Development Agency of Eastern Serbia (RDA-ES). RDA-ES has been established jointly by six municipalities, the business sector and civil society. Mr. Jeremic currently

manages activities related to creating, supporting and encouraging regional development and creation of a stimulating business environment in Eastern Serbia. His main expertise is in cross-sector partnerships, regional development and strategic planning. Earlier he worked with the European Agency for Reconstruction at OSCE and one of Serbia's main regional NGOs.

Dubravka Jurlina Alibegović has worked at the Institute of Economics, Zagreb, since 1987 where she is Head of the Public Sector Department. She is team leader in several research projects and studies regarding budgeting and economic development at regional and local level, intergovernmental fiscal relations, local public finance, infrastructure financing, and financing of science and education. During 2000-2002 she worked in the Ministry of Science and Technology as a Deputy Minister responsible for management, budgeting and co-ordination of activities in preparing the Strategy of Science Development of Croatia.

Irina Kolesnikova is Senior Research Fellow at the Institute of Economics of the National Academy of Sciences of Belarus (NASB) since 1997. She is also with the Institute of Social and Economic Development in Minsk, as well as Associate Professor at the Belarusian Economic State University. She is in charge of research and development activities, particularly in the area of regional development, local finance, fiscal relations, entrepreneurship and enterprise restructuring. She is author of more than 60 publications.

Haralambos Kondonis is a Senior Research Fellow at the South-East European Research Centre of Sheffield University, a Research Fellow at the Greek Diplomatic Academy, a Research Associate at ELIAMEP in Athens, member of the IASFM in The Hague and an Expert-Counsellor at the Greek MFA. His main expertise is in regional and cross-border co-operation and democratisation processes. He has co-operated with OSCE/ODIHR, the Stability Pact for SEE, the European Commission and the European Council. He has published academic articles in journals in Canada, Greece, Italy, Serbia, the UK and the US and has studied International Relations (LSE), European Politics (Reading), and Political Science (Athens).

Zdenka Kovač is currently a Senior Lecturer and researcher of social entrepreneurship at GEA College of Entrepreneurship, Slovenia and a DIFID-London School of Economics expert on social governance in Bosnia and Herzegovina. In the past she has been in charge of designing employment programmes at local and national level, a Director of the Small Business Development Centre (SBDC), State Secretary for Employment and Minister for Regional Development and Structural Policies of the Republic of Slovenia. She has co-authored several books and articles on issues of regional development, entrepreneurship, public policy and local governance.

Kalyan Pandey has worked at the UNDP office in Albania since 2002 where he manages the Local Governance Cluster Programme, which includes

several sub-projects related to local governance and development. He joined the UNDP in 1994, first at the Nepal office and then in Kyrgyzstan, where, as Chief Technical Advisor and Programme Manager he managed several programmes on local governance, decentralisation and local development. Prior to joining the UNDP, he worked as Decentralised Planning Training Co-ordinator at a semi-government institute in Nepal for 18 years and also worked as short term training specialist with the UN Food and Agriculture Organisation (FAO) in Rome and the Asian Development Bank, and provided consultancy services in China, Myanmar and Nepal.

Ivana Rašić Bakarić joined the Institute of Economics, Zagreb in 2001 where she works as a Research Assistant in the Department for Spatial Economics. She earned her Masters degree with a thesis in operational research methods at the Graduate School of Economics and Business, University of Zagreb, in 2005, where she also gained her Bachelors degree in 2000. Her specialisation is mainly in econometrics in the field of regional and urban economics. She worked during 2000-2001 in a private company, Creditreform d.o.o. in Zagreb, specialised in creditworthiness assessments. In addition, she occupied a position in KPMG Croatia as project assistant on the establishment of the central state treasury and the introduction of the SAP programme at the Ministry of Finance of the Republic of Croatia.

Željko Šević is Professor of Accounting, Finance and Public Policy, and Director of Research, Outreach & European Affairs, in the University of Greenwich Business School in London. His principal expertise is in public sector accounting and finance, public policy and comparative public administration, and strategic management accounting. He has also held a number of visiting academic/research positions in Australia, Austria, Bulgaria, Croatia, Japan, Poland, Slovenia, Ukraine and the US, and has gained professional experience in both public and private sectors, at a senior level, before becoming a full-time academic in the mid-1990s. Mr. Šević holds terminal degrees in law and financial economics and also has accounting professional qualifications.

Jelena Šišinački holds a Research Associate position within the Department of Spatial Economics at the Institute of Economics, Zagreb, which she joined in 1995. She is author of numerous studies and articles in the field of transport infrastructure, regional development, local administration and self-government, and works frequently as a consultant in various local and regional development projects. She earned her doctoral degree on "The Costs and Benefits of Road Infrastructure" at the Graduate School of Economics and Business, University of Zagreb in 2005, where she also gained her Masters degree in 1999 and Bachelors degree in 1994.

David Smallbone is Professor of Entrepreneurship and Small Business in the Small Business Research Centre at Kingston University, United Kingdom. As well

as undertaking numerous SME-related projects in various mature market economies, Mr. Smallbone has been involved in studies of entrepreneurship in transition economies, including Poland, Bulgaria, the Baltic States, the Russian Federation, Ukraine, Belarus, Moldova, Uzbekistan and China. His fields of expertise are mainly entrepreneurship, public policy and transition economies.

Nenad Starc is a Senior Research Fellow in the Institute of Economics, Zagreb where he holds the position of Head of the Regional Economics Department. His main interests are local development, and in particular the methodology of preparing programmes for local self-government units; sustainable development, on which theme he teaches at Zagreb University; and island development. Mr. Starc has recently been the main author of the Croatian Island Development Programme.

Desislava Stoilova joined the Faculty of Economics at the Southwest University, Bulgaria after her graduation in 2000 as an assistant professor in Finance. In 2006 she obtained a PhD with a thesis in the field of local finance. Now she teaches Public Finance and conducts research activities in the area of fiscal decentralisation, intergovernmental fiscal relations and local financial management. She is author of more than 20 publications primarily intended to promote the application of some effective private sector tools for financial management in the public sector.

Paul Stubbs is a sociologist born in the United Kingdom currently Senior Research Fellow in the Institute of Economics, Zagreb where he is part of a multi-disciplinary team researching local and regional development in Croatia. He has worked as a consultant on social policy issues for UNICEF, UNDP, DFID, and Save the Children. His latest book, co-edited with Bob Deacon, on *Social Policy and International Interventions in South East Europe*, was published in November 2007 by Edward Elgar. His fields of expertise include social policy, social exclusion, child care reform, civil society development, corporate social responsibility, and computer mediated activism.

Marijana Sumpor works as a Research Associate in the Department of Spatial Economics at the Institute of Economics, in Zagreb since 2001. Besides her research activities she is actively involved in consultancy activities as well as various forms of capacity building. During 1995-1998 she worked at the Department for Macroeconomic Analyses and Forecasts in the Ministry of Finance, Republic of Croatia; and from 1998 to 2000 in the Risk Management Department at BNP-Dresdner Bank Croatia. With the thesis entitled "Co-ordination of development policies towards an integrative regional development policy" she earned a PhD in economics from the University of Split in 2005. She gained her Masters degree in 1999 and her Bachelors degree in 1995 at the Graduate School of Economics and Business, University of Zagreb.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(84 2007 03 1 P) ISBN 978-92-64-03851-6 – No. 55841 2007

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