Baltic Partnerships

INTEGRATION, GROWTH AND LOCAL GOVERNANCE IN THE BALTIC SEA REGION

Edited by Sylvain Giguère

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Local Economic and Employment Development

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

For over a decade, the LEED Programme has been privileged to play a major role in the developments occurring in the Baltic Sea region with regard to the economy, employment, local development and governance. Soon after the fall of the Berlin Wall, the LEED Directing Committee extended an invitation to the newly independent states and economies in transition to join in the process of exchanging experience. Poland rapidly became a member of the OECD as a whole together with its southern neighbours, the Czech Republic, Hungary and Slovakia. Like them it integrated well into the peer review process of the Organisation and showed a strong commitment to learn as much as possible from other members' experiences in all public policy areas. In 2003 Poland hosted an international conference on the decentralisation of labour market policy; the event led to a breakthrough on the issue of how to ensure public accountability while allowing for a degree of flexibility in a decentralised framework (see the OECD publication Managing Decentralisation: A New Role for Labour Market Policy, *2003).*

Collaboration with the other transition economies has taken different forms. In 1999 the LEED Directing Committee set up a discussion forum to nurture entrepreneurship and enterprise development in the three Baltic States – and the forum indeed shed new light on the benefits that could come from partnership with an organisation such as the OECD. In 2003 Latvia and Lithuania joined the LEED Programme, taking advantage of a 2001 amendment of the LEED Mandate by the OECD Council that made it possible for non-member countries to join the programme as full participants. Co-operative activities were also implemented jointly with Russia: a seminar on employment and local governance was hosted by the Ministry of Labour in Moscow in March 2003 to examine Russian innovations in a cross-country comparative perspective.

Simultaneously, LEED worked extensively with the Nordic countries on issues of local governance and employment. These countries have been a formidable source of policy lessons for the LEED Directing Committee and the OECD over the past years. Finland played a key role in the process in promoting the OECD Study on Local Partnerships carried out by the LEED Programme. Denmark, Norway and Sweden also participated in this project, along with nine other countries throughout the OECD area; each organised a seminar to debate its results with local and national stakeholders (OECD, Local Partnerships for Better Governance, *2001;* New Forms of Governance, *2004).*

Much of the work carried out with the Baltic Sea region has thus been able to feed into the policy research agenda on local governance and employment initiated within LEED, of which this publication is an offshoot. This agenda was launched in 1998 following the Venice high-level conference on decentralisation, which stressed the importance of improving local governance to enhance policy outcomes, as outlined by the seminal report on Local Management of Employment and Training *(1998). It also* identified partnership and decentralisation as two principal avenues for achieving this goal (OECD, Decentralising Employment Policy: New Trends and Challenges, 1999). The work on partnership and decentralisation proved extremely important in the implementation of this agenda, in that it clarified the capabilities and limits of both instruments. Local Governance and the Drivers of Growth, released by the OECD in 2005, strengthened the foundations of local governance by relating its key aspects (co-ordination, adaptation and participation) directly to the problem of economic growth. Thematic aspects of the local governance/employment nexus have been analysed further in two recent publications: skills upgrading for the low-qualified (Skills Upgrading: New Policy Perspectives, 2006) and the integration of immigrants into the labour market (From Immigration to Integration: Local Solutions to a Global Challenge, 2006).

LEED is now in a position to help the Baltic Sea region to benefit fully from the lessons learnt through this agenda. The expertise gained is indeed broad and can be applied to a range of policy and institutional contexts. The Baltic Sea is an excellent pilot region for implementing these lessons: the area is already an experienced laboratory for economic and administrative reform carried out in the pursuit of ambitious programmes to foster innovation, entrepreneurship and skills enhancement. Yet, while transnational governance frameworks are in place, little progress has been made toward local governance in some countries, especially the Baltic states and the Russian Federation. This aspect is of critical importance for competitiveness and social cohesion, not only in the countries concerned but throughout the region.

To help the region make progress on these issues, the LEED Directing Committee has carried out a project on employment, economic development and local governance in the region. Research was commissioned and seminars held in Rīga, Vilnius and St. Petersburg in 2005; national policy makers and local stakeholders representing local government, business and civil society met to discuss the barriers to effective governance and explore ways to overcome them. The seminars generated a healthy policy debate that has fuelled policy and institutional development.

This publication presents the result of the research and policy debate as part of this activity. This project would not have been possible without the contribution provided by the European Commission (DG Employment, Social Affairs and Equal Opportunity), the Ministry of Economics of Latvia, the Ministry of Social Security and Labour of Lithuania, and all the countries that participated in the various projects stemming from LEED's policy research agenda on local governance and employment. It is my hope that the book can serve as a key source of policy guidance to enhance prosperity and social cohesion in the Baltic Sea region.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Executive Summary

Integration and local governance: drivers for growth

Though diverse in terms of level of economic development and type of institutional framework, the Baltic Sea region (BSR) is an area of close co-operation. A common geography provides the basis for shared interests in policy issues such as security, the environment and economic development. A great number of initiatives have been set up since the end of the Cold War to nurture economic integration and promote economic growth and the competitiveness of the region. Many of these initiatives have been led by the states themselves but others have emerged from business, civil society and sub-national governments.

There is clear understanding that integration and co-operation can contribute to achieving growth by increasing the density of exchanges within the region. Most of the benefits from integration materialise through the free circulation of goods and factors. But connecting economic actors through networking and information sharing makes it possible to enhance business and foreign direct investment opportunities, thus helping the poorer countries to catch up more quickly and the richer to penetrate a large market more easily. This leads to increased competition, which in turn stimulates the creation of business networks, further innovation advances and better strategies.

While good transnational governance frameworks are conducive to promoting a strong regional competitiveness agenda, the potential of the region remains unfulfilled in the absence of effective governance mechanisms at the local and regional levels. National or transnational innovation systems are ineffective if they are not based on sound local innovation systems that are closer to business, higher education institutions and training organisations. Transnational co-operation among firms produces suboptimal results if strong links are not established between local firms to start with. The flow of international talent (which is relatively resource-intensive and costly to organise) provides greater added value once human resources are efficiently allocated locally and nationally.

Local governance matters when it comes to growth and competitiveness. Some of the main factors of growth and competitiveness are sensitive to local conditions, to the actions of local and regional actors, and to situations of interdependence. This is especially true of innovation, of skills, and of entrepreneurship. Analysis of how these three drivers of growth perform shows that there are three aspects of governance to which attention should be paid: the co-ordination of policy; the adaptation of policies to local conditions; and the participation of outside partners (mainly business and civil society) in shaping measures.

Baltic contrasts

On this account, the performance of the BSR is mixed. While the Nordic countries have proved particularly innovative and ambitious in their respective governance agendas over the past ten years, progress has yet to be made in the Baltic states and Russia.

In the three Baltic states, the process of accession to the EU has had a positive effect on governance through helping to shape the institutions governing employment and economic development. However, labour market policy and vocational training are managed in a top-down manner without much adaptation to local conditions, and central government holds most of the purse strings for local government. Genuine local employment and economic development initiatives are lacking in all three countries. The development of social dialogue is weak and corruption remains a serious problem. In addition, in Estonia and Latvia there is a clear and urgent need to accelerate territorial reform. In both countries the great number of small municipalities represents a barrier to the creation of effective local employment and economic development initiatives.

Comparison between the Baltic states reveals that Lithuania is ahead of its neighbours on the governance agenda, in that it is the only one of the three to have carried out local government reform, with the establishment of two tiers of elected government interlinked by a regional-level administration appointed by central government and a consolidation of municipalities. The numerous small municipalities in Estonia and Latvia are unable to cope with current economic and social challenges. Lithuania's reform has not solved all problems of strategic capacity and cost efficiency at the local level however, as its municipalities remain financially dependent on the national level and have little scope to initiate policies or programmes that address local priorities and target pressing local needs.

Territorial reform is only part of the response needed to foster endogenous development effectively. Successful local development, whether in the

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economic, employment or social spheres, requires an efficient organisation of local government duties combined with local governance mechanisms for co-operation between public, private and non-governmental sectors. Only then is it possible to pool knowledge, expertise and resources, share risks and improve outcomes. To tackle critical challenges, such as the threat of rapid population decline that is due to hit Estonia in the future, no single organisation – let alone one at the local level – can provide a satisfactory response. In Latvia the government now recognises the importance of regional strategies in promoting economic development, but is still in the process of building strong regional institutions that can produce a "platform" for both economic competitiveness and the removal of regional disparities.

Governance issues that arise in Russia are similar to those in the Baltic states, though the underlying challenges are different: here the principal issue is the need to diversify the economy and create quality jobs. Regional agencies and other partners in North West Russia take initiatives and design endogenous development strategies to tackle these issues. However, their success is impeded by serious obstacles such as the limited financial independence of regions, the limited development of active labour market policies, and the slow progress of local government reforms. The current governance framework, rigid and centralised, is not conducive to developing local initiatives, let alone implementing joined-up solutions to complex issues. Employment services do not have sufficient room for manoeuvre to pursue strategies geared towards the specific problems of their regional labour market (*i.e.* skills upgrading, integrating immigrants). The weakness and underdevelopment of the local level of government hinders the development of territories and provides obstacles to further reform, including that of the provision of public goods. Corruption and the lack of transparency are rampant.

A challenging agenda ahead

The governments of the Russian Federation and all three Baltic states therefore have a challenging agenda ahead. There is currently a lack of co-ordination, adaptation to local conditions and participation of business and civil society in shaping measures in all the countries reviewed. Correcting these failures is all the more pressing given that the resources available for economic and employment development are scarce; there is a need to combine these resources, use them strategically and draw on all expertise available.

Wide experience from the OECD area and other parts of the Baltic Sea region can be used to help the Baltic states and Russia make progress. The two main avenues taken by countries to improve governance are decentralisation and partnership, each of which can take various forms. Decentralisation comprises devolution to lower levels of governments and the delegation of decision-making responsibility within the same administrative structure. The concept of partnership takes in a range of governance forms, from the rather small-scale area-based partnerships developed in Ireland to fight social exclusion and various territorial employment pacts in Europe to regional strategic platforms addressing endogenous development issues and regional skills alliances that match workforce development and job opportunities on a wider geographical scale.

The general lesson from the OECD experience is that decentralisation, devolution and partnership should be used with care. The surest way to stimulate strategic planning, co-ordination, adaptation and participation in the field is to: *i)* provide flexibility in the management of key policies and measures; and *ii)* strengthen capacities at local level in order to refine local diagnosis of opportunities and threats, develop cross-cutting strategies, organise fund-raising, achieve successful implementation of measures, promote innovation and undertake evaluation. Establishing a form of governance such as partnership or decentralisation must be seen as a complement to these steps.

The importance of learning from each other

Implementing these lessons will be made easier by learning from the experience of the BSR itself. The area includes some of the industrialised world's most innovative countries in respect of local governance; these boast an impressive track record in pursuing governance objectives through the establishment of different forms of partnership, decentralisation and devolution. Finland in particular has a wide experience of area-based partnerships to fight social exclusion and re-integrate disadvantaged groups in the labour market. Sweden, a country that has a long and critical experience of social partnership, embarked a few years ago on developing regional strategic platforms to encourage co-ordination on endogenous development initiatives, innovation and entrepreneurship. Norway has been experimenting with regional strategic platforms for many years, and recently drew on the lessons from this experience to launch a new governance structure for regional development. Denmark has long promoted a co-ordinated approach to labour market policy and economic development at regional level, and is now streamlining its regional structures to increase their critical mass. In Germany, numerous partnerships have been established to fill policy gaps left by a complex institutional framework and co-ordinate actions for economic and social development. Poland, whose governance challenges are similar to

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those of the Baltic states, has an experience of devolution to local government that is worth examining.

When the lagging countries manage to close the gap in governance separating them from the most experienced in the region, they will be more successful in enhancing prosperity and raising living standards, and the entire region will be closer to achieving its common goals. The Baltic states and Russia should capitalise on the current spirit of integration and co-operation that flourishes along the shores of the Baltic Sea, and learn from other countries about their particular governance achievements and failures.

Countries would also do well to learn from the exchange of best practice that takes place within Germany. Models cannot be wholly replicated; it is important to identify transferable mechanisms that can still be helpful in a different context. Areas in Germany's Western *Länder* have a long experience of trying to fill the gaps left by the complex administrative and policy framework of the country – an experience considered an asset by the Eastern *Länder*. These same lessons could also prove helpful in the broader Baltic Sea Region.

Kaliningrad also offers a useful model for learning from other regions and countries, mainly through cross-border co-operation initiatives. The Kaliningrad region has a unique situation: a Russian enclave in Europe, it is also a special area for EU-Russian co-operation and more likely to co-operate intensively with territories of foreign states than any other region of the Russian Federation. Improvement of local governance and the elaboration of development strategies in the framework of EU regional policy directly benefit the Kaliningrad region. Therefore, adjacent EU regions are considered not just as economic rivals or partners, but as role models as well. Kaliningrad can be seen as a pilot region for designing and testing new mechanisms for bilateral partnerships and new forms of governance for economic development in the Russian Federation.

A further important topic for cross-country comparison is the question of whether or not a country needs a regional tier of government. Various models of regional government have evolved from the modernisation of the sub-national state across Europe and elsewhere over recent decades. The establishment of strong, directly elected regional governments could become a driving force for regional development in the Baltic states. The regionalisation process is a complex one however, as politicians often hope to balance the interests of important interest groups such as business organisations, political parties, large cities, smaller local governments, ministries, and the populations of rural municipalities and small towns. It is therefore advisable to take full advantage of lessons on the creation of a regional tier of government from other countries, and the Baltic Sea region has rich experience to offer.

Finally, innovation should be a central topic for international comparison and exchange of best practice in the BSR. It is a common priority for the countries in the region; they see innovation as key to tackling the structural challenges facing their economies. These countries are already attempting to link policy makers, government agencies and experts – taking advantage of geographical proximity and policy learning synergies – to develop a joint conceptual framework and to create a critical mass for joint innovation frameworks and programmes. In this way, the Baltic Rim aims to serve as an example to other regions in Europe and the OECD area – for creating environments for policy makers and practitioners to establish joint activities, build strong industrial clusters and develop methods for measuring and evaluating innovation performance and policy success.

The Baltic Sea region is becoming a formidable laboratory for both economic integration and international co-operation. Provided that local governance is improved, and the lessons arising from previous experience are adequately learned and applied, that laboratory represents a significant opportunity to increase the prosperity and living standards for all in the region.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 1

Integration, Growth and Governance in the Baltic Sea Region

by
Sylvain Giguère

The Baltic Sea region includes some of the industrialised world's most innovative countries in the area of local governance, as well as a number of countries where the need for progress is urgent. Flexibility in policy management, governance mechanisms and local capacity is lacking in the transition economies of the region. Nurturing policy co-ordination, adjusting policy to local conditions and involving business and civil society in shaping measures will help Russia and the Baltic States to promote entrepreneurship, innovation and skills enhancement. The region's emerging agenda of integration and co-operation provides a unique opportunity for the states to learn from each other's experiences and move ahead on governance issues, stimulating growth and competitiveness.

A space of co-prosperity

There has been much discussion over the past 15 years on the economic integration of the countries surrounding the Baltic Sea.[1] Separated by the East-West divide for half a century, the countries that share links to the sea and its coasts have gradually rediscovered their state of structural interdependence. Governments and their partners from business and civil society have identified common interests transnationally, established forums for co-operation and set goals to be achieved collectively.

Proximity provides the principal basis for this shared interest. Clearly it has been the main determining factor behind countries working together on critical policy issues such as security, the environment and economic development. But historical and cultural ties may also have played a part. The Hanseatic League, the trading system that brought prosperity to hundreds of cities around the Baltic Rim towards the end of the Middle Ages, is identified by some as having laid the foundations for a tradition of economic co-operation that continues today. This tradition is reflected in the deep-rooted entrepreneurial spirit that is considered to be a feature of the area.

Opinions differ on whether the region is really becoming more integrated in economic terms. After all, the potential for regional economic integration is maximised when countries are at the same level of development and have similar political traditions and institutional frameworks. On this account the case for integration is weak, as the region is so diverse. The Baltic Sea region (BSR) is composed of ten countries: four Nordic countries (Denmark, Finland, Norway, Sweden), all of which serve as models for a modernised but still generous welfare state; three Baltic states (Estonia, Latvia, Lithuania) that have embraced, to varying degrees, wide-ranging reforms to move from a planned to a competitive, market-based economy; Germany, a federal state with a diversified economy and a sophisticated administrative structure; Poland, whose economy, largely based on industry and agriculture, is undergoing a difficult restructuring process; and Russia, a power that needs to proceed with challenging political and economic reforms. The widely differing populations of the BSR countries also contribute to differences in governance issues and capacities.

Asymmetry is also associated with the presence of the EU in the region: only two countries (Denmark, Germany) were members of the EU before 1995, at which time they were joined by Finland and Sweden. Four post-communist

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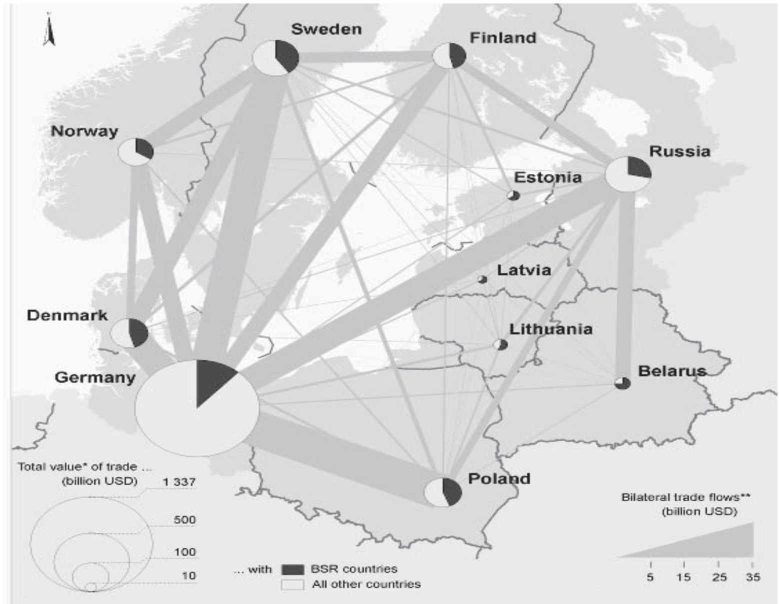
states (the three Baltic states and Poland) joined the EU as recently as May 2004. And to date only two countries, Finland and Germany, have adopted the euro. It is also important to remember that half of the BSR countries were behind the Iron Curtain until 15 years ago, and three of them were federated states within the Soviet Union. All in all they constitute a very heterogeneous mix, which following Paas and Tafenau (2004) can be classified into two different groups: five high-income countries (Germany and the Nordic countries) and five middle- or low-income countries (the Baltic states, Poland and Russia).

One factor that goes against integration is that the predominant economic interests of some of the BSR countries lie outside the region. For example, the comparatively prosperous German *Länder* are part of the Western European core, and co-operate mainly with Western European countries. Likewise, the Baltic states have kept strong economic ties with their eastern neighbours (Peschel, 1998). Yet recent studies examining trends in trade indicate that the region is indeed becoming increasingly integrated economically. In 2001, trade flows within the BSR were 2.4 times larger on average than the total trade flows outside the region.[2] On that basis the BSR was the only region to stand out as significantly integrated among three European regions examined (the BSR, Central Europe and the Mediterranean area), each composed of both old and new EU member states (Paas and Tafenau, *op. cit.*). The relative importance of trade within the BSR is illustrated by Figure 1.1, which shows the bilateral trade and their share in total trade for each country of the region (including Belarus).

Another measure of integration frequently cited is the increasing number of initiatives for co-operation taken in the region. This could reflect a growing awareness of the need to act in a co-ordinated way in areas of common interest, and of the danger of unilateralism, though it is difficult to judge the effectiveness or the influence of the various networks created. The first of these platforms for co-operation, the Commission for the Protection of the Baltic Marine Environment (HELCOM), dates back to 1974, well before the end of the Cold War, and was driven by environmental concerns over an increasingly polluted Baltic Sea. It was followed in 1992 by the creation of the Council of Baltic Sea States (CBSS), which serves as a forum for intergovernmental co-operation in almost all policy areas. Under CBSS, forums have been set up to focus on specific issues – such as Baltic 21, which assists countries in their efforts to achieve sustainable development. In addition, a platform for overall co-operation in the area and dialogue with Russia – the Northern Dimension – was established by the European Union in 1999.[3] More specifically, the European Union supports transnational collaboration on spatial planning, regional development and cross-border co-operation through the Baltic Sea region INTERREG III B Neighbourhood Programme.

Figure 1.1. **Trade integration in the Baltic Sea region**



* Sum of reported imports and exports. *Source:* IMF Direction of Trade Statistics. ** Sum of both directions based on reported exports by origin.

Perhaps more telling is the number of independent, non-profit initiatives taken to promote economic development objectives in the region. Examples include the Baltic Development Forum (BDF) and its Baltic Sea Initiative to discuss an overarching regional strategy; the Baltic Sea Forum (BSF); and the Baltic Sea Chamber of Commerce Association (BCCA). Other networks link up sub-national authorities, such as the Baltic Sea States Sub-regional Co-operation (BSSSC) and the Union of Baltic Cities (UBC). These initiatives remain linked to national policy agendas (and to the process of European integration) and can be seen as a complement to co-operation between central governments (Kern and Löffelsend, 2004; Scott, 2002).

All the initiatives taken since the end of the East-West divide share a common objective: to promote the economic growth and competitiveness of the region. How can that agenda be pursued in such a diverse group of countries with such different economic conditions?

Integration, growth and governance

Integration and co-operation can contribute to achieving growth by increasing the density of exchanges within the region. Connecting economic actors through networking and information sharing makes it possible to enhance business and foreign direct investment opportunities. Poorer countries can catch up more quickly through larger flows of FDI and greater access to advanced technology. The richer countries are in turn in a better position to penetrate a large market and benefit from enhanced opportunities for outsourcing. In the long run, the whole region will gain from the increased specialisation and improved efficiency that results from market enlargement. More competitive productive sectors across the region will attract FDI and talents from outside the region. And increased competition will stimulate the creation of business networks, further innovation advances and better strategies (Porter and Sölvell, 2001).

Clearly, most of the benefits from integration materialise through the free circulation of goods and factors. All but one country (Russia) are part of the European single market, which was extended to the European Free Trade Area (EFTA) – of which Norway is a member – in 1993. Fostering exchange and information sharing and jointly promoting economic development objectives can be seen as an additional boost to the results from an enlarged market. Collaboration on economic development reinforces existing clusters – as foreign firms are encouraged to join existing networks – and drives innovation by connecting national innovation systems and supporting the transnational flow of talents. A good transnational governance framework within the BSR thus makes for a strong regional competitiveness agenda.

Yet transnational governance is only part of the story: it is also important to support the development of effective governance at the local and regional levels. National or transnational innovation systems will be ineffective if they are not based on sound local innovation systems that are closer to business, higher education institutions and training organisations. And transnational co-operation between firms will produce suboptimal results if strong links are not established between local firms to start with. The flow of international talent (which is relatively resource-intensive and costly to organise) will provide greater added value once human resources are efficiently allocated locally and nationally. In addition, effective governance mechanisms do more than help the most competitive regions maximise their contribution to national prosperity. As patterns of economic growth do not necessarily benefit all regions equally and sometimes lead to divergence between core areas and big cities on the one hand and peripheral rural regions and old industrial towns on the other, these mechanisms can also help disadvantaged regions to speed up adjustment.

Indeed, local governance matters to growth and competitiveness. We can also see this when we look at how some of the factors of growth are sensitive to local conditions, to the actions of local and regional actors and to situations of interdependence. This is especially true of innovation, skills and entrepreneurship (Giguère, 2005).

- *Innovation*. Innovation stems from a three-phase process: knowledge generation, the sharing and diffusion of that knowledge among potential users, and the application of the new knowledge to the development of the product. This will normally result in a new commercial activity or the renovation of existing one. The phases in the process are governed by different factors. Knowledge generation depends on the research capacities of academic establishments and firms' R&D activities, as well as on the quality of the human resources involved. Diffusion and, to a certain extent, application depend on the effectiveness of relations between the worlds of teaching, research, business and training. It follows that stimulating innovation consists of: *i)* facilitating the construction of a knowledge base by encouraging research activities and attracting firms using leading-edge technologies, as well as gifted researchers and students; and *ii)* facilitating co-operation and co-ordination between the production, distribution and utilisation of research. For *i)*, it is essential that national policies be properly adapted to local conditions. For *ii)*, there obviously needs to be good horizontal co-ordination, which is why there are frequent efforts to set up networks of firms and local innovation systems. In both cases it is crucially important that firms be involved in the different mechanisms.
- *Skills*. To build a pool of skilled labour, one needs to attract talents, boost education, upgrade the skills of the low-qualified and integrate immigrants in the labour market. Few of these goals can be achieved by a single organisation, let alone a single government agency. In fact, pursuing any of these goals may require overcoming a policy gap. Take the example of skills upgrading: those who reintegrate into the labour market after a spell of long-term unemployment have little access to further training and no longer qualify for employment services. A string of local voluntary organisations strive to fill the gap left by national policy, but research shows that strong co-ordination with government and business organisations is nonetheless required for that action to be effective. Good co-ordination between government, the non-profit sector and local employers is also a common feature of successful initiatives to integrate immigrants into the labour market (OECD, 2006a, b).
- *Entrepreneurship*. Any initiative to foster entrepreneurship must take into account the local dimension. The nature of entrepreneurial activity varies across local areas owing to differences in demography, wealth, education, occupation profiles and so on. Within the same country some areas can have enterprise birth rates up to six times higher than others (OECD, 1998) and particularly enterprising areas may confer important competitive advantages. Business assistance schemes need to be tailored to local

conditions. Local and regional governments, business organisations, training service providers and economic development organisations are useful partners for governments in this endeavour.

Thus three aspects of governance merit special attention to foster growth and prosperity: policy co-ordination; the adaptation of policies to local conditions; and the participation of outside partners (mainly business and civil society) in shaping measures. How does the BSR fare with regard to the three?

Baltic governance: the East-West divide

The East-West divide still leaves its mark in the BSR. It is all the more apparent because the high-income countries of the region, and especially the Nordic countries, have proved particularly innovative and ambitious in their respective governance agendas over the past ten years. They have experimented with numerous forms of governance, such as area-based partnerships and regional strategic platforms for economic development. They have a great deal of experience with tripartism and decentralisation. They have restructured their local and regional governments, modernised their administrations, made use of public-private partnerships (PPPs) and outsourced a number of services. These developments have been analysed extensively by the OECD (2001, 2003, 2004).

It was not possible for the post-communist countries to make similar progress on these aspects during that same period, as priority was given to more pressing political and economic reforms – stimulating participatory democracy can only come second to establishing an effective representative democracy.

And yet Poland, the three Baltic states and Russia have recently, to varying extents, become a dynamic laboratory in the field of governance. Much experimentation has taken place thanks to the EU accession process. Since accession (and even before it), EU assistance programmes have been facilitating experimentation with new forms of governance, allowing for wider co-ordination, consultation and participation in strategic planning processes. Enlargement has also had impacts in Russia, since the EU runs co-operation programmes in the Russian Federation that are inspired by similar principles (*e.g.* the Tacis Programme).

Poland in particular has been ambitious in its governance agenda. Towards the end of the 1990s three tiers of territorial government were established, the autonomy of local governments was increased and the implementation of labour market policy was devolved. Some aspects of these reforms have proved challenging, as reports have documented insufficient capacities at the local level to manage the programmes or deliver services adequately. More promisingly, at the same time Poland has taken steps to modernise the public administration and designed a flexible approach to accountability requirements in order to make policies as adaptable as possible to local needs. The government has drawn lessons from its early experiments and stabilised its governance framework in a way that is likely both to stimulate innovation at the local level and to fulfil efficiency and accountability standards (see Box 3.1 and OECD, 2003).[4]

Today it is in the Baltic States and Russia that the governance challenge mainly lies – where progress needs to be made in the three key governance aspects noted in the previous section.

Governance failures

In the three Baltic states, the process of accession to the EU has had a positive effect on governance through helping to shape the institutions governing employment and economic development. A notable example is employment policy, for which the European Employment Strategy has imposed a mandatory template. In 2005, as new member states, the three countries participated fully for the first time in the National Action Plan for Employment process. The EU is also important in terms of resources. This influence has nonetheless not been sufficient to impact local governance significantly, as Vanags reports in Chapter 2 of this volume:

- The governance of both employment and economic development remains highly centralised. Labour market policy and vocational training are managed in a top-down manner without much adaptation to local conditions. Central government holds most of the purse strings for local government.
- The development of genuine local employment and economic initiatives is poor in all three countries. Only recently have there been attempts to develop a more bottom-up approach, through a programme promoting local employment initiatives (Lithuania) and more local labour market projects receiving financial support (Latvia). The local strategic framework remains weak by all standards.
- The development of social dialogue is weak, in part due to the low coverage of trade unions, especially in the private sector. The development of meaningful social partnership at the local level is contingent on reasonably representative trade unions.
- Corruption, or the perception of corruption, remains a major problem and challenge – especially in Latvia and Lithuania.
- In Estonia and Latvia there is a clear and urgent need to accelerate territorial reform. In both countries the high number of small municipalities represents

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a barrier to creating effective local employment and economic development initiatives. Small and poor municipalities have been left behind in the allocation of pre-accession resources.

Lithuania is indeed ahead of its neighbours on the governance agenda, in that it is the only Baltic state to have carried out local government reform, as Ó Cinnéide reports in Chapter 3. The reform resulted in two tiers of elected government, one at national level and the other at local level, that are interlinked by a regional-level administration appointed by central government. A crucial feature of the reform was the consolidation of over 500 local government units into 60 municipalities, enabling recruitment of professional staff and provision of local services in a cost-efficient manner. This contrasts sharply with the prevailing situation in neighbouring Estonia and Latvia where efforts to amalgamate municipal administrations have failed, leaving numerous small municipalities unable to cope with current economic and social challenges.

The reform has not solved all problems of strategic capacity and cost efficiency at the local level, however. Lithuanian municipalities are still in a relatively weak position by international standards. They manage a limited number of administrative functions, many of which they implement on behalf of the state and over which they have little or no decision-making authority. Moreover, the local authorities lack financial independence as their capacity to raise revenue locally is considerably constrained; they therefore rely mainly on state transfers, and most of those have previously been allocated to implementing assigned national functions by the municipalities. In a situation reminiscent of Poland, already discussed, local governments have little scope to act in a proactive manner or to initiate policies and programmes that address local priorities and target pressing local needs.

Though territorial reform is important, it is only part of the response needed to foster endogenous development effectively. The lesson from Lithuania for both Estonia and Latvia is that it is not enough to reform and strengthen the core institutions of local government. It is as crucial to build around these institutions a framework of partnership involving business interests, citizens and voluntary and third-sector organisations. In this, the challenges for local governance in the Baltic states are similar in important respects to those identified for more advanced economies, as Geddes explains in Chapter 4. The shift from government to governance is seen as a means of including all actors and sectors in governance processes, in order to pool knowledge, expertise and resources, share risks, and improve outcomes. In the case of Latvia, the government now recognises the importance of regional strategies in promoting economic development, but is still in the process of developing strong regional institutions that can provide a "platform" for both economic competitiveness and the removal of regional disparities.

Cases of partnerships have been identified in Latvia but their contribution to local governance is unclear. There are poor connections between weakly structured partnerships working in different fields within the same geographical area, and few linkages with the national level. Training and technical assistance for local projects are lacking, and no guidance is provided by government. There is an open debate on what incentives are needed to facilitate the emergence of effective local economic development projects. Signs are encouraging however, as the local dimension of projects supported by the European Social Fund (ESF) is seen as expanding. The number of projects concerned with local and regional labour market issues was increasing in 2006 compared to the previous year.

Similar conclusions are obtained for Estonia by Jauhiainen in Chapter 5. Implementing reform remains essential, but territorial reform alone is not enough. Professionalisation of administrative, management and leadership skills is needed, along with greater decentralisation of decision making, clearer independence of local budgets from state funding, and more intensive inter-municipal collaboration. Successful local development, whether in the economic, employment or social spheres, requires an efficient organisation of duties of local government combined with the implementation of sound local governance mechanisms involving co-operation between public, private and non-governmental sectors. According to some, the lack of attention to these governance mechanisms has actually contributed to the failure of policy initiatives to reform the territorial and public administration. To tackle critical economic, human and employment challenges, such as the threat of rapid population decline that is due to hit Estonia in the future, no single organisation – let alone at local level – can provide a satisfactory response. What is and will be needed is appropriate and interactive co-operation between public, private and non-governmental sectors at local, regional and national levels.

Indeed, participatory democracy has become an important issue in the Baltic States. In Lithuania, the economic benefits arising from a relatively successful transition to a free market economy have not reached everyone, and social disparities are widening despite government reforms, a more sophisticated approach to economic planning that facilitates business, and special labour market measures targeted at depressed areas throughout the country. Though Lithuania has made progress in creating a functioning representative democracy, and involving the social partners and other stakeholders in the development process, these efforts need to be redoubled in order to create a form of governance that is truly participative as well as representative (Ó Cinnéide, Chapter 3).

Governance issues that arise in Russia are similar to those of the Baltic states although the underlying challenges are different, as Denisova and

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Svedberg explain in Chapter 6. The North West federal district is generally regarded as one of the most dynamic parts of Russia. However, its economy relies heavily on raw materials such as minerals and wood. The region was traditionally dependent on heavy industry (*e.g.* shipbuilding, machinery), which has undergone a painful process of restructuring over the past decade. One key challenge is to diversify the economy to make it more competitive and sustainable in the long run. Another is job creation. Though unemployment in North West Russia is lower than the Federation's average, too few jobs are created and most are in low-paid service sectors. Simultaneously, labour shortages are experienced in some high-skilled sectors. Therefore there is a clear need for designing and implementing endogenous strategies that seek to enhance innovation, build a pool of skilled labour and foster entrepreneurship. In achieving this, the country can build on the healthy development of research centres and higher education institutions in St. Petersburg.

Regional agencies and other partners in the Russian Federation do take initiatives to tackle these issues and propose strategies and projects. However, their success is impeded by serious obstacles such as the limited financial independence of regions, the limited development of active labour market policies and the slow progress of local government reforms. The current governance framework, rigid and centralised, is not conducive to the development of local initiatives, let alone the implementation of joined-up solutions to complex issues. Employment services do not have sufficient room for manoeuvre to pursue strategies geared toward the specific problems of their regional labour market (*i.e.* skills upgrading, integrating immigrants). Most of their budget is spent on income assistance measures and basic employment services. The weakness and underdevelopment of the local level of government hinders the development of territories and raises difficulties for further reforms, including that of the provision of public goods. Corruption and the lack of transparency are rampant.

Thus a challenging agenda is ahead for the governments of the Russian Federation and all three Baltic states. There is a lack of co-ordination, adaptation to local conditions and participation of business and civil society in shaping measures in all countries reviewed. However, some progress is being made, as governments now acknowledge local governance issues as central to the agenda of growth, competitiveness and social cohesion. In Russia, the newly established Ministry of Regional Development is implementing a twofold programme consisting of, in the first phase, setting up strategic planning mechanisms in the regions and, in the second, designing appropriate institutional structures for their implementation. Behind this objective lies the concern that the resources available for economic and employment development are scarce; there is a need to combine them, use them strategically and draw on all expertise available. The need to take an integrated approach to economic and employment development is also being articulated in projects to stimulate regional development strategies in the three Baltic states.

Moving ahead

What are the viable options for these countries? The experience of OECD countries in improving governance is vast. As mentioned earlier, the Nordic countries have been particularly keen to improve their already advantageous situation in this field. The two main avenues taken by countries to improve governance are decentralisation and partnership, each of which can take various forms. Decentralisation comprises devolution to lower levels of governments and delegation of decision-making responsibility within the same administrative structure. The concept of partnership takes in a range of governance forms, from the rather small-scale area-based partnerships developed in Ireland to fight social exclusion and various territorial employment pacts in Europe to regional strategic platforms that foster endogenous development and match workforce development and job opportunities on a wider geographical scale.

This experience, as well as the lessons that can be drawn from it, has been analysed extensively in other OECD reports (see in particular OECD, 2001, 2003, 2004 and 2005). It is possible to extract some central lessons of particular relevance to the emerging economies of the Baltic Sea region that could be used as guidelines for further governance improvements:

1. There is no one-size-fits-all model of partnership. The choice of the form to be used needs to be informed by the local institutional context, needs and ambitions. Even if one model of partnership seems to be used generally to address an issue in a given country (such as regional strategic platforms to address innovation and economic development topics), another form of governance may better match a different institutional framework. In some countries, greater results may be obtained through informal collaboration than through an institutional form of partnership.
2. Partnership should be considered a complement to other governance reforms. The establishment of partnerships does not in itself guarantee better policy co-ordination or sufficient adaptation of policies to local conditions. Partnerships may provide appropriate solutions to localised problems, but alone they are unable to generate significant reorientation of policies or greater room for manoeuvring for local public service organisations. Establishing partnerships requires significant efforts to preserve accountability in the use of public funds.

3. A partnership is not necessarily the best service delivery instrument. Partnerships can be effective to varying degrees, but other organisations may be better suited to programme implementation or service delivery tasks, *i.e.* private service providers or non-profit voluntary organisations. Area-based partnerships and other collaborative platforms are strategic in nature: they design a strategy and organise co-operation in a way that will make that strategy work. Mixing strategy and delivery can sometimes have a negative impact on policy effectiveness, public accountability and the legitimacy of the partnerships themselves.
4. Decentralisation does not necessarily lead to better adaptation to local conditions or support the development of area-based strategies. Greater flexibility in the implementation of programmes does not necessarily follow from the delegation of decision-making responsibility to subaltern officers in the hierarchy and in the field. Management by objectives, where this involves the setting of clear targets for the implementation of programmes and the monitoring of performance, does leave some leeway in terms of the methods that local officers can use to achieve their targets. However flexibility is rarely available in the strategic orientation behind such programmes and the target-setting process.
5. Successful devolution is hard to achieve. Devolution is a tricky exercise. For the recipients of power to be in a position to perform their new tasks adequately they need to be furnished with appropriate resources, both financial and human. Not only is an appropriate transfer of resources difficult to estimate, but devolution is difficult to implement due to political and administrative obstacles. As examples in Poland and elsewhere show, it is difficult to make the right match between responsibility and resources.
6. Civil servants should be at the core of new forms of governance. Any co-ordination mechanism that relies solely on the capacity of non-government stakeholders (*e.g.* civil society organisations) to convince civil servants to participate in collective strategic exercises will fail. Local public service officers possess information on the local context and national programmes that is critical to the preparation of diagnoses, and have strategic capacities that can be put to use in the design and implementation of strategies. Appropriate incentives should be devised for their participation, and performances monitored accordingly.

The main conclusion that can be derived from such lessons is twofold. First, *flexibility is a central pillar of effective governance*. The only way to stimulate strategic planning, co-ordination, adaptation and participation in the field is to provide flexibility in the management of key policies and measures. In a management-by-objectives framework, this requires allowing local officers the freedom to alter targets set at the national level in accordance with local strategies, initiatives and projects. Second, *capacities must be reinforced*. In order to be able to translate information and feedback on programme implementation into policy-relevant diagnoses, feasible crosscutting strategies, fundraising, successful implementation, innovation and evaluation, civil servants and practitioners alike require a considerable amount of training, coaching, monitoring and networking.

A rich learning area

In implementing such lessons and recommendations, there is a great deal that the BSR countries can learn from their neighbours within the region. The BSR includes some of the industrialised world's most innovative countries in respect of local governance. They have an impressive track record in pursuing governance objectives through the establishment of different forms of partnership, decentralisation and devolution. Some have further reformed their governance framework following review of the outcomes achieved. Analysing their experience would allow countries to build on previous success and avoid repeating mistakes:

- Finland has a wide experience of area-based partnerships to fight social exclusion and re-integrate disadvantaged groups in the labour market. The programmes have been drastically streamlined in recent years but the partnerships that remain in existence offer strong insights on ways to facilitate collective problem-solving locally (see Box 4.5 and Ó Cinnéide, 2001). Some of Finland's governance developments have been inspired by the Irish partnership model (see Box 4.4 and Turok, 2001). The country is also attempting a cross-sector approach to policy through establishing combined offices at regional level, though most of the policies concerned are managed following strict performance requirements that encourage a relatively narrow approach to implementation.
- Sweden, a country with long and thorough experience of social partnership, embarked a few years ago on developing regional strategic platforms (called regional growth agreements) to encourage co-ordination of endogenous development initiatives, innovation and entrepreneurship. The model has been reviewed recently for use in regions with greater critical mass and more involvement from local and county officials. The review of Swedish regions' experience highlights some difficulty in incorporating broader dimensions (such as skills, education and social development) in the economic development agenda and effectively co-ordinating policies (see Box 4.3 and Morgan and Sol, 2004).
- Norway has been experimenting with regional strategic platforms for many years in a few counties and recently drew on the lessons from this experience to launch a new governance structure for regional development.

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Regional partnerships, involving public, private and civil society actors, design four-year county plans that propose strategic orientations for national policies while co-ordinating local and regional actions. It is not clear whether these changes give rise to modifications in the management framework of national policies concerned (Geddes, 2004; Knutzen, 2003).

- Denmark has long promoted a co-ordinated approach to labour market policy and economic development at regional level. In the 1990s it decentralised the former and set up regional labour market councils, which incorporate local and regional government representatives. Decisions made by the councils have not always been considered binding by some stakeholders, such as the county administration. A reform (taking effect in 2007) is currently streamlining the territorial structure from 14 to 4 regions in order to increase the critical mass of the regions and improve co-ordination of policies (see Box 3.2 and Keane and Corman, 2001).
- Germany has a complex institutional framework; different policies are managed at different governance levels and by different stakeholders. One of the challenges for the local level is to fill gaps and co-ordinate actions in order to promote economic and social development. Many partnerships have been initiated in the economic development, employment and social inclusion spheres to meet that challenge. Although many experiences have been successful, they have remained localised and issue-based. Rare are the initiatives that have influenced governance or policy frameworks significantly (see Box 3.3).

Given the current spirit of integration and co-operation that flourishes in these countries, it is to their experience that the transition economies should look for inspiration. When the lagging countries manage to fill the gap that separates them from the most experienced ones, they will be more successful in enhancing prosperity and raising living standards, and the entire region will be closer to achieving its common goals. A cross-country comparative approach should help accelerate the catch-up process.

Case studies in cross-country comparison and exchange of best practice

There are thus plenty of opportunities in the Baltic Sea region to exchange experience in the field of governance. As models cannot be wholly replicated from country to country, it is important to identify transferable mechanisms that can be helpful in another context. In Germany for example, some areas in the Western *Länder* have long experience in trying to fill the gaps left by the complex administrative and policy framework of the country. That experience has generated helpful lessons for improving governance in the Eastern *Länder* (and could do so for the broader Baltic Sea region).

Chapter 7 by Kuhle examines the workings and results of both a partnership for economic regeneration in North Rhine Westphalia and a similar one set up in Brandenbourg. It compares the achievements of the partnerships, taking into account the different degrees of difficulty faced, and draws conclusions for the potential of transferring experiences to different contexts.

Kaliningrad offers a useful model of how to learn from other regions and countries, mainly through cross-border co-operation initiatives. The Kaliningrad region is in a unique situation, as Ignatiev demonstrates in Chapter 8. A Russian enclave in Europe, it is also a special area for EU-Russian co-operation and more likely to co-operate closely with territories of foreign states than any other region of the Russian Federation. Indeed, improvement in local governance and the elaboration of development strategies in the framework of EU regional policy directly benefit Kaliningrad. Therefore, adjacent EU regions should be considered not just as economic rivals or partners for the region, but as role models as well. The case of Kaliningrad well illustrates the benefits of cross-border co-operation and the advantages of exchanging experience and best practice with foreign partners on specific issues of common interest. Kaliningrad can be seen as a pilot region for designing and testing new mechanisms for bilateral partnerships and for experimenting with new forms of governance for economic development in the Russian Federation.

A further important topic for cross-country comparison is the question of whether or not a country needs a regional tier of government. Začesta and Pūķis in Chapter 9 show how the development of various models of regional government has been a major aspect of modernising sub-national governance across Europe over recent decades. Unlike other EU member states, Latvia has not yet addressed the issue of whether it should establish a regional tier of government. The establishment of strong, directly elected regional governments could become a driving force for regional development in the country. The regionalisation process is a complex one however, as politicians often hope to balance the interests of several important interest groups such as business organisations, political parties, large cities, smaller local governments, ministries and the population of rural municipalities and small towns. It is therefore advisable to take full advantage of lessons on creating a regional tier of government from other countries.

Finally, a central topic for international comparison and exchange of best practice should be innovation. As discussed at the outset of this chapter, the countries of the Baltic Sea region share a number of common priorities for policy development, and innovation is one of them. Countries see innovation as key to tackling the structural challenges facing their economies, as Wise Hanssen explains in Chapter 10. Countries of the region are attempting to bring policy makers, implementing agencies and experts together – taking advantage of geographical proximity and policy learning synergies – to develop a joint conceptual framework and create a critical mass for joint innovation frameworks and programmes implemented in the BSR. In this way, the Baltic Rim aims to serve as an example to other regions in Europe and the OECD area for creating environments for policy makers and practitioners to establish joint activities, build strong industrial clusters and develop methods for measuring and evaluating innovation performance and policy success.

The Baltic Sea region is becoming a formidable laboratory not only for economic integration, whose outcome may remain unknown for some time to come, but also for international co-operation. Provided that the lessons from previous experience in improving local governance are adequately learned and applied, both integration and co-operation represent significant opportunities to increase the prosperity and the living standards for all in the region. Improving governance should therefore be at the core of the Baltic Sea region's agenda for growth, competitiveness and social cohesion.

Notes

1. The author would like to thank Francesca Froy, Mike Geddes, Micheál Ó Cinnéide, Marcus Svedberg, Ekaterina Travkina and Alf Vanags for their comments on this chapter.
2. This estimation takes into account the size of the economy, the level of economic development and the distance between the countries, using variables in a model of gravity equations.
3. The Northern Dimension concept covers a broad geographic area, stretching from the Arctic and sub-Arctic to the southern shores of the Baltic, and from North West Russia in the East to Iceland and Greenland (Denmark) in the West.
4. Local governance developments in Poland have been extensively analysed by the OECD. Poland has been a participant in the peer review process of the Organisation since it joined in 1995, together with the Czech Republic, Hungary and Slovakia. As such it is the only former communist country of the Baltic Sea region to be member of the OECD. In 2003 it hosted an international conference on decentralisation to provide an opportunity for comparing its achievements in the field of governance with those of other member countries. A publication followed, entitled *Managing Decentralisation* (OECD, 2003), which analyses the case of Poland in several chapters, by Michał Boni ("Poland: Opportunities, Mistakes and Challenges of Decentralisation"), Grażyna Gęsicka ("Poland: A New Accountability Framework for Human Resource Development Programmes"), Sylvain Giguère ("Managing Decentralisation and New Forms of Governance") and Xavier Greffe ("Decentralisation: What Difference Does it Make?"). Poland is one of the 11 countries participating in the new OECD project on Integrating Employment, Skills and Economic Development (IESED) implemented by the OECD LEED Programme.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 2

The Governance of Employment and Economic Development in the Baltic States*

by

Alf Vanags

Running through governance structures in the Baltic states is a tension between the old and the new – between the mentality of the Soviet Union and the vision of the European Union. Much progress has been made to improve governance since the fall of communism, yet much remains to be done. The governance of both employment and economic development remains highly centralised, and this poses obstacles to local innovation in policy development and initiatives of local development. The EU accession process was crucial in shaping new institutions, but there is a clear need to accelerate reform. Promising signals are sent by attempts to develop a more bottom-up approach within the framework of horizontal collaboration.

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The economic and employment context in the Baltic states

Macroeconomic performance

As is rather well known, during the early 1990s all three Baltic states suffered a severe "transitional recession" with cumulative output declines in the region of 40-50%. Growth resumed around 1995 and since then real GDP growth has been truly remarkable. Cumulative real GDP growth for the period 1996-2003 has been 51% for Estonia, 59% for Latvia and 52% for Lithuania. Moreover, the growth rates for the first half of 2004 show no signs of a slowdown – in fact quite the opposite. Table 2.1 below puts recent Baltic growth performance into a European perspective – growth in the Baltics has been better than in the new member states (NMS-10) as a whole and much better than in the EU15.

Table 2.1. **Recent GDP growth in the Baltics and elsewhere**

	1999	2000	2001	2002	2003
EU15	2.9	3.5	1.6	1	0.7
NMS-10	3.3	4.1	2.4	2.5	3.6
EE	–0.1	7.8	6.4	7.2	5.1
LT	–1.7	3.9	6.4	6.8	9
LV	3.3	6.9	8	6.4	7.5

Source: Eurostat.

In all three countries growth has been generated by a combination of strong capital accumulation – investment as a share of GDP has been running at around 20% in Lithuania and 25-30% in Latvia and Estonia – and total factor productivity (TFP) growth. The two effects have had an approximately equal impact, and have more than offset the impact of negative employment growth.[1]

Nevertheless, there is a long way to go to achieve catch-up with the EU15 – the Baltic states remain three of the four poorest EU member states, with Latvia in bottom place, Lithuania next and Estonia, which has recently overtaken Poland, now lies in fourth from bottom place. However, the gap to the next country up is quite large.

On the potentially negative side, all three countries have been running persistent current account deficits – Latvia in the region of 8-10% of GDP and

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Lithuania at around 5-6% of GDP. In Estonia the deficit has steadily worsened, going from around 4% of GDP at the beginning of 2000 to around 14% at the end of 2003. However, these deficits have been substantially covered by inflows of FDI – especially in Estonia, where cumulative inflows have been twice as large as in Latvia and Lithuania. In all three countries there has been a pre-accession surge of imports, leading to large deficits in the second quarter of 2004 – 11% of GDP in Lithuania, 17% of GDP in Latvia, and no less than 20% of GDP in Estonia.

After the initial stabilisation of the early 1990s inflation has generally been rather modest in all three countries. Between 1999 and 2003 prices in Latvia rose at around 2-3% a year, in Estonia at between 5.8% (in 2001) and 1.3% (in 2003), and in Lithuania at 1% or less and in 2003 prices in Lithuania actually fell by 1.1%. In all three countries there has been an EU accession price surge, with inflation in Latvia running at an annual rate of 7.4% in the latter part of 2004, and in Estonia and Lithuania 4.7% and about 3%, respectively.

An important development in all three countries has been the emergence of a residential housing market with sharply rising property and land prices. This has been fuelled by historically low interest rates and the readiness of banks to lend freely. As a result the ratio of apartment prices to earnings is rather high by the standards of Western European countries, *e.g.* the United Kingdom. This makes the housing market and the banking sector potentially vulnerable to negative shocks.

Macroeconomic policies

The Baltic currency reforms are generally regarded as among the most successful of the Baltic reforms, and among the most successful of the transition economies. Estonia went straightaway in 1992 for a currency board with the Estonian kroon pegged initially to the Deutschmark and then to the euro. Lithuania formed a currency board arrangement in 1994 with a peg to the US dollar, and repegged to the euro in February 2002. Both countries are now participating in the EU Exchange Rate Mechanism II as a prelude to probable entry into the Single Currency in two years' time. By contrast the Latvian lat was pegged to the SDR[2] in 1994 without a currency board arrangement, and on 30 December 2004 repegged to the euro. The fixed rate systems have survived a number of banking crises, most notably the Russian crisis of 1998.

All three countries have aimed to be fiscally prudent – most notably Estonia, which has a zero budget deficit policy. In this Estonia has succeeded, and has actually run a small budget surplus over 2001-03. Latvia and Lithuania have been running budget deficits in the region of 2% of GDP.

Estonia and Latvia have flat rate income taxes at 26% and 25%, respectively. In Lithuania income tax is 33%, but some incomes are taxed at 15%. Income taxes are a major source of finance for local authorities. Corporate income tax is a flat 15% in Latvia and Lithuania; in Estonia it is zero on undistributed profits but the same as normal income tax on profits that are distributed. In all three countries social taxes are rather high, which means that the "tax wedge" on low incomes is rather high – ranging from just over 37% in Estonia to nearly 41% in Latvia.

Labour markets

A major feature of the transition has been the dramatic fall in employment in all three countries: in Estonia employment fell by 30% between 1990 and 2000; in Latvia it fell by nearly 29% between 1990 and 2002; and in Lithuania employment fell by nearly 20% between 1991 and 2001. The fall in employment is a composite of the decline in working age population caused by migration of Russian citizens, and industrial restructuring. The smaller employment decline in Lithuania reflects the fact that in 1990 it had a much smaller Russian population than either Latvia (which had the largest) or Estonia. Many previously resident Russians have migrated to Russia.

After some years of "jobless growth" in the second half of the 1990s, employment has started to pick up in all three countries in response to the persistently buoyant economies. Thus, according to Labour Force Survey data, in Estonia employment has grown by about 1% a year in each of the three years since 2001; in Latvia employment growth has been about 2% a year over the same period; and in Lithuania growth was nearly 4% in 2002 and just over 2% in 2003.

The strongly growing economies have also had a noticeable impact on unemployment in all three countries. This is illustrated in Table 2.2.

Table 2.2. **Unemployment developments in the Baltics and elsewhere**

	1999	2000	2001	2002	2003
EU15	8.7	7.8	7.4	7.7	8
NMS-10	11.8	13.6	14.5	14.8	14.3
EE	11.3	12.5	11.8	9.5	10.1
LT	11.2	15.7	16.1	13.6	12.7
LV	14	13.7	12.9	12.6	10.5

Source: Eurostat.

Not only has there been an improvement in overall unemployment, but recent growth has had a positive impact on some of the most difficult areas of

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the labour market. For example, Table 2.3 shows recent developments in long-term unemployment.

Table 2.3. **Developments in long-term unemployment in the Baltics and elsewhere**[1]

	1999	2000	2001	2002	2003
EU15	4	3.5	3.1	3.1	3.3
NMS-10	5.1	6.5	7.5	8.1	:
EE	5	5.7	5.7	5	4.6
LT	4.3	7.6	9.1	7.3	6.1
LV	7.6	7.9	7.2	5.7	4.3

1. Persons unemployed for 12 months or more as a percentage of the active population.
Source: Eurostat.

The biggest impact on long-term unemployment has been in Latvia, where the share of long-term unemployment has almost halved compared with 1999. In Lithuania it is down by one-third from a peak in 2001, while in Estonia the impact has been limited.

Other aspects of the labour market have also improved in one or more of the countries. For example, the employment rate of older workers (aged 55-64) has improved in all three countries and especially in Latvia and Estonia. This improvement has been especially marked among older women, for whom the employment rate has gone up in 2003 by more than 12 percentage points from a share of 26.6% of the age group in 1999, and in Estonia by more than 8 percentage points from 39.2% in 1999. Generally the employment rate of older workers in the Baltics is higher than in the EU15 and much higher than in the NMS-10.

Regional disparities

Although the labour markets of the Baltic states are generally regarded as "flexible", this seems to apply to mobility across jobs – as demonstrated for instance by evidence from Estonia on the length of stay in one job: Cazes and Nesperova (2001) found that one in five people stayed in a job for less than a year, and older workers (over 45 years) on average have stayed less than ten years with their employer (in the United States it is 11 years). Wages too are regarded as flexible, though we do not have formal evidence. However, regional labour market indicators in Latvia and Estonia indicate deep and persistent structural problems at the regional level, indicators in Lithuania less so. For example, employment rates in the Estonian counties vary from nearly 63% in Tallinn to just over 43% in Voru. By contrast, in Lithuania the highest employment rate is just over 66% in Taurage county (not Vilnius) and the lowest employment rate as much as 54.5%. Regional employment rates in Latvia are reported by the five traditional regions (now also designated as planning regions) – Rīga, Kurzeme, Latgale, Vidzeme and Zemgale. These are larger than the counties of the other countries. Nevertheless there are considerable disparities, with the employment rate in Rīga at 66% and in Latgale just 52%. There are also large disparities in unemployment rates.

The differences in employment and unemployment are reflected in regional differences in GDP per capita. Thus in Latvia, Rīga in 2002 had a GDP per capita at 182% of the national average; no other region exceeded 83% of the average, and Latvia's poorest region – Latgale – had a GDP per capita income at 48% of the average. There is a similar story in Estonia, with Tallinn at 153% of the national average, the next highest region of five (Western Estonia) at nearly 73% and the poorest (Northeast Estonia) at nearly 59%. In Lithuania the data on GDP per capita are at county level, which should be more dispersed because the counties are somewhat smaller than the regions of Estonia and Latvia – but GDP per capita in Vilnius county in 2002, the richest at nearly 144% of the national average, was only about 2.5 times higher than the poorest, Taurage, which had just over 57%. Apart from Vilnius county, Klaipeda also had a per capita GDP in excess of the national average at nearly 109%. Although not insignificant, Lithuania's regional income disparities are much less acute than in Latvia and Estonia. However, it should be said that the disparities have worsened since 2000 – Vilnius has become richer (in 2000 its per capita income was only 134% of the national average) and the poorest is poorer (Taurage's was just over 60% of the national average in 200).

Institutional aspects of economic development

In any country that functions as a market economy, economic development is supported by a variety of policies and institutions. At the national level there are basic macroeconomic policies, already briefly discussed in the previous section, which are implemented by national-level institutions such as the central bank and the finance ministry. There are also national-level rules and laws governing activities such as enterprise formation, enterprise activity, freedom of association, etc. that are governed in part by the courts, in part by specialised agencies such as an enterprise registration agency, and partly by local authorities in various functions such as planning or zoning. There are also sector-specific or theme-specific policies, *e.g.* scaling down of a declining industry (say steel) or promotion of innovation, that are typically implemented by ministries and specialised agencies, possibly in collaboration with local authorities. Thus, typically there is a complex system of institutions and responsibilities that has evolved over time in response to changing needs and possibly merely to changing fashions.

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The starting point of any assessment of the institutional aspects of economic development in the Baltic states must be their shared history of 50 years as Soviet republics. Not only did they possess none of the institutions of a modern market economy, but also – in contrast to other Central and Eastern European countries – they had no experience of independent statehood or of independent policy making. The consequence was that in the early transition there was a tendency to go for widely different "solutions" – for example, in trade policy, Estonia went at once for the highly liberal "zero option" of completely free trade, whereas Latvia in the first instance introduced extensive quantitative restrictions on trade which, prompted by international institutions such the IMF and World Bank, were quickly removed and replaced gradually by more modest tariffs.

The role of the international institutions in the first instance, and of the EU subsequently, has been crucial in the institutional development of the Baltic states. In the first instance the international institutions managed to steer the three countries away from what they regarded as "extreme" solutions[3] and subsequently (after 1995 when the three countries applied for EU membership and were accepted as EU associate countries) the EU accession process has provided a template for many institutional developments.

Thus the current institutional framework for economic development is in many ways the product of the EU template. This has applied to the basic legal framework regarding the economy as well as in more specific instances such as the regulation of, say, utilities; here the EU has insisted on the creation of independent utility regulators as opposed to ones that were in danger of being in "captured" by the regulated sector. Nevertheless, the three countries remain different in many ways, not least in their local government structures and in the style in which policies are developed and applied.

The key micro-level policy areas supporting economic development have been rather similar in all three countries, namely:

- Small and medium-sized enterprises (SMEs).
- Entrepreneurship.
- Innovation.
- Regional policy.
- Tourism.
- Structural funds.

It has to be said at the start that policy making in most of these areas has in all three countries by and large originated with central government – in the relevant ministry – and often with the production of a policy paper (concept), followed by the formulation of a programme and finally (sometimes) by implementation. The involvement of other actors – local governments, social partners, etc. – often (but not always) has come at a consultation phase after the policy paper or programme has been written.

Since the various tiers of local government are potentially key actors in the implementation of many policies the chapter first offers a brief account of local and regional government in each country. This will be followed by a description of the structure and development of the institutions supporting economic development in each country, and by a presentation of regional policy.

Regional and local government

Local government was a focus of the independence movements in all three counties even before the break-up of the Soviet Union led to restoration of full independence. Thus national-level democracy was preceded by democracy at the local level when in 1989 the local government elections were held, the first democratic elections of the postwar period in which seats were contested and in which the principle of majority rule was accepted. Thus all three countries entered the independence period with a territorial local government structure inherited from the Soviet Union. In the early years of transition a variety of laws were passed legitimising local governments and defining their functions. In the process there was a substantial restructuring of the whole system in Lithuania, and in Estonia a significant delegation of responsibilities to lower tiers. In Estonia the central government was "very eager to delegate as much responsibility as possible […] to municipalities" (Tiirinen, 2000, p. 17). Table 2.4 shows the structural changes implemented in the 1990s.

Table 2.4. **Changes in the local government system in the Baltic states during the 1990s**

Population (million)	At the beginning of transition, number of:		By the end of decade, number of:	
	Tiers	Local government units	Tiers	Local government units
Estonia, 1.37	2	249	1	247
Latvia, 2.37	2	559	2	552
Lithuania, 3.45	2	526	1	56

Source: Vanags and Vilka (2002).

Estonia and Lithuania also moved from a two-tier structure of elected local government to a single-tier structure. During the 1990s all three countries adopted the European Charter of Local Self-Government: Estonia did so in 1994, Latvia in 1996 and Lithuania in 1999.

Estonia

The territory of Estonia is divided into 15 counties and 241 municipalities (municipalities are divided into towns and rural municipalities). Local governments were re-established in Estonia in November 1989 and the first elections were held in December of the same year. Soviet-time *rajons* were renamed as counties and the municipalities corresponded more or less to Soviet primary administrative units. Initially there was also a secondary level formed by 15 counties and six republican towns. However, the current structure is a single-tier system introduced by the Law on Local Governments, adopted in 1993. The law stipulates that towns and rural municipalities are local self-governing units, while counties are part of the central government. The counties have no elected bodies. County governors are appointed by the central government in consultation with the municipalities of the territory covered by the county.

Table 2.5. **Estonian counties and population on 1 January 2003**

County	Population	Towns	Rural municipalities	Self-governing units	Development plan adopted
Harju	505 563	6	19	25	23
Hiiumaa	11 340	1	4	5	5
Ida Viru	183 449	7	16	23	20
Jõgeva	39 144	3	10	13	13
Järva	40 145	2	14	16	16
Lääne	29 799	1	11	12	11
Lääne-Viru	69 980	4	14	18	17
Põlva	33 601	1	13	14	13
Pärnu	91 627	3	20	23	23
Rapla	38 523		10	10	10
Saare	37 987	1	15	16	14
Tartu	149 965	3	19	22	20
Valga	36 715	2	11	13	13
Viljandi	59 065	4	14	18	18
Võru	40 813	1	12	13	13
Total	1 367 716	39	202	241	229

Source: Ministry of the Interior and the internet portal of municipalities *http://portaal.ell.ee/arengukavad*.

Estonian municipalities are responsible for basic education, social services and primary healthcare, housing, water supply, sewage, physical planning, municipal public transport and maintenance of roads. The tax base of municipalities is closely tied to national taxes, which has made for a low predictability of revenues. However, the primary problem is the uneven potential of municipalities, as many of them are very small: about one-half have less than 2 000 inhabitants. In an analysis of the performance of Estonian local authorities, Reiljan and Timpmann (2001) find that municipalities with less than 3 000 inhabitants have difficulties in carrying out their basic functions because of insufficient funds.

Table 2.6. **The size of Estonian municipalities in 2003**

Number of inhabitants	Towns	Rural municipalities	Total
0-1 000	–	27	27
1 001-2 000	6	92	98
2 001-5 000	8	64	72
5 001-10 000	11	19	30
10 001-	14	–	14
Total	39	202	241

Source: Ministry of the Interior.

Two reform themes have been and remain under discussion: one concerns the size of municipalities and the other concerns the introduction of a second tier of local government. In 1995 municipalities were given the right to merge with neighbouring municipalities. However, the idea of mergers or amalgamations has found very little support among the municipalities themselves. Central government has attempted incentives to stimulate mergers, offering EEK 1 million (nearly EUR 64 000) to merging municipalities. In practice, however, the municipalities have to bear considerable costs themselves, which has limited adoption of the reform (Reiljan and Timpmann, 2001). In July 2000 the Ministry of the Interior initiated a new reform strategy whose main goal was to increase the administrative capacity of the municipalities. However, one of the means of improving that capacity was to create larger municipalities by voluntary mergers, and mergers continue to have very little support from municipalities. Further monetary incentives have been offered but to date the number of municipalities has decreased by just six, from 247 to 241 in 2000, as against a reform target of 108.

The other theme of reforms concerns the creation of a second tier of local government. A new politically elected county council would replace the current appointed county governor. According to the proposal, municipalities within the territory of the county would elect representatives from members of the municipal governments. The idea is to transfer some of the responsibilities of municipalities to the county level. A new body, *maakogu,* would be created and this body would elect the county governor. This is similar to the Latvian system except that the municipalities would elect the whole county council, rather than just the governor (or mayor), as happens in Latvia.

Latvia

Latvia has two levels of local government. Governments in the first tier are known as towns (*pilseta*), villages (*pagasti*), and *novads*. The last-named is an amalgamation of several smaller municipalities (towns and villages). Amalgamation has been encouraged under the 1998 Act on Administrative Territorial Reform. Latvia's seven republican cities have the rights and responsibilities of local governments.

All municipalities are governed by elected councils, which in larger cities are elected by party list. In some municipalities, especially in small ones, groups of candidates form their own list without party affiliation. Once elected, the councillors elect a chairman (mayor), who acts as the chief executive. Under local government law, councils are obliged to appoint an executive director on the recommendation of the mayor. In small municipalities the mayor may also act as executive director. In addition to the usual functions and responsibilities of local government, Latvian municipalities have a responsibility for promoting entrepreneurship as well as to prevent unemployment and provide temporary paid work for the unemployed.

The second tier of local government consists of 26 *rajons*, or districts. The seven republican cities also function as districts. Before 1997, district councils were directly elected and hence had a political identity separate from the municipalities (except in the republican cities, where the council took on both sets of responsibilities). Since then the districts have been governed by councils made up of the mayors of the municipalities within their territory. The districts perform a largely co-ordinating role and have few independent functions of their own.

As in Estonia, most Latvian municipalities are very small – over 70% have a population of less than 2 000. In fact the average population size of rural municipalities is only just over 1 500. As a consequence, a main aim of reform has been to promote the amalgamation of municipalities large enough to enable the provision of high-quality services, as well as well as to promote local economic development. This reform was initially envisaged as voluntary, with the latest deadline expiring at the end of 2004. However, take-up has been modest – at last count there were 26 amalgamated municipalities (*novadi*), thus reducing the number of municipalities to 504 as against a target of 102. The new Minister for Regional Development and Local Government has stated that despite these slow developments he does not intend to force amalgamations. Local authorities are represented by the Union of Local and Regional Governments of Latvia in negotiations with the government and in bodies where local governments are represented.

For finance, municipalities rely mostly on the personal income tax followed by grants from the central government. Some revenue comes from property taxes and from non-tax sources, such as income from entrepreneurial activities, fines, and fees. Latvian municipalities are constrained in their ability to borrow – they are barred from raising loans on national or international capital markets and can turn only to the state treasury or in certain circumstances to the Municipal Development Fund and Latvian Environmental Investment Fund.

Lithuania

As is clear from Table 2.4, Lithuania is the only one of the Baltic states that has managed a comprehensive reform of its local government system. This was effected in 1995, when the previous two tier system was abolished. Thus at present Lithuania has only two levels of elected government – national and municipal. The reform radically reduced the number of elected municipalities and at the same time introduced counties, which were a totally new arm of the regional state administration that operates at a level above the new municipalities. Currently there are 60 municipalities and ten counties where the county-level administrations are appointed by the national government.

Municipalities are classified as "city"- and "district"-type local authorities (LA), and some city LAs are geographically surrounded by a single district LA (*e.g.* Siauliai City is surrounded by Siauliai District). Some municipalities are further subdivided into neighbourhoods for administrative purposes – these are essentially based on the pre-reform lowest-level municipalities.

The present structure is a result of a 2000 reform that increased number of municipalities from 56 to 60. Additional municipalities were created in Kalvarija, Kazlu Ruda, Pegege, Rietava and Elektrenai, and the Marijampole District was eliminated (divided between Kalvarija and Kazlu Ruda). At the same time Vilnius City gained territory from Vilnius District.

Local councils are elected from party lists under a PR voting system; the council then elects its leader, the mayor. However, the Lithuanian Constitution provides for control of LA matters by Parliament, severely limiting municipal autonomy.

The basic Law on Local Self-Government was passed in 1994 and has been amended 36 times as of the beginning of 2004. The Law divides local authority functions into four categories, according to how much formal independent decision-making power belongs to the municipality. The categories are:

- Independent – that is, functions in which the municipality has complete freedom of action, *e.g.* pre-school education.
- Assigned – that is, functions that are basically assigned by the state but where the LA has some decision-making power, *e.g.* transport for rural pupils.

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- State – these are functions completely controlled by the state though carried out by the LA, *e.g.* compulsory school-age education.
- Agreed – new functions negotiated between the state and LAs as to budget and administrative features.

The law also provides for election of a community representative from local housing units. The lowest level of democratic government is the elected co-operative housing administration, which decides issues such as heating level and building renovation expenditures. The law names the Lithuanian Association of Local Authorities as the institution to represent municipalities in national and other negotiations.

There is not much financial independence for municipalities – 56% of their revenue in 2005 will come from specific (categorical) grants, mostly the "pupil basket" grant, *i.e.* finance of compulsory-age education. The financial independence of LAs varies; for example, for Pagege 68% of the budget approved by Parliament for 2005 comes from specific grants, *vs* only 13% for Neringa. However, overall 7% of revenue comes from wealth taxes, which can be levied by LAs; in practice however, this proportion can vary from 25% in Palanga to 1% in Visaginas.

Much LA expenditure is either for administration of national functions or heavily regulated so as to leave little decision-making power in the hands of the LA. The major areas that LAs control are pre-school education and public works (*e.g.* sweeping and snow clearing). Apart from general education, the major budget items for state functions administered by LAs include administration of welfare payments, transport discounts for certain demographic groups, and fire services.

The reform has left Lithuania with municipalities that are very large by European standards (excepting the United Kingdom) – the average population is 58 000. Also unusual is the complete absence of LAs with less than 2 000 population (the smallest population is Neringa, with 2 400).

The Lithuanian counties (see Table 2.7 for some data) have much the same functions as their counterparts in Estonia and Latvia – namely, they act as a co-ordinating agent of central government. The county governor implements state policy in education, social services, healthcare, culture, environmental protection and agriculture, and also has responsibility for territorial planning. The county governor has the right to participate in cabinet meetings of the central government if the agenda includes topics that affect the interests of the county.

Summary

In Estonia and Latvia, the main problem of local governments is that many of them are too small to function effectively. It is partly a problem of

Table 2.7. **Basic characteristics of Lithuania's 10 counties in 2003**

	Population in 2003	GDP in 2002 (millions of euros)	GDP in 2002 (% of national)	GDP per capita in 2002 (thousands of euros)	Average recorded wage in 2002 (euros)	Registered unemployment rate in 2002	Infant mortality (under 1 year of age per thousand live births)
Alytus	186 340	607.1	4.1	3.2	255	14.2	10.7
Kaunas	696 143	2 799.4	19.1	4.0	271	8.8	6.6
Klaipeda	382 945	1 767.3	12.0	4.6	287	10.0	9.3
Marijampole	187 607	527.9	3.6	2.8	233	14.8	7.9
Panevezys	297 521	1 081.9	7.4	3.6	260	15.5	5.8
Siauliai	367 166	1 143.2	7.8	3.1	238	14.2	9.9
Taurage	133 473	324.3	2.2	2.4	220	14.6	7.2
Telsiai	179 137	632.5	4.3	3.5	284	15.9	7.0
Utena	183 131	633.5	4.3	3.4	309	11.0	7.5
Vilnius	848 090	5 150.8	35.1	6.1	341	8.7	7.8
Lithuania	3 462 553	14 667.9	100.0	4.2	293	11.3	7.9

Source: Statistics Lithuania (2003), *Counties of Lithuania: Economic and Social Development 2002* (Vilnius), Bank of Lithuania website *www.lbank.lt*, own calculations.

funds – small rural municipalities are very likely to be poor also – but also a matter of economies of scale and of the ability to attract high-quality professional staff. However, the municipalities are jealous of their independence and reluctant to dilute it through mergers and amalgamations.

Overview of institutional development

Estonia

The early legislation on enterprises included the Enterprise Law of November 1989 and the Law on Ownership in June 1990. The Law on Ownership recognised private ownership and granted equal status to private and other types of ownership. The Ownership Law also formed the legal basis for privatising state property. In 1995 a new law regulating enterprises came into force, the Commercial Law. The new law filled gaps in the early legislation by being specific about enterprise governance; for example, it gave definitions of the functions of the Board of Directors of joint stock companies. The Commercial Law was also the basis for establishing a uniform commercial register in Estonia. The first Bankruptcy Law came into effect in September 1992 and was amended in 1997. From the latter year, it has been compulsory for companies to appear in the commercial register. The growth of enterprises has been rapid: since 1997 about 10 000 new ones have been established annually, whereas the number of enterprise deaths has been relatively small, about one-tenth of the number of new businesses. The development of the private economy was spontaneous as well as influenced by policy choices about how to privatise former state property. For enterprise privatisation Estonia adopted an entrepreneurial approach, meaning an early ownership transfer of state-owned enterprises to strategic investors, mainly for money. By 1996 more than 90% of formerly state-owned enterprises had been privatised (Terk, 2000). According to estimates, about 20% of enterprises were privatised to employees and 25% to management, which implies that 45% of the enterprises were privatised to insiders and the rest to outsiders (Äripäeva kirjastus, 1999).

The first support systems for enterprises developed spontaneously outside the public sector, created by businesses themselves. The current Estonian Employers Confederation was established on 29 November 1997; however, it has its roots in an industry organisation originally established in 1917 and re-established in 1991. The Confederation has 24 business organisations as its members; it represents 1 500 employers in their relations with legislative and executive authorities and employee representatives. In 1989, the Estonian Chamber of Commerce and Industry (ECCI) was re-established with some hundred members. As of 25 August 2003, the ECCI had 3 340 members. A Small and Medium-Sized Enterprise Association (EVEA) was founded in the beginning of the 1990s; it has about 400 member companies. The association offers training, legal help and business consultations.

The beginning of public sector support for business was in 1996, when the Regional Development Foundation was established as a regional network of centres with representation in all of Estonia's counties. These Regional Enterprise Centres offer support schemes and services to local entrepreneurs; other support schemes were introduced in 1997-2000. All support programmes were developed at the ministry level. The support structure was reorganised in 2000 when eight different foundations were merged into two: Enterprise Estonia (EAS) and KredEx. Enterprise Estonia offers support programmes for business start-ups, training programmes, export planning, product development and R&D financing. Besides export credits, KredEx offers loan guarantees for companies whose self-financing is not sufficient or that lack a credit history for getting a bank loan.

As mentioned in the first section, at the national level uneven economic growth has received much attention as regional development has been strongly polarised to the territory around Tallinn, the capital city. Programmes for economic development exist in all 15 counties. However, since counties are a part of the central government, it is questionable whether the programmes can be classified as regional.

Generally, municipalities have no economic development plans. However, Tallinn differs in this respect: the city introduced a programme for small business development in February 2002. The background was that the governmental support schemes for small enterprises do not apply to businesses registered in Tallinn, since economic growth of the capital region has not been considered a problem. Tallinn's programme has two purposes: one is to increase the competitiveness of small enterprises by primarily supporting technologically based SMEs, and the other is to boost entrepreneurship in order to improve the rate of employment. The programme offers different support schemes, including those for start-ups and apprentices. The city has also launched an incubation programme and started developing a science park at Tallinn University of Technology. The park, Tallinn Tehnopol, was established in March 2003 by the city in co-operation with the university and the Ministry of Economic Affairs and Communications.

Latvia

In Latvia the institutional basis for a market economy started in September 1990, when the Law on Entrepreneurial Activity was adopted. This law defined general matters concerning the establishment, registration, management and dissolution of enterprises. A Law on Joint Stock Companies followed in 1993, a Law on Credit Institutions in 1995, a Law on Bankruptcy in 1996, and so on. Thus by 1999 the EU in its regular report on Latvia's progress in meeting the Copenhagen criteria was able to report that: "Latvia can be regarded as a functioning market economy. The legislative framework for business activity is in place" (EU Regular Report, 1999).

A new EU-compliant Commercial Law came into force in January 2002, which among other things simplified the procedures for registering business that are now quite streamlined by international standards.

As in Estonia, entrepreneurs were quick to organise: the Latvian Chamber of Commerce and Industry (LCCI) was formed in 1990 and the Latvian Employers Confederation (LEC) in 1993. The LEC was quickly involved as the social partner on the employer side in the first tripartite co-operation council, also created in 1993, and both the LEC and LCCI are founder members of the National Economic Council, created in 1999.

Many of the areas of economic development policy – entrepreneurship, SMEs, innovation, tourism – are implemented by the Economics Ministry. Policy is defined through a series of "national programmes", *e.g.* the National Innovation Programme 2003-06, the SME Programme 2004-06, and the National Tourism Programme 2000-10. The Economics Ministry is also the co-ordinating ministry for the National Action Plan for Employment (NAPE) (more on this in the employment sub-section below) and has also developed strategy documents such as the Long-term Economic Strategy for Latvia and the Single Strategy Document.

Regional development policy and responsibility for the National Development Plan (the basis for the Single Programming Document, SPD) rest with the Ministry for Regional Development and Local Government.

In the past the typical procedure for developing the national programmes has been rather top-down, with the draft document written by civil servants (sometimes with the help of academics or consultants) and often from a template drawn from elsewhere (abroad). Once a draft is ready there are consultations with the National Economic Council, composed of representatives from business, trade unions and local authorities, and with other affected sectors or organisations such as the recently formed (2003) Council of Small and Medium-sized and Crafts Enterprises of Latvia (with representatives from 27 regional and SME organisations) or the Foreign Investors Council of Latvia.

There appears to be a gradual shift towards more broadly and locally based consultation, as with the creation of the Council for Small and Medium-sized and Crafts Enterprises of Latvia.

Lithuania

The role of the various tiers of government. In Lithuania economic development planning has been largely concentrated in the hands of national government. When a new governing coalition is formed it must produce a programme for its term of office, and this must be approved by Parliament before the new government can be installed. Since this government programme is the result of sensitive negotiations between coalition partners, all subsequent government economic planning must adhere to the objectives it sets. In November 2001, however, there was an attempt by the Ministry of Economy to bring in policy advice from outside the government. As part of the preparation of the *Long-term Lithuanian Economic Development Strategy*, the Ministry established 14 expert groups led by academics in the respective fields. The resulting document was approved by the government in June 2002 but was never presented for approval to Parliament. Instead an alternative document, the *Long-term State Development Strategy,* was prepared completely within national government structures after a government directive assigned responsibility for preparing each section to national ministries in December 2001. This latter strategy was approved by the government in July 2002 and by Parliament in November 2002. In April 2003 an Implementation and Monitoring Oversight Commission was established without any representation from local or regional institutions.

The Single Programming Document marked the first time the government (led by the Ministry of Finance) conducted wider consultations, including with municipalities and business associations. The SPD working group included the Lithuanian Association of Local Authorities (LALA) as well as business and union confederations. The process started in May 2002 with the conference "Partnership in the Planning of EU Financial Assistance", in which 150 social partners participated. All partners were also invited to participate in ministry-led, sector-specific SPD working groups. The conference presented SPD priorities and implementation measures and took feedback on desired directions of socio-economic development and opportunities for further partnership. In September and October 2002 there were informal consultation seminars in each of the ten counties. Then partners themselves organised their own SPD seminars, inviting ministry representatives. This was done by the LALA, the Confederation of Lithuanian Industrialists, and other stakeholders. The Ministry of Finance alone took part in 70 of these partner-organised events. Consultations with local authorities, the LALA and counties were particularly intense in the following areas: "Reinforcement of partnership capacities", "regional policy", "Effective use of EU SF financial assistance", "Participation of Lithuanian municipalities in the preparation and implementation of the SPD", "Role of the municipalities and their abilities to absorb EU structural assistance", "Lithuanian self-government today and in future", and the "European future in Visaginas".

The consultations for the Single Programming Document may have created a useful precedent. In December 2004, the LALA contacted the Ministry of Economy regarding the *Small and Medium-sized Enterprise Development Tools for 2005* draft government decision. The local authorities are involved in the creation of regional plans, *e.g.* participation in working groups for preparation of the Vilnius County development plan by experts and division heads from all the county's local authorities.

Counties and municipalities are also responsible for producing their own economic plans. The capital, Vilnius, has published the *Vilnius City Strategic Plan 2002-11.* In county plans priorities tend to be all-encompassing; it is difficult to conceive of a project that would fall outside one of the priorities. However, the plans also contain specific projects, and six of the ten counties give the criteria for success, date of completion, and funds required by source. This becomes the focus of the plan. The Kaunas County and Vilnius County plans do not include budget allocations but only list means for achieving objectives. The means listed, however, are fairly specific, such as "Prepare a human capital study of Kaunas region, as a necessary condition for the attraction of investment".

Hence we can see which specific projects have received priority approval, and – in those plans that list budget allocations – which projects and

Table 2.8. **Comparison of county regional plans for innovation in business**

County	Total budget (million euros)	Private (million euros)	Implementation period
Alytus	82.4	35.6	2004-2006
Kaunas	Not included		
Klaipeda	2.2	No indication	2003-2006
Marijampole	1.7	0.5	2005-2007
Panevezys	3.1	0.1	2004-2006
Siauliai	69.3	32.1	2004-2006
Taurage	0.3	No indication	2004-2006
Telsiai	12.2	5.6	2004-2006
Utena	5.7	1.5	2004-2010
Vilnius	Not included		

Source: Statistics Lithuania (2003), *Counties of Lithuania: Economic and Social Development 2002* (Vilnius), Bank of Lithuania website *www.lbank.lt*, own calculations.

municipalities are receiving more support. Some projects are very long term, *e.g.* Utena City is to get a EUR 9.6 million project to renovate water supply in the city by 2020, and EUR 1.9 million is committed from the national budget. Others are more immediate – for example, the largest commitment for long-term local plan preparation in Utena County is to Zarasai, for which the national government pledged EUR 188 000 by 2005. Hence the first advantage of these plans is the increase in the transparency of data. Clearly even the projects with the shortest time horizons imply commitments that may be broken by a change of government. However, the second advantage of the plans is that they create a political impediment to cuts. The benefit to the state from creating a more credible commitment is that the other partners (local authorities, businesses and the EU) are more willing to contribute toward achievement of the goal. The government can increase the credibility of its commitment by increasing the political penalties for reneging. The Lithuanian government does this by advertising its plans widely.

As an example of the role of the county plans, Table 2.8 illustrates some of the variety in provision for innovation in business across the ten counties. Hence Alytus County planned the largest expenditures on innovation in industry. Kaunas and Vilnius Counties did not mention innovation at all in their development plans. Of the six counties that gave a breakdown, all except Panevezys expected to use EU structural funds to induce large expenditures from private business.

The role of employers, chambers of commerce and tripartism. The Lithuanian Business Employers' Confederation has an ongoing dialogue with national government, sending it proposals on various business-related issues. Examples from 2004 included a draft amendment to the privatisation law, property taxation, and the minimum wage. Similarly the Lithuanian Confederation of

Industrialists makes both public announcements of its opinion on policy issues and direct appeals to the national government. Recent issues addressed by the Confederation include introduction of the euro, savings compensation and EU entry. The Lithuanian Chamber of Commerce is perhaps less transparently politically active, although it has many contacts with government. It was active in discussion with all political parties before the 2004 parliamentary election. It has also signed a co-operation agreement with the Minister for Social Security and Labour.

The Tripartite Council of Lithuania, under the auspices of the Ministry of Social Security and Labour, contains representatives of three union confederations, two industry confederations and five ministries. The Council's discussions have concentrated on fields related to taxation, social insurance, employment law, enterprise law, EU membership and unemployment. The Lithuanian Labour Exchange is responsible for the Tripartite Commission. These commissions, functioning on a voluntary basis, are also set up at the regional labour exchanges for the consideration of employment issues. The commissions consist of representatives of trade unions, employers and public authorities.

Partnerships, local or regional development agencies, local initiatives. There are no local or regional development agencies in Lithuania. County administrations and local authorities have their own departments to manage economic development in their jurisdiction. Counties also have regional development councils. Local initiatives for economic development are most evident in the capital, Vilnius. Here efforts have been made to ease bureaucratic obstacles for investors, to improve transport infrastructure in the city and to direct development around a geographical cluster away from the historical centre. Another tool, used in Lithuania more frequently outside the major cities, is tax abatement for property taxes.

Regional policy and structural funds

It might be thought that regional policy is an area where one could find more in the way of bottom-up initiatives. However, in practice the evidence is rather mixed.

Estonia

Regional policy in Estonia is the responsibility of the Ministry of the Interior, which has a Sub-ministry of Regional Affairs with its own minister. The Ministry is responsible both for spatial planning and for regional development, and has worked out a national plan: *Long-term National Spatial Plan – Estonia 2010*. Counties have to prepare county strategies in co-operation with municipalities. Since the counties are part of central government, this seems a rather top-down process.

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Regional development policy is based the Estonian Regional Development Strategy adopted in 1999. The strategy aims at:

- Bringing living standards (average income per household) in all counties to at least 75% of the level of the Estonian average.
- Keeping unemployment rates for all counties at no more than 35% above the Estonian average.

In 2000-03 several regional development programmes were implemented. These included programmes for the islands, industrial regions and agricultural regions; local initiative centre networks; and cross-border co-operation programmes. The projects have been aimed mainly at developing human resources, at improving the business environment and at improving local infrastructure.

The targets for 2003 have not been fully met. In 2003 living standards in Ida-Viru and Jõgeva counties remained below 75% of the Estonian average, and the unemployment rates for Ida-Viru (82%), Jõgeva (58%) and Põlva (37%) counties exceeded Estonia's average unemployment rate by more than 35%.

Latvia

From 1996 to 2002, regional affairs were the responsibility of a variety of institutions. Following a review undertaken in 2001,which reported the inconsistent use of basic terms such as "regional policy" and "regional development" and concluded that Latvia lacked a co-ordinated and efficient regional policy, responsibility for regional affairs was consolidated in 2002 in a Regional Policy and Planning Board within the Finance Ministry. The Board drafted the Regional Development Law (adopted on 21 March 2002) and the Spatial Planning Law (adopted on 22 May 2002) as well as the first draft of the National Development Plan (NDP) which was to be the basis for the Latvian Single Programming Document (SPD). In February 2003 the functions and tasks of the Regional Policy and Planning Board were transferred to the Ministry of Regional Development and Local Government, where they remain today.

Regional policy in Latvia has two components: one concerns regional planning and the other concerns measures to combat regional disparities.

Planning. The Regional Development Law of 2002 created five planning regions that correspond to Latvia's traditional regions and also reasonably closely to the country's five statistical regions at NUTS III level. The planning regions and their constituent local governments are:

- Kurzeme – the cities of Liepāja, Ventspils and local governments of Kuldīga, Liepāja, Saldus, Talsi and Ventspils districts.

- Latgale – the cities of Daugavpils, Rēzekne and local governments of Balvi, Daugavpils, Krāslava, Ludza, PreiXi, and Rēzekne districts.
- Rīga – cities of Rīga and Jūrmala and local governments of Limbaži, Ogre, Rīga and Tukums districts.
- Vidzeme – the local governments of Alūksne, Cēsis, Gulbene, Madona, Valka and Valmiera districts.
- Zemgale – the city of Jelgava and local governments of Aizkraukle, Bauska, Dobele, Jelgava and Jēkabpils districts.

Each planning region has a Regional Development Agency; these agencies have prepared Regional Development Plans and other local planning documents, often with the technical assistance of foreign advisers. The problem with the Development Plans and the Development Agencies is that there is no explicit mechanism for implementation, nor for incorporating plans into mechanisms that do implement real policy, *e.g.* the structural funds. An inspection of the Latvian SPD reveals rather minimal attention to the regions and no role for the Regional Development Agencies.

Regional development. Regional development policy in the sense of addressing regional disparities and promoting regional economic activity and employment was initiated with the Law on Specially Assisted Territories and the creation of the Regional Fund in 1998. The Regional Fund provides support and facilitates entrepreneurial activities in designated assisted territories approved by the Cabinet of Ministers.

Support is mainly in the form of interest rate subsidies for businesses. There is also co-financing for business training projects and for municipalities to develop business support infrastructure (*e.g.* tourism and business support centres).

Average annual allocations from the Regional Fund have been approximately LVL 1 million (approximately EUR 1.4 million); this is therefore a small programme. However, it is claimed by the government that during the six years of its operation (1998-2003) 3 000 new permanent and 3 500 temporary jobs have been created and 3 900 jobs have been preserved; the figures in 2003 included 793 new jobs, 563 temporary jobs and over 800 jobs preserved.[4]

Nine projects were also implemented under the Phare 2000 national programmes "Economic and Social Cohesion Measures in Latgale" and "Economic and Social Cohesion Measures in Zemgale". The programme has continued with the state aid programme "Development of Business (Entrepreneurial) Activity in Specially Assisted Territories" that complies with SPD requirements. As before, support is available for enterprises registered and operating in specially assisted territories in the form of an interest rate subsidy (loans and credits to enterprises) or as an initial investment in fixed assets. Only small and medium-sized enterprises are eligible for assistance.

Lithuania

Regional policy (as well as local authorities) comes under the responsibility of the Ministry of Interior. This is the result of a reorganisation that abolished the Ministry of Public Administration and Local Government several years ago. That ministry seems to have been moved more or less wholesale to the Ministry of Interior, which now has a Department of Public Administration. This ministry includes a Local Government Policy Division that deals with LA matters, and a Department of Regional Policy that handles development co-ordination and management issues. It should be noted that the Lithuanian Ministry of Finance wields a lot of power in regional and local government matters through its control of the budget. In particular, the Finance Ministry's Budget Department contains a Regional Development and Local Authority Budgets Division.

Regional policy appears to be integrated in Lithuania. Its goals, content and objectives are defined by the Law on Regional Development (December 2002). The main goal is to reduce social and economic disparities both between and within regions, and to promote even and sustainable development of all the national territories. The regional dimension is integrated into all general national sectoral programmes and in the measures of the Lithuanian SPD.

Policy is shaped and implemented though:

- The State Long-Term Development Strategy and the Single Programming Document of Lithuania for 2004-06.
- The General Plan of the Territory of the Republic of Lithuania.
- Strategies and programmes that integrate regional policy at the level of individual economic sectors.
- General plans of designated region (county) development and administrative units.
- Municipal development programmes.
- Targeted integrated state regional development programmes aimed at solving acute regional problems.
- Regional and local development initiatives.

Instruments take the form of state support for projects implemented in critical areas and in regions facing specific regional and local problems in specific economic sectors. Here of course Lithuania has one major specific regional problem – the Ignalina Nuclear Power Plant.

Goals of the Regional Development Programme include:

- Creating conditions for the development of a regional planning system in Lithuania.
- Providing opportunities for regions and municipalities to receive EU structural support for projects.
- Preparing for implementation of the EU Communities Initiative Programme INTERREG III.

Thus there is an emphasis on assisting county administrations in drafting or updating development plans and identifying the most important regional problems (including unemployment), and also on developing a regional development vision. Regions and municipalities in critical areas have also been assisted in preparing for the successful exploitation of EU structural funds support.

At the level of direct regional measures the EU PHARE 2000 Economic and Social Cohesion Programme supported 265 projects with budgets totalling EUR 22 million in three target regions of the country (Klaipėda-Taurage, Utena and Marijampole Counties) as of end-2003.

PHARE support has been aimed at two priorities: business development and human resources development, using the Business Development Fund and the Human Resources Development Fund as instruments. Measures financed by the former promoted the creation of new companies, the development of business competitiveness and new job creation. Measures financed by the latter focused primarily on the training and retraining of vulnerable groups – youth, the unemployed, single mothers and pre-retirement age people. An important element has been development of training programmes, the training of teachers and instructors, and the purchase of training equipment.

Five municipalities (Mazeikiai, Lazdijai, Akmene, Pasvalis and Druskininkai) were identified as having special problems, and joint implementation plans for addressing social and economic problems have been developed for these municipalities. Socio-economic development measures aim at, *inter alia*:

- Developing local infrastructure.
- Increasing the attractiveness of the municipalities for investment.
- Increasing labour force mobility.

Institutional aspects of labour market policy

Labour market policy is an area in which the structure of policy has been defined very much at the top – and in this case the top means not just the central governments in the Baltic states, but Brussels. As part of the

EU accession process all the candidate countries, including the Baltic states, were committed to implementing the European Employment Strategy (EES) and have been participating in the process since 1999. The "new" EES has three "overarching objectives":

- Full employment.
- Improving quality and productivity at work.
- Strengthening social cohesion and inclusion.

These objectives are implemented through a National Action Plan for Employment (NAPE) for each member state which, within a framework of ten guidelines, should contain the following elements:

- An assessment of the current situation.
- A description and evaluation of measures undertaken in the previous year.
- An elaboration of measures proposed for the future.
- A definition of expected outcomes and targets.

The Baltic states have produced several NAPEs in previous years without participating fully in the EES as member states. Employment policy has also been shaped by Joint Assessment Papers developed and agreed at governmental level with the European Commission. The Baltic states participated for the first time in the full process in 2004.

Estonia

Institutional flexibility (labour market regulations) in Estonia is demonstrated by a relatively open wage-setting process, relatively weak but increasingly developed social dialogue, relatively low employment protection measures, low unemployment benefits, and the small impact of active labour market policy (Vesilind and Rell, 2000; Philips, 2001; Freytag, 2002; OECD, 2003). A liberal wage policy has been a feature of Estonia from the beginning of transition. Government intervention in the wage policy of the business sector is minimal, being limited to the establishment of minimum wages and fulfilment of obligations defined in labour legislation. The latter consists mainly in providing internationally acknowledged rights to workers. Salaries in the public sector are often linked to pay in the business sector, which has increased the attractiveness and competitiveness of jobs in the public sector (Antila and Ylöstalo, 2003).

A big problem for the Estonian labour market is the mismatch between what is offered by the educational system and labour market demand. The problem is especially acute in vocational education; many vocational school graduates remain unemployed after graduation (Berde *et al.*, 1999, p. 210; Venesaar, Marksoo and Maldre, 2001). In recent years this has also become a problem for young people with higher education who have insufficient employment in the economy. That may explain why for instance four out of five unemployed persons accept jobs that require a lower educational level than they actually have (Estonian Human Development report, 2002, p. 34).

Workforce mobility is revealed primarily in a fast circulation of labour, including movement within, out of and into the labour market. Labour circulation in Estonia appears to increase in periods of instability (in contrast to Western countries), when enterprises reduce the number of jobs or restructuring occurs and many workers have to change employment. This indicates that employers rather than workers drive labour market mobility in Estonia (Estonian Human Development Report, 2002). The role of employers in influencing the labour market movements is also indicated by the reasons given by workers for losing employment – the main ones are liquidation, bankruptcy or redundancy (Statistical Office of Estonia, 2001) as compared with the less than 5% of workers who left their last job because they were not satisfied with the wages, the work or the working conditions.

The flexibility of the labour market and the mobility of the workforce are determined also by the ability of the enterprises to leave the market, which means the existence of a bankruptcy law and the absence of subsidies for insolvent enterprises (Freytag, 2002). Some analyses have indicated that high employment flows in enterprises are a result of fast reforms in Estonia compared to other transition economies (*e.g.* Slovenia) (Faggio and Konings, 1999; Haltiwanger and Vodopivec, 2001). Employment mobility in Estonia is comparable with that in the United States and the United Kingdom (Davis and Haltiwanger, 1999).

The Ministry of Social Affairs is responsible for the development of employment policy in Estonia. The principal policy documents prepared in 2004 were the Labour Market Strategy in May and the Estonian NAPE in August. Active labour market policy is implemented by the Labour Market Board and its sixteen public employment service branch offices located in every county plus Tallinn. The capacity of the Estonian public employment service is regarded as limited (OECD, 2003) with weak connections with employers, minimum service impact, and a lack of capacity for training workers for many new professions. That may be why labour market policy has had modest results despite the implementation of a number of new programmes in recent years (Ministry of Social Affairs of Estonia, 2003). The result has been a relatively low average open unemployment rate because of low unemployment benefit – below 10% of average wages in 2001; a short period of benefit payments – 6-9 months; modest help from employment offices in job-seeking and training; and the weak role of social partners. There is little interest in registering as unemployed, so that the number of registered unemployed typically stands at between 50% and 75% of the number of unemployed as measured by the labour force survey.

Modernising the public employment service

The work of the Labour Market Board includes providing the unemployed with social protection and employment services; processing and analysing the jobseekers' data; and co-operating with state institutions, local governments and workers, and trade unions and associations. Attention has been repeatedly drawn to the need to increase the human resources and administrative capacity of the public employment service.

The capacity problems of the public employment service in Estonia have been repeatedly pointed out as crucial obstacles to meeting the targets of labour market policy, *e.g.* in the Labour Market Strategy. There is a need to train staff and improve the quality and efficiency of the services offered. It is proposed to use ESF projects to remedy these problems.

In 2005-06, it is planned to completely reorganise the work of the public employment service. The aim is to provide clients with forms of assistance tailored to their needs and to improve co-operation with local employers. The general principles for the new service are established in the Estonian Labour Market Strategy. When clients turn to the public employment service, they will be interviewed in order to identify the kind of assistance they need most. Depending on the assistance needed, they will be directed to the career and counselling centre or to the case management centre. The former deals mainly with clients regarded as ready to compete in the open labour market.

Clients who require more assistance and support and/or integrated services, as well as people who have not found a job through the career and counselling centre within four months, will be directed to the case manager. The task of the case manager is to assess the client's abilities and problems together with the client and to prepare a personalised action plan for finding a job. It is essential to involve the services of other systems and to integrate them with employment services.

One problem currently is the lack of unity in the provision of labour market measures: the State Unemployment Allowance and active labour market measures are administrated by the Labour Market Board offices, but the Unemployment Insurance Benefit is provided by the Unemployment Insurance Fund. This complicates the task of combining different measures and requires double resources.

Latvia

The formal basis of Latvian labour market institutions is a series of legislative measures aimed at bringing the rights and obligations of Latvian labour market participants in line with EU requirements. These include a new Labour Law and a Law on Labour Protection, both adopted in 2002. Enforcement of labour legislation as well as responsibility for health and safety is in the hands of the State Labour Inspectorate. A Law on Labour Disputes was adopted in 2003, and there is now a tripartite body to appoint public conciliators.

Between 1995 and 2001 a three-tier reformed pension system was introduced. The first tier remains a pay-as-you-go system, the second is a mandatory funded system and the third a voluntary private funded system. Unemployment insurance was introduced in 1995 and modified to offer less generous benefits in 1999. Insurance against occupational accidents and diseases was introduced in 1997.

Although an EU- and ILO-compliant labour market framework apparently has been created in Latvia, employers frequently ignore the legislation and regulations. Thus there are many people who work without employment contracts, and pay regulations and provisions are also frequently violated. Also there remains the widespread practice of envelope wages, whereby workers have an employment contract at the minimum wage but their pay is supplemented by untaxed cash in the "envelope". The resources of the State Labour Inspectorate and other agencies such as the State Revenue Service have been insufficient to check these practices.

Wage setting in the private sector is largely decentralised with a minimum of intervention by the state. Where there are bilateral agreements, either at the enterprise or sectoral level, non-union employees are also entitled to the agreed wage. The state also defines the minimum wage.

Apart from the NAPE and other documents that figure in the implementation of the EES, Latvia does not have an employment or labour market policy document as such. The Ministry of Welfare is the government department most closely involved with labour market and employment issues. Other relevant departments include the Economics Ministry, the Ministry for Regional Development and Local Government, and the Ministry of Education and Science.

The main institution implementing labour market measures is the State Employment Agency (SEA) – in particular, the SEA is responsible for an array of active labour market measures such as occupational training, retraining and increasing the qualifications of the unemployed; paid temporary public works; measures to increase competitiveness (job clubs) and measures aimed at specific groups such as pre-retirement age persons or unemployed people with disabilities. The SEA also acts as an employment placement agency for the registered unemployed.

In addition to the SEA the Professional Career Counselling Centre (PCCC) is responsible for implementing policies aimed at preventing unemployment by providing career counselling and vocational guidance services. The PCCC offers vocational guidance free of charge to individuals; maintains an up-to-date methodological basis for providing career counselling services tailored to specific target groups; and provides access to information about education opportunities. Also, the PCCC offers consultation services for a fee to businesses in areas such as career counselling, human resource management, recruitment, retraining and psychological support.

Local employment initiatives

Representatives of SEA branches meet regularly with local municipalities. In 2003, as a result of the joint activities of the branches and municipalities, local employment promotion action plans were developed for 65 towns, 14 amalgamated municipalities (*novadi*) and 462 rural municipalities.

In order to strengthen the co-operation of governmental and municipal institutions and non-governmental institutions in co-ordinating and discussing their interests in issues concerning employment policy implementation, the State Employment Agency is in the process of creating Advisory Councils in all branches of the SEA.

Case study: Daugavpils

The City Council Development Department. Daugavpils, Latvia's second-largest city, is located in the country's poorest region, Latgale. It is host to problematic enterprises and to problematic workers. The City Development Department has been working on a "Development Plan of Daugavpils" created for the next seven years (2005-12). The plan concerns the creation of new enterprises and new working places, and there is a section devoted to employment and unemployment issues.

There is also a yearly document produced by the Development Department based on data gathered from various industries and firms in Daugavpils; it covers, *inter alia,* future investment plans, new projects, and the number of employees planned by enterprises. This document is more like a report than a plan, since it does not contain proposals for directed actions or measures that will or should be taken.

In some instances the Development Department of the City Council has created a working group consisting of representatives from a problematic enterprise (a recent example is Dauer Lokomotive, which was proposing large layoffs), from the development department and from the trade unions, together with representatives of the SEA. The idea is to create an orderly and managed layoff process.

The process involves an agreement between local stakeholders and is co-ordinated by the SEA on joint actions. The institutions agree among themselves on what is necessary to be done from the other party and what measures the other party is obliged to take (*e.g.* the number of people that have to go through certain educational training, voluntary work events, etc.).

Employment planning in Daugavpils and Daugavpils district. A typical employment promotion plan is usually 9-11 pages long and is created on the basis of a framework provided by the central SEA office in Rīga. A separate plan is created for each *pagasts* and also for Daugavpils city. The process usually starts in November/December with meetings between the local SEA branch and the municipality, during which mutual issues among the parties are discussed. The plans for the *pagasti* are gathered together and signed by the district mayor; the plan for Daugavpils is signed by city mayor.

The procedure for developing employment plans is uniform throughout the country. After such plans have been drawn up in the various parts of Latvia they are sent to Rīga for review and approval; there they are also evaluated in terms of what can actually be done, taking into account the financial constraints and resources available.

The development plan prepared by the Economic Development Department at the City Council is separate from the SEA-supported employment plan. The employment issues touched upon in the two plans may be different, and there may be different visions and perspectives.

Lithuania

In Lithuania employment policy is the sphere of the Ministry of Social Security and Labour, which was responsible for co-ordinating the working group that prepared Lithuania's NAPE.

Employment policy design

Lithuanian employment policy aims to be integrated with the country's main programming documents, such as the State Long-term Development Strategy, the Long-term Economic Development Strategy, the General Plan of the Territory of the Republic of Lithuania, the Convergence Programme of Lithuania and the Single Programming Document.

The Employment Increase Programme of the Republic of Lithuania for 2001-04 has been the main strategic document on employment policy and is developed and implemented in co-operation with several institutions – the Ministry of Social Security and Labour, the Ministry of Economy, the Ministry of Finance and the Ministry of Education and Science.

Implementation of the Employment Increase Programme is co-ordinated by the Ministry of Social Security and Labour; other ministries participating must co-ordinate their common activities in line with the programme. In the

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process of co-ordination the parties agree on common goals, and on who implements specific objectives and takes specific measures.

The Employment Increase Programme for 2001-04 has been developed by an inter-agency workgroup made up of representatives of the ministries whose policy and programmes have the biggest impact on employment. The working group was headed by the Ministry of Social Security and Labour as the main institution dealing with employment policy issues at the national level. Key implementing institutions were the Lithuanian Labour Exchange and the Lithuanian Labour Market Training Authority. From 2004 the NAPE replaces the Employment Increase Programme.

Best practices in employment policy

The Lithuanian NAPE identifies several initiatives that it regards as representing best practice. Three of these, discussed below, are local employment initiatives, Support for the Long-term Unemployed in Creating Local Networks, and unemployment prevention measures.

Local employment initiatives. These are projects involving social partners that aim to create subsidised jobs in areas with the highest unemployment, *i.e.* a rate (either current or threatened) of 1.5 times the national average.

Open tenders are announced for proposals. The beneficiary, a small or medium-sized business, must cover at least 35% of the project expenditures. The maximum state support to one project is EUR 100 000, and for the creation of one job EUR 5 200. The project implementer undertakes to employ those without jobs, with priority accorded persons who are the most vulnerable on the labour market (the long-term unemployed, people with disabilities, etc.) and to maintain them in such jobs for three years.

Over the period 2001-03 the programme has created 1 240 new jobs. Their multiplication effect is very important – research shows that for every ten jobs created by the project directly, one additional job was created. The projects also appear to have been quite profitable. Other benefits include:

- Involvement of the social partners.
- Project implementers and administrators attend special training courses where they learn about procedures of project implementation, funds management, monitoring and control and report preparation.
- The projects are good practice in preparing for the exploitation of the EU structural funds.

Support for the Long-Term Unemployed in Creating Local Networks. This is a project implemented by the Lithuanian Labour Market Training Authority in co-operation with partners from the Netherlands – Nehem International and

Huesken & De Pree Consultancy. The project offers support for the long-term unemployed by creating local networks in four regions of Lithuania (Klaipeda, Taurage, Panevezys and Alytus). The goals of the project are:

- To create a methodology returning the long-term unemployed to the labour market.
- To train the consultants of local divisions of the Lithuanian Labour Market Training Authority to work with this methodology.
- To create a co-operation network on the local and regional levels of agencies interested in solving the problems of long-term unemployment.
- To test the developed methodology and present it to other organisations in all regions.

A methodology of returning the long-term unemployed to the labour market was developed – the *Work Opportunities Programme* – with a view to training those who have not worked over a long period, to enable them to eliminate psychological and social barriers that prevent them from participation in the labour market. Training was conducted in groups; communication with other group members (all long-term unemployed) under the supervision of a qualified psychologist helps to motivate people in shaping their active social position and solving difficulties in life.

The Work Opportunities Programme consists of four stages. The first, "What I Want?", was designed with a view to helping the participants to crystallise their desires and develop their objectives and values. During the second stage, "What I Can?", the participants were encouraged to discover their capacities and strong sides, and to evaluate the skills they have that can contribute to realising their desires. During the third stage, "Is It Possible?", the organisers tried to help participants assess their real prospects – personal and situational opportunities. During the fourth stage, "The Action Plan", the participants were trained to compile a real action plan according to which they could take effective action. At the end of the programme, examples of successful and unsuccessful employment efforts and the effectiveness of the action plans were analysed.

During project implementation the organisers mobilised various institutions, which delegated representatives for participation in the creation of local networks. *Co-ordination Committees* and *Initiative Workgroups* were formed, comprising the representatives of municipalities, the Chambers of Commerce, Industry and Crafts, local labour exchanges, trade unions, educational institutions, private structures, industrialists' associations, non-governmental organisations (NGOs), the media, lawyers and other organisations. Local council members took active part in meetings and training courses with the long-term unemployed; they described their institutions, answered questions, helped with labour market orientation and provided information on job vacancies. Council meetings were held regularly, and psychologists and consultants reported on the course of the training, on the problems that arose, and on the proposals and requests made by clients. They also discussed how they managed to employ the long-term unemployed participants and refer them to training courses.

Work Opportunities Centres were established under the Labour Market Training and Counselling Authorities in Alytus, Panevėžys and Klaipėda. They have become a place of vocational information, guidance and counselling measures, working with the long-term unemployed, social partners and the local community. In the Work Opportunities Centres participants had and will have an opportunity to use computers, read the press, and get the information they need when looking for a job on the Internet.

Of the 250 long-term unemployed groups that have completed the Work Opportunities Programme during the project, 50% got a job – and of those, 78% found a permanent job, 16% were employed in public works, and 5% started their own business.

Unemployment prevention measures. In a market economy reorganisation, liquidation or bankruptcy of a company is a common phenomenon that results in mass layoffs. Their regulation/prevention is one of the goals of the Lithuanian Labour Exchange.

Lists of companies at risk have been compiled in the regions (cases of partial employment, reductions in the number of staff, etc.). Local labour exchanges in the country undertake information and counselling work with employees who have received a dismissal notice from their employers. This work is carried out in provisional labour exchange divisions (mini labour exchanges) established at insolvent companies or companies intending to dismiss employees.

A mini labour exchange provides:

- Information on job vacancies.
- Individual and group counselling.
- Information about active labour market measures.
- Answers to questions.

The mini labour exchange may organise visits to or from other (local) companies to provide people with opportunities to learn about other options. In co-operation with the Ministry of Labour of Denmark, a *Mass Layoff Handbook* was developed and posted on the website of the Lithuanian Labour Exchange (*www.ldb.lt/atleidimai*).

Tripartite co-operation

Estonia

The Estonian NAPE was prepared under the guidance of the Labour Market Department of the Ministry of Social Affairs. Other departments of the Ministry, as well as the Ministry of Education and Research, the Ministry of Internal Affairs, the Ministry of Economic Affairs and Communications, the Labour Market Board, the Labour Inspectorate and the social partners also contributed to the NAPE.

Social partnership. Coverage of the workforce by trade unions and employers' associations is rather low in Estonia, although it is on the rise. As of 1 January 2004, trade unions covered 48 467 workers, who represent about 7.6% of the workforce and about 8.5% of the employed. The number of companies with trade union representation grew by 24 to 567 in 2003. The Estonian Employers Confederation (ETTK) unites approximately 1 500 companies that employ 150 000 workers (approximately 35% of those employed in the private sector).

Estonia's Joint Assessment Paper 2001 emphasised the need to develop an institutional framework for including social partners in policy making, and progress has been made. The PHARE Twinning project *Social Dialogue in Estonia* that was carried out from Autumn 2002 to Spring 2004 contributed to the development of social dialogue and social partnership, and the government has allocated EEK 1.9 million (just over EUR 120 000) over the period 2004-06 to support the promotion of social dialogue.

The most important tripartite institutions dealing with labour market issues directly or indirectly are:

- The Social and Economic Council.
- The National Employment Council, founded in 2003 for supporting and complementing the work of Regional Employment Councils.
- The Council of the Unemployment Insurance Fund, comprising representatives.
- The Working Environment Council.
- The Vocational Council, which aims to co-ordinate vocational education reforms.
- The Adult Education Council.

The most important of the tripartite councils is the Social and Economic Council, created in 1999. The Council gives representatives of employers and workers the opportunity to be involved in the design and implementation of national economic and social policies. It is aimed at an equilibrium between the requirements of economic development and those of social protection.

The Council's main function is to advise the government and local authorities on social and economic issues. All three social partners, *i.e.* employers, employees and government, have equal representation in the Council (6 + 6 + 6) and are completely free to nominate their members. In addition the government nominates five independent experts (researchers, scientists) and a chairperson of the Council. There is also the option to invite independent experts from outside the Council to advise on specific issues. Topics discussed have included the free movement of labour, minimum wages, lifelong learning and adult education, and tax policy.

The National Employment Council has the following responsibilities: uniting labour market parties; collecting the opinions of the Ministry of Social Affairs, the Ministry of Education and Research, and the Ministry of Economic Affairs and Communications; and advising the government on labour market issues. It also co-ordinates the work of the Regional Employment Councils. The task of Regional Employment Councils is to advise the public employment service at local level on the preparation of County Employment Strategies and on the provision of active labour market measures.

The role of the social partners has been especially important in promoting the development of human capital and lifelong learning. Representatives of both employers and workers contribute to the development of the professional qualifications system through Vocational Councils. In 2002, the Estonian Confederation of Employers (ETTK) launched an extensive survey of labour force needs in co-operation with the Ministry of Social Affairs. The survey aimed at forecasting the demand for skilled labour in the private sector in 2003-05. Four hundred and fifty medium and large enterprises took part in the survey, and labour market need was identified in 13 sectors.

In 2003, the Estonian Confederation of Trade Unions (EAKL) and ETTK both supported the use of the EU structural funds for developing human resources and improving social dialogue. They also stressed the need to involve the social partners in the allocation of structural funds.

Two agreements concluded in the course of social dialogue in Estonia directly support the implementation of the European Employment Guideline "Making Work Pay through Incentives to Enhance Work Attractiveness". One was concluded in 2001 for setting the level of the minimum wage: it aims at achieving at least 41% of the average monthly gross wage in Estonia by 1 January 2008. The second is a tripartite agreement to raise the tax-free income threshold; it aims at a gradual rise in the threshold to EEK 2 000 (EUR 128) by 2006. Both EAKL and ETTK are committed to reducing the prevalence of undeclared work, and there is co-operation with the Labour Inspectorate and the Tax and Customs Board at both branch and central levels.

Latvia

The NAPE is developed by a steering group that includes:

- Representatives of public institutions (the Ministry of Welfare, Ministry of Education and Science, Ministry of Agriculture, Ministry of Regional Development and Local Governments and the State Employment Agency). If necessary, the development of the NAPE is assisted by the Ministry of Finance, Ministry of Justice and other ministries.
- Social partners (the Latvian Free Trade Union Confederation and Latvian Employers' Confederation).

During the development process of the NAPE, municipalities, regional development agencies, councils and other bodies may be asked for proposals and information.

Monitoring of the NAPE is the responsibility of the Ministry of Economics and is implemented on a semi-annual basis. The institutions assigned various responsibilities for measures submit progress reports on a semi-annual and annual basis. The social partners also provide information on their activities in the field of promoting employment. The monitoring report surveys the employment and unemployment conditions in the country and summarises the performance of public institutions and social partners in implementing the planned measures; it also highlights shortcomings in achieving the anticipated results and with detailed explanations (insufficient funding, initiative or activity; impediments in the legal framework, etc.).

Social partnership. The most important employment policy issues are reviewed by the National Tripartite Co-operation Council (NTCC), which consists of representatives from government, employers and trade unions. Employers and employees are represented respectively by the two intersectoral organisations, the Confederation of Latvian Employers (LDDK) and the Free Trade Unions' Federation of Latvia (LBAS). The government side includes representatives from Ministries of Welfare, Economics, Health, Finance, Regional Development and Municipalities, and Justice.

The Council is the primary means ensuring social partners' participation in the legislative process dealing with issues of relevance to them. The objectives of the Council are "to ensure and promote cooperation on national level among the government, the employers, and the employees (trade unions) in order to achieve solving of the issues relating to socio-economic development that would promote consent and be in accordance with the interests of society and government, by developing and implementing strategies, programmes and normative acts affecting social and economic issues, which would guarantee social stability and growth in welfare, as well as heighten the social partners' co-responsibility for the decisions made and their enforcement."

The Council is made up of seven representatives from each participant. The government representatives are nominated by the Cabinet of Ministers, and the representatives of the social partners are elected by the relevant decision-making institutions of the respective organisations; representatives can be replaced by the participants at any time. At least five representatives from each participant are required to form a quorum; decisions are reached by agreement, and are binding to all parties. The Council should meet whenever it is necessary, but no less frequently than once every two months.

During the EU accession process, virtually every change or project in legislative process touching upon issues relevant to employers and employees has been reviewed in NTCC. The most recurring themes are job safety, minimum wage, the pension system and healthcare.

The outputs of the work of NTCC are the proposals – and occasionally, objections – submitted to Ministries or Commissions that prepare legislative projects. The result is improved or adjusted legislation that is of concern to employers and workers, and occasionally the entire population. However, the NTCC itself is not involved with the implementation of legislative requirements. Thus it can be regarded as an informative body bringing detailed information to the intersectoral organisations, which can then promote compliance among their members.

The Ministry of Regional Development has recently proposed to create regional tripartite councils. The aim is to further develop partnership between the SEA, trade unions and employers' organisations at the local level.

Lithuania

The National Action Plan was drafted by an interagency committee consisting of representatives of the Ministry of Social Security and Labour, the Ministry of Finance, the Ministry of Transport and Communications, the Ministry of Education and Science, the Ministry of Economy, the Ministry of the Interior, the Ministry of Agriculture, the Department of National Minorities and Lithuanians Living Abroad under the Government of the Republic of Lithuania, the Department of Statistics, the Lithuanian Labour Exchange, the Lithuanian Labour Market Training Authority and the Labour and Social Research Institute.

Social partnership. In Lithuania the tripartite system is based partly on agreements between the government, employers' organisations and trade unions and partly on laws covering the provision of the tripartite collaboration (*e.g.* the Law on the Support for the Unemployed, the Law on Vocational

Training, etc.). The Labour Code of the Republic of Lithuania, in force since 1 January 2003, sets out the social partnership system, consisting of the Tripartite Council of the Republic of Lithuania and other tripartite and bipartite councils (commissions, committees) formed in accordance with the procedure laid down in the laws or collective agreements.

Tripartite collaboration in Lithuania has been important in issues relating, *inter alia,* to unemployment, work pay, social guarantees for employees, safety at work and healthcare for employees. The drafting and discussion of the Labour Code has benefited from social dialogue.

The Tripartite Council of the Republic of Lithuania has been functioning since 1995. It consists of 15 members – five representatives from each of the social partners. The interests of trade unions are represented by the Lithuanian Trade Unions' Confederation, the Lithuanian Labour Federation and the Lithuanian Trade Union "Solidarumas". Employers are represented by the Lithuanian Confederation of Industrialists and the Lithuanian Confederation of Business Employers. The government is represented by the Ministry of Social Security and Labour, the Ministry of Justice, the Ministry of Economy, the Secretary of the Ministry of Agriculture and the Deputy Minister of Finance.

Social partnership in the activities of employment agencies. Representatives of employers and employees are encouraged to co-operate in organising, performing and controlling the activity of employment agencies at both national and local/regional levels. A Tripartite Commission under the State Labour Exchange and 46 local tripartite commissions under each local labour exchange have been established with the specific aim of dealing with issues relating to the labour market and implementation of labour market policy measures and services.

The Tripartite Commission under the Lithuanian Labour Exchange consists of 15 members. Ministries, Lithuanian trade union organisations and Lithuanian organisations of industrialists and business employers represented at the Tripartite Council of the Republic of Lithuania delegate their representatives to the Commission. The Lithuanian Association of Local Authorities nominates observers.

The local tripartite commissions are established according to the principle of equal tripartite partnership and consist of six or nine members depending on the area of the region served by the local labour exchange and the number of social partners located within the region willing to participate in the Commission's work.

The local commissions have delegates from local associations of trade unions and employers, in accordance with the mutual agreement between the local organisations of Lithuanian industrialists and business employers. Representatives of the state institutions are appointed by county governors and directors of local training authorities, and representatives of municipalities (neighbourhoods) by municipalities. In addition, local private employment intermediation companies delegate one representative each to tripartite commissions as observers by mutual agreement. Members of the tripartite commissions perform their functions on a voluntary basis and are accountable to the organisations and institutions nominating them. Decisions are of an advisory character.

Some recent institutional reforms

Institutional reform across a broad front has been ongoing in all three Baltic countries. Much of it has been prompted by requirements of the EU accession process – thus all three countries have implemented labour legislation in line with the EU, regarding working time, vacancies and termination of contract, non-discrimination rules and health and safety. As already noted, the mechanisms to enforce such legislation are sometimes lacking, so the actual impact has perhaps been less than the letter of the law implies. However, limited enforcement contributes to *de facto* labour market "flexibility".

Some initiatives have been created by pre-accession assistance programmes. For example, an important driver for developing sectoral and regional social dialogue in Latvia has been the Phare Twinning Project on the Promotion of Bipartite Social Dialogue. Apart from raising awareness of social dialogue, the impact is difficult to assess; however, evidence suggests that the number of bilateral agreements is increasing. Also, there is now a proposal for tripartite social dialogue at the regional level.

All three countries have implemented pension reform with the introduction of funded pillars to supplement the former pay-as-you-go systems. Here the World Bank has taken the initiative. The payoff to pension reform accrues over time, but if the reform is credible there is an immediate impact on the incentive to participate in the official economy.

In the sphere of economic development there have been important policy changes in corporate taxation in Estonia and Latvia (not required by accession). Estonia introduced a zero rate of corporate income tax on reinvested profits and also recently reduced the tax rate. In Latvia there has been a dramatic reduction of corporate income tax by stages, from 25% to just 15%. The aim is to follow the Irish model and attract FDI. A further move to reduce the tax rate to 12.5% has been put on hold following negative comment in the EU.

Estonia has made efforts to reform its business support system. In 2000 the Ministry of Economic Affairs and Communications reorganised the previous structure by establishing the government foundation Enterprise Estonia (EAS). Enterprise Estonia is a merger of seven different organisations, including the former Innovation Foundation, the Tourist Board, and Invest in Estonia. Compared to the earlier organisation, the new foundation has clear goals and an atmosphere of client-friendliness. However, the results are disputed. When the activities of the R&D Financing Programme of the EAS were evaluated by the State Audit Office in October 2004, one of the main gaps identified was that far fewer new jobs had been created than anticipated. The auditors remarked that EAS lacked routines for evaluating over-optimistic forecasts that had been presented by applicants. In addition, they pointed out that the procedures were too slow and that there was no feedback to applicants about funding decisions.

In January 2002, Estonia followed Latvia in introducing an earnings-related unemployment benefit. Employees (0.5% of wages) and employers (0.25% of gross wages) pay insurance premiums into a special Unemployment Insurance Fund. This should guarantee the unemployed a higher level of income than before, providing them with the possibility of searching for a new job with less worry about their economic situation. However, the payment period is relatively short; this is intended to stimulate active search for work by the unemployed. In addition, in order to unify the administration of labour market measures, the Unemployment Insurance Fund, the Labour Market Board, the Ministry of Economic Affairs and Communications, the Ministry of Finance and the social partners aim at creating a new organisation model by 2005 (Estonia's NAPE, 2004).

Estonia has made considerable efforts to adjust its labour market legislation and policy to requirements set by the International Labour Organisation (ILO) and the European Union. The impact on the labour market has been limited. The relatively high layoff compensation and the time required to give notice of dismissal have so far been the only factors that have diminished the flexibility of the Estonian labour market. But the payment period and rate of unemployment benefits have been estimated to be low (Philips *et al.*, 2002). Research indicates that considering all socio-demographic factors (age, health, place of residence, etc.), social transfers have not significantly influenced the probability of employment (Kuddo *et al.*, 2002). However, both the unemployment insurance system that came into force in 2003 and the gradual increase in minimum wages (32% of the average wages in 2002) are expected to diminish the flexibility of the labour market.

Lithuania has been especially active in the reform of local government. In the first instance it totally reformed the system inherited from the Soviet Union by removing the hundreds of small municipalities that remain in both

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Estonia and Latvia. More recently it introduced a package of changes to local government that took effect with the local government elections of March 2000. There were changes in the borders of municipalities and an increase in their number, from 56 to 60. There was also a change in the term of office of local authorities, from three years to two-and-a-half years. The additional municipalities of Kalvarija, Kazlu Ruda, Pegege, Rietava and Elektrenai were created. At the same time Marijampole District was eliminated and its territory divided between Kalvarija and Kazlu Ruda. All of the new municipalities are small by Lithuanian standards. The largest is Elektrenai, with a population in 2003 of 29 000 compared to an average Lithuanian local authority population of 58 000.

In addition to the abolition of Marijampole District, changes were made in the territory of 14 other previously existing municipalities (Birstonas, Druskininkai, Marijampole City, Vilnius City, Akmene, Kaisiadoriai, Lazdijai, Mazeikai, Plunge, Sakiai, Silute, Trakai, Varena and Vilkaviskis). For example, the inclusion of Grigiskes into the territory of Vilnius City was the result of lobbying by two members of Parliament. Lobbying by another member to create a new municipality of Nemencine in Vilnius County failed, however. During the legislative process there were also calls to delay the changes until 2003.

As a result of these changes the population of Trakai was halved, from around 79 000 to 37 000, largely due to the creation of Elektrenai. Elektrenai also received territory from Kaisiadoriai. Two of the new municipalities were simply parts of one previously existing jurisdiction. Pageges was previously contained within Silute. Rietavo was carved entirely out of Plunge. Hence both Silute and Plunge saw significant falls in their population. Of the previously existing municipalities, the most affected were Marijampole District, which was abolished and its territory divided between Kalvarija and Kazlu Ruda; and Trakai, which saw the half of its population around the town of Elektrenai separate into a new municipality. The impact of this reform can be seen in terms of the change in the municipal environment:

- *The division of Marijampole District into Kalvarija and Kazlu Ruda.* These two new municipalities are similar in terms of population and area, although a greater proportion of the residents of Kalvarija live in rural areas. Kalvarija's unemployment rate is 7-8% higher than that of Kazlu Ruda. Average recorded wages in Kazlu Ruda were 25% higher than in Kalvarija in 2000, but this difference had diminished to 8% by 2002. Kalvarija spends a higher proportion of its budget on social security and welfare.
- *The secession of Elektrenai from Trakai.* Elektrenai is less than half the area of the new Trakai District and hence has almost double the population density. Elektrenai's population live predominantly in urban areas whereas

Trakai's population remains mostly rural. Trakai also has a greater proportion of ethnic minorities than Elektrenai; one-third of Trakai's population are Poles. Elektrenai's recorded wages were 12% higher than Trakai's in 2000, increasing to a 26% difference by 2002. Trakai's budget has shifted more towards expenditure on the environment and utilities whereas Elektrenai spends relatively more on recreation and culture.

- *Secession of Pageges from Silute*. Pageges is only a third of the size of the new Silute District, but is also less densely populated. Pageges is more heavily rural than Silute. However, the average wage in Pageges was 3% higher than in Silute in 2000, and this difference increased to 12% by 2002.
- *Secession of Rietavo from Plunge*. Rietavo is also smaller, less dense and more rural than its parent municipality. Rietavo's average wage was 9-10% higher than in Plunge.

Hence the main impact of this reform was to create new smaller municipalities. The division of Marijampole District created two jurisdictions with very different levels of unemployment, facilitating greater focus (including regional funds) on this problem in Kalvarija. Elektrenai's independence from Trakai allowed two areas with quite different demographics to align municipal spending more closely with the population's needs. More unusual was the creation of two small, mainly rural municipalities, Pageges and Rietavo. That experiment may prove useful in evaluating proposals for more radical restructuring of Lithuanian local government.

Challenges

As already outlined in the first section, all three Baltic countries have been growing exceptionally rapidly since the mid-1990s, so that living standards have risen in Estonia from 34% of the EU25 average in 1995 to 49% in 2003; in Latvia from 30% to 41% over the same period; and in Lithuania from 34% to 46%. Employment has also improved, especially in recent years. However, convergence of living standards remains a long way away and unemployment remains high with the Labour Force Survey rate in all three Baltic countries, above both the EU15 rate and the EU25 average rate, with only Poland and Slovakia posting higher unemployment. A major problem remains the persistence of large regional disparities on the basis of all indicators, especially in Latvia and Estonia.

Thus at a broad level the challenges facing the Baltics are:

- To maintain growth at rates that will achieve convergence of living standards with the rest of the EU.
- To address regional disparities.

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Will stable currencies and prudent fiscal policies be sufficient to meet these challenges? One suspects not. All three countries surely have to continue with both deepening and broadening institutional reform in order to sustain growth and improve the quality of life of their inhabitants.

One key challenge and opportunity will be the deployment of the EU structural funds. All three countries are Objective 1 EU regions and hence receive large sums of money through these funds. Such resources are of course very welcome but deploying them involves a number of risks (challenges):

- The first challenge is simply that in general the funds should be used "properly", *i.e.* for good projects. Especially in the current programming period there has been a fear of poor take-up, which has encouraged allocation procedures that favour fast take-up rather than project quality.
- The risk of large-scale "rent-seeking" activity. For private enterprises the funds offer the possibility of "privately profitable" projects, and there is a danger that too many real resources will be used to compete for the capture of these profits.
- The risk that the funds will fail to address the regional disparity problem *among* the three Baltic countries. There are two problems here – one is simply that of perception, and the other is more concrete. At the level of perception there is the problem that all three countries are small and hence in the EU regional policy nomenclature they appear as NUTS II regions. This means that in EU-wide descriptions of regional disparities, the rather large disparities among all three countries simply do not appear. More concretely, the co-financing requirements of the structural funds mean that there is a risk that large and wealthy municipalities will be able to claim a disproportionate share of SF resources.

This last point leads to what is definitely a positive feature of the structural funds with respect to local economic development – namely, that the funds will offer local authorities the opportunity to act as partners in both European Social Fund (ESF) and European Regional Development Fund (ERDF) projects that can directly influence local employment and development issues.

At the same time, such opportunities point to a major challenge for both Estonia and Latvia. There is an urgent need, firstly, to accelerate and then complete their territorial reform in order to create local authorities that can operate on an effective scale. Research in Estonia by Oppi and Moora (2004) has shown that small and poor municipalities have been left behind in the allocation of pre-accession resources. The authors claim that their research "has demonstrated convincingly that mainly towns (instead of poorer rural municipalities), larger local government units (instead of more lagged-behind smaller ones), and those municipalities with a higher level of socio-economic potential (instead of the more stagnant and vulnerable ones) have managed to obtain most of the resources available. It is a serious threat for the post-accession structural policies, as well" (p. 12). The same is surely also true for Latvia, where there are also many hundreds of small and ineffective municipalities.

Other challenges for all three countries include the following:

- Increasing the level of "endogenous entrepreneurship". According to the most basic measure of entrepreneurship – the number of SMEs per 1 000 of population – all three Baltic states lag far behind the EU15; even Estonia, generally regarded as the most entrepreneurial of the three, has a ratio less than half the EU15 average. The Latvian and Lithuanian figures are still lower. Research undertaken at BICEPS[5] for Latvia shows that using the Global Entrepreneurship Monitor (GEM) methodology, the "new business prevalence index" for Latvia was (for 2003) 0.8 per 100 population. This compares with 3.2 for the United Kingdom, 4.9 for the United States, 3.1 for Finland, 2.1 for Sweden and 1.1 for Slovenia.
- Decreasing the "tax wedge" on low incomes, which is at about 40% in Latvia and Lithuania and about 37% in Estonia – this compares with an average of about 37% in both the EU15 and the EU25.
- The high tax wedge on low incomes is connected with another problem and hence challenge: the prevalence of undeclared work. In Latvia especially, it is common practice to pay workers the minimum wage as declared income and to supplement this by undeclared cash payments "in the envelope".
- The development of social dialogue. This is very weak at the bilateral level – in part because trade union coverage is very low, ranging from about 18% of employment in Latvia to 14% in Lithuania and 11% in Estonia. Coverage is especially low in the private sector. The development of meaningful social partnership at the local level is contingent on reasonably representative trade unions.
- The development of genuine local employment and economic development initiatives. All three countries remain highly centralised – especially because the central government holds most of the purse strings. Here the structural funds may provide the impetus for local development.
- Corruption, or the perception of corruption, remains a major problem and challenge – especially in Latvia and Lithuania.

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Conclusion

This chapter has attempted to examine the state of governance of employment and economic development in the Baltic states. Several broad conclusions have emerged from the exercise:

- The governance of both employment and economic development remains highly centralised – not least because the central government holds most of the purse strings of local authorities. Only recently have there been serious attempts to develop a local, more bottom-up approach. Often these attempts have been the result of collaboration with other partners, *e.g.* the local employment initiatives in Lithuania.
- The EU accession process has been crucial in shaping the institutions governing employment and economic development. Indeed, it is hard to imagine what the institutional environment would look like in the absence of the EU accession process. A notable example here is employment policy, where the European Employment Strategy has provided a mandatory template for policy. In 2005, as member states, the three Baltic countries for the first time participated fully in the National Action Plan for Employment process.
- The EU is also important in terms of resources. Firstly with its pre-accession assistance – much of which in recent years has been aimed at improving institutional capacity – and, from 2004 onwards, with the structural funds, which will provide opportunities for bottom-up local economic development.
- In Estonia and Latvia there is a clear and urgent need to accelerate territorial reform. In both countries the large number of small municipalities represent a barrier to creating effective local employment and economic development initiatives.
- Finally, running through the governance structures is a tension between the old and the new – between the mentality of the Soviet Union and the vision of the European Union. Thus in Estonia and Latvia the municipalities correspond to the old Soviet administrative units and are tenacious in their efforts to resist territorial reform that will make more "modern" employment and economic development practices more easy to implement effectively. At a broader societal level there is an absence of "trust" which inhibits endogenous entrepreneurial development. Thus according to the results reported in (Dombrovsky and Ubele, 2005), over 40% of new businesses in Latvia have just one owner, and another 25% have just two owners – *i.e.* there is a "mistrust" of majority rule.

What all of this confirms is what is intuitively clear – namely that it is a hard and time-consuming task to change a society, especially from outside.

Social structures have a propensity to reproduce themselves. The Baltic states may have been acknowledged as "functioning market economies" by the EU, but it will be a long time (if ever) before they are indistinguishable from, say, a Scandinavian country such as Denmark or Sweden.

Notes

1. These figures are from a growth accounting study carried out by the Baltic International Centre for Economic Policy Studies (BICEPS) for the World Bank (see *www.biceps.org*).
2. Special Drawing Rights, the IMF unit of account.
3. Though it has to be said that initially the IMF opposed both the creation of the Latvian transitional currency and the Estonian currency board. Both central banks went ahead against IMF advice.
4. Latvian NAPE, September 2004, pp. 60-61.
5. See Dombrovsky and Ubele, 2005.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 3

Enhancing the Development Process in Lithuania: Toward Truly Participative Governance

by

Micheál Ó Cinnéide

In the relatively short period since its independence, Lithuania has made great strides along the road to a free market economy and a functioning democracy. The country's enhanced economic performance has been facilitated by government reforms and a more sophisticated approach to economic planning that have led to a more favourable environment for business. Various policies have been introduced to promote entrepreneurial activity, and special labour market measures have been targeted at depressed areas throughout the country. However, the economic benefits arising from this relatively successful transition have not reached everyone in society, and social disparities are widening. Though Lithuania has made progress in creating a functioning representative democracy and involving the social partners and other stakeholders in the development process, these efforts need to be redoubled in order to create a form of governance that is truly participative as well as representative.

Introduction

Lithuania, in common with other post-socialist states of Eastern and Central Europe, is confronting major development challenges in its transition to a modern market economy and an independent democracy. Although it has achieved impressive growth rates in recent years, the gap in GDP per capita between Lithuania and the more developed countries of the European Union is still very pronounced. Following massive economic restructuring in the 1990s, unemployment increased sharply. On the positive side, Lithuania has recorded one of the highest growth rates in the European Union over the past few years. Initially, growth was achieved mainly through improvement in labour productivity. More recently, however, growth in GDP has translated into additional employment with the result that the overall unemployment rate has lowered significantly. Strong inroads also have been made into lowering the level of youth unemployment. The female employment rate, the employment rate for older workers, and the total employment rate are all showing modest improvements (EC, 2004; Vanags, in this volume).

Nevertheless, Lithuania remains one of the poorest countries in the European Union. High levels of unemployment, relatively low labour productivity, inequity and social exclusion, growing regional disparities leading to out-migration and decline, and an insufficient level of entrepreneurial activity are indicative of the range of development challenges facing the country. The structural deficiencies of key determinants of competitiveness, such as inadequate physical infrastructure, insufficiently developed skills of the labour force, limited innovative capacity, etc. constrain the prospects for economic development. The government recognises that these and other deficiencies must be addressed if economic development is to be sustained in the long term and the future prosperity of the country secured. To that end it has embarked on a range of initiatives that seek to foster endogenous development and also enhance the attractiveness of Lithuania as a destination for foreign investment. New forms of governance are being advanced, approaches to development planning in line with international best practice are being deployed at various spatial scales, and some novel local development initiatives are under way.

There are, however, strongly held views that these and related innovations need to be pursued with fresh and sustained vigour in order to adequately address the development challenges facing Lithuania, given the

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Figure 3.1. **Map of Lithuania**

Source: *http://encarta.msn.com.*

global competition. This chapter outlines and evaluates the outcomes of recent governance initiatives in the domains of economic, employment and social development. It compares the results obtained with outcomes in other countries of the Baltic rim. It analyses the main obstacles being met and identifies ways in which further progress might be realised.

Democracy and a free market economy

The drive toward achieving both democracy and a free market economy in the post-socialist states of Eastern Europe, including Lithuania, is hampered by inevitable tensions between these twin goals. As Stenning (1999) points out, the penetration of free market influences into people's lives can have detrimental consequences for the realities of democratic practice. In opening a country's economy to the full impacts of globalisation, large sectors are subjected to massive restructuring, leading to economic hardships for significant proportions of the population, who may well respond by voting for political parties promising to reverse, halt or significantly modify the process. Furthermore, large socio-economic disparities typically ensue, resulting in a relatively small privileged class with a disproportionate share of the available social, economic and political capital and a relatively large proportion of the population that is alienated from the process because of unemployment, poverty and social exclusion. Such social disparity frequently finds its greatest expression at local level. There, political apathy, associated with a preoccupation with meeting basic needs, leaves local politics captive to privileged classes – who may well be inclined to divert available resources toward business development requirements at the expense of the social welfare needs of a much larger sector of the population (Clark, 2000).

One effect of economic restructuring in Lithuania was an initial steep rise in unemployment, as traditional industries succumbed to global competition. Total employment fell by 20% between 1991 and 2001 (Vanags, in this volume). A considerable polarisation of the population occurred, and a relatively small sector gained control of much of the country's wealth – leaving much of the population in a relatively deprived situation. Growing social and regional disparities inevitably led to feelings of disillusionment and alienation from the reform processes; this resulted in chronic political instability at national level, as reflected in frequent changes in coalition government since the establishment of independence. No fewer than five different governments were in power in Lithuania between 1999 and 2001 (Evans and Evans, 2001).

An interesting analysis of the impacts of free market economic policies on democratisation at local level is reported in the case of Siauliai, Lithuania's most northern city and its fourth largest urban centre (Clark, 2000). The city's high-technology industrial sector of the Soviet era underwent drastic decline when it was exposed to global competition in the early 1990s. As capital became concentrated in the hands of a relatively small business élite, some 10 000 of the city's 22 000 industrial workers were left jobless, and this had strong deflationary effects on services and other sectors of the local economy. This apparently gave rise to a pronounced degree of disillusionment with the economic reforms and is regarded as contributing substantially to widespread political apathy, especially among the lower socio-economic classes. The resultant weak political voice of these classes was compounded by the demise of trade unions and of a whole range of associations that hitherto provided assistance to disadvantaged social groups, but now lacked sufficient state support mainly due to the privatisation of state assets. Thus Clark's analysis reveals that the transition to a free market economy has had serious societal consequences at the local level in Lithuania.

This weakening of local democracy, associated with the existence of a significantly large underprivileged and socially excluded population segment, heralds a need for a more inclusive approach to local development in Lithuania. In many countries, notably Ireland, local area partnerships have been deployed to good effect in such circumstances (Turok, 2001). Characterised by a practical problem-solving approach, a needs-driven agenda, and an action orientation, the

Irish partnerships have played a vital role in helping poor and socially excluded groups re-enter economic circuits and engage more fully in society. They are essentially local development agencies, whose boards are drawn from a cross-section of the local population, including *a)* community and voluntary organisations involved in the economic and social development of their areas, *b)* public bodies with involvement in fields such as employment, enterprise, education, and welfare services, and *c)* elected public representatives together with representatives of trade unions, employer organisations, and other members of the business community. These partnerships are given resources and considerable discretionary powers to respond flexibly to problems they prioritise within their catchment areas.

Most importantly, the partnerships seek to involve target populations in the full range of their activities. Participation not only generates a sense of community ownership of the process and associated activities, but also facilitates "action learning". There is intrinsic educational value in involving all segments of a local community in devising and effecting solutions to their own expressed priority needs. Participants acquire information, new understanding of and empathy with others, self-confidence, and a range of multi-situational skills as they endeavour to progress with the initiatives they have decided to embark upon. These acquisitions are gains with a potential to multiply and, as such, are critically important to local development, especially in deprived areas where the requisite talent may not be readily available (Commins, 1985; Ó Cinnéide and Keane, 2004).

This approach favours local communities being placed at the very heart of the local development process, identifying their own needs and priorities, organising locally for concerted action, and generally demanding that public authorities work with them in achieving their goals. Communities are less the *object* of development processes but are cast much more as the *architects* of their development agendas. Transforming hitherto passive and apathetic communities that are frequently imbued with a strong sense of dependency into ones that assume a large measure of responsibility for their own development requires major change in the culture of local governance that prevails in Lithuania. The establishment of local learning centres – as in parts of Sweden, for example – that would function as knowledge nodes and facilitate networking between universities, businesses and other local stakeholders could play a vital role in transferring R&D results to dispersed communities. Third-level institutions in particular have an important role to play in mobilising local communities, in helping them undertake realistic appraisals of the potential for development that exists locally, and in enabling them to realise that potential over time. By facilitating civil engagement in this fashion, local communities – at both the individual and community levels – may be empowered through a process of experiential learning to assume primary responsibility for their own development needs and to see the apparatus of state as a means of assisting them in realising their agenda (Ó Cinnéide, 1987). In the Lithuanian context, a strategy of mobilising disillusioned and disadvantaged groups and empowering them to participate effectively in the development process may well be a prerequisite to their meaningful involvement in local area development partnerships. It should also be borne in mind that this is a slow process and that a good deal of patience and perseverance is required in order to allow for this approach to take hold.

Enhancing governance

OECD countries throughout the world have sought to reform their systems of government, principally by decentralising power to the regional and local levels in line with the principal of subsidiarity. These reforms are designed to ensure strong and flexible regional and local government capable of acting decisively in support of the development needs of their territories in a manner that increases the effectiveness of public expenditure and enhances economic performance. Overall, the trend may be seen as a response to the relative inflexibility and remoteness of national institutions in addressing local needs (OECD, 2004). Decentralisation is a process that distributes power and responsibilities in a manner that allows governments at different levels to be significantly independent though co-ordinated within an overall framework.

The nature and extent of this decentralisation varies greatly from country to country. There are differences with regard to the range of functions discharged and the degree of financial autonomy afforded regional and local government institutions. Decentralisation of power leads to issues relating to policy differences from one territory to another. A variable resource endowment base among regions often raises the issue of equity. There is moreover the requirement of co-ordination between agencies at different levels of the territorial hierarchy in order to optimise performance. For these and related reasons, government reform involving decentralisation has been a protracted and difficult process in many countries, and one requiring ongoing modifications and improvements in the light of experiences and evaluation.

Radical reform of the system of government in Lithuania was implemented during the 1990s (Vanags, in this volume). It resulted in two tiers of elected government, one at national level and the other at local level, that are interlinked by a regional-level administration appointed by central government. A particularly noteworthy feature of the reform included the consolidation of over 500 local government units into 60 municipalities. Thus in a country of approximately 3.5 million people, municipalities generally have the necessary population threshold and critical mass to recruit professional staff and provide local services in a cost-efficient manner. This contrasts sharply with the

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prevailing situation in neighbouring Estonia and Latvia; efforts to amalgamate municipal administrations in those countries have been largely frustrated, leaving an unwieldy number of local government units, most of which are too small to discharge their functions efficiently and effectively.

While admittedly there has been considerable progress in government reform in Lithuania, municipalities are still in a relatively weak position by international standards. They discharge a limited number of administrative functions, many of which they implement on behalf of the state and over which they have little or no decision-making authority. Moreover, the local authorities lack financial independence as their capacity to raise revenue locally is considerably constrained; they therefore rely mainly on state transfers, and most of those have previously been allocated to implementing assigned national functions by the municipalities. Local government in Lithuania is more akin to an additional tier of state administration than to an independent tier of government. Lack of autonomy at local level means that local governments have little scope to function in a pro-active manner or to initiate policies and programmes that address local priorities and target pressing local needs. That this situation is not unique to Lithuania is well demonstrated by the case of Poland, where parallel efforts at local government reform have been implemented but where the outcomes, as in the case of Lithuania, are still less than totally satisfactory (Box 3.1).

Enhanced governance in the context of local economic and employment development is generally regarded as having three basic dimensions: *a)* co-ordination of policies – in particular, co-ordination of labour market policy with social and economic policy; *b)* adaptation of policies to local conditions so as to ensure a good fit; and *c)* participation of civil society and the social partners in local decision making (OECD, 2001). Participation is regarded as a particularly important dimension of governance for sustainable development (Meadowcroft, 2004). Functional advantages of participatory practices in development planning include better informed, more educated and empowered stakeholders, enhanced legitimacy, and improved prospects of successfully implementing agreed plans as a result of added commitment stemming from a sense of ownership of the planning process. Countervailing arguments include the extra costs and time involved in meaningful engagement. It is argued that enhanced participation may result in slow decision-making and in less efficient administration.

Various examples of participatory planning processes can be seen in Lithuania. Stakeholder consultation was stipulated to ensure smooth accession to the European Union. The preparation of the *Single Programming Document* was a milestone; this was the first time that representatives of the social partners, the municipalities and various other interests were intensively involved – through sector-specific working groups, seminars, etc. –

Box 3.1. **Promoting local autonomy in Poland**

The restoration of local government in Poland was enacted in 1990: a period of popular protest led by the trade union movement resulted in the election of approximately 2 500 municipal councils in May of that year. They were charged with a narrow range of administrative functions relating primarily to the development and maintenance of physical infrastructure facilities such as local roads, public transportation in cities, the conservation of heritage sites and parks, water supply, sewage services, and waste collection and disposal, A middle tier of government, consisting of 49 regions, was appointed by central government and remained in the control of state administration.

This system was further reformed in 1998 with the establishment of three tiers of territorial government. The local level was maintained more or less as before: 2 500 municipalities with elected local councils. Some 314 counties and an additional 65 cities that perform both county- and municipal-level functions were designated. These are further amalgamated into 16 regions. Elected municipal and county councils have been allocated an enhanced range of functions, extending beyond local infrastructure to such areas as primary- and secondary-level education, employment and social welfare services, and security. Regional-level government undertakes broader-level functions, including planning regional-level strategy, promoting international networks and international competitiveness, and co-ordinating the development of regional-level facilities including universities and hospitals.

There has been a good deal of public disillusionment with the effects of these reforms. The elected local bodies do not have the financial means to act decisively in support of local agendas as they depend heavily on central government transfers, most of which are earmarked for the delivery of agreed services. Public perception that local councils were too big, too unwieldy and indecisive, and too costly led to a decrease in the number of elected representatives and the direct election of the head of municipalities in 2002. New initiatives (at least partly) in response to the promptings of the European Commission and other international bodies include the establishment of local partnerships for development, education and employment and the adoption of strategic planning processes at the local level. However, there is widespread feeling that old structures and procedures are yielding only slowly to modernising influences, and that a great deal of perseverance and patience will be necessary to effect the desired reforms.

Source: Sobolewski, 2005.

in furnishing input and generally influencing the final outcome. Under the European Employment Strategy, the first *National Action Plan for Unemployment* was completed in 2004 in a manner that broadly corresponds with best

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practice throughout the European Union. The European Social Fund and other external bodies are supporting new employment initiatives at the local scale and once again, the involvement of local stakeholders in the planning of these projects is reported as contributing to their success. Regional development plans have been prepared in association with business and other interests for each of the ten counties and municipalities have also engaged with other stakeholders in the course of drafting local level plans.

Executive policy unreliability, or the degree to which government policy decisions were not implemented within a reasonable time scale, has been identified as a significant weakness of the system of planning and public administration in Lithuania. This has arisen largely because of a failure to integrate policy formulation and fiscal planning, with the result that agreed government programmes tended to have no fiscal basis (Evans and Evans, 2001). Failure to deliver on agreed priorities tends to undermine confidence in strategic planning processes and to destabilise government. However, in preparation for accession to the European Union and more recently in agreeing priority objectives for structural funding, there has been a concerted effort to systematically align policy objectives and funding sources. It is recognised that these reforms need to be adopted more widely and fully adhered to, in the interest of good governance and the attainment of policy goals.

In Lithuania, participatory planning processes were introduced in the first instance to conform to European Union norms and the European Commission's expectations with respect to national economic planning. Even though there was little or no tradition of consultative planning in the country, the precedent that has been set appears to be gradually taking hold. Yet, while government generally appears to favour a broad coalition of interests in furthering the development agenda, participatory planning and development processes in Lithuania appear to be somewhat superficial in nature and may lack real influence. As matters stand local communities are still very much the objects of development programmes. They appear to be largely passive recipients of policies and interventions that are sculpted by government without the purposeful involvement of other partners. The social partners and trade unions in particular do not appear to be working closely with government in a spirit of mutual trust and support, but rather find themselves in a tightly regulated arena that has been framed through legislation.

That participatory processes of development are alien not only to public authorities but also to society at large may in large measure be attributable to the tradition of central economic planning and the top-down command structure that epitomised Soviet socialist regimes. Fostering participatory practices is especially difficult in countries where representative democracy is being rebuilt following a long period of totalitarianism, as in the case of Lithuania and other transition economies of Eastern Europe (Giguère, 2004). It may well be that participatory processes in these societies can only be developed on a gradual basis. This, however, should not be construed as a plausible reason for overlooking the merits of participatory processes in these countries, for it is precisely here that the need for participatory government to bolster fledgling democratic processes is most acute, and that the potential rewards of steadfastly pursuing a policy of broad participation in decision making are likely to be most significant.

It is also acknowledged that many western economies with long-established democratic governments are only now experimenting with new, more embracing governance forms in relation to development planning. It is clear from recent comprehensive studies on the subject (OECD, 2004; OECD, 2001) that various governance models are being fashioned in many countries in accordance with local conditions and expectations. No particular model is regarded as superior to all others, although there is general agreement on the essential features that characterise best practice in this field. Lithuania can learn from these experiences in its attempts to establish the system of development planning and governance that best meets the prevailing circumstances in that country.

The need to strengthen the role of the social partners in all aspects of economic and employment policy formulation and implementation in Lithuania is strongly articulated by a number of Lithuanian analysts. They refer to the critical requirement for public authorities to work in partnership with business interests and the wider community in tackling structural problems in the labour market and reducing regional disparities in the level of development. It is pointed out in the case of the local employment initiatives, for example, that the best results are obtained in areas where the whole community works together in a spirit of mutual co-operation. However, the low penetration of labour unions that prevails in Lithuania reduces their representational legitimacy and limits their effectiveness in this regard. Employer organisations too need to be more inclusive and professional in their approach to economic and social planning.

The Lithuanian government formally endorses the principle of social partnership in the new Labour Code it enacted in 2003. Fundamental principles of freedom of association and freedom of collective bargaining are included in the code. Acts to hinder the formation of trade unions as well as interference with their lawful activities are prohibited. The code provides for the formation of labour councils in enterprises where no trade unions exist, in an attempt to improve the representation of workers in collective bargaining processes. Lithuania has also signed the European Social Charter and has incorporated the major European Union Directives into its labour law.

Notwithstanding these developments, some considerable unease is expressed regarding the evolution of labour law in Lithuania. Workers' rights

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to assert legitimate grievances, and in particular the basic right to strike, appear to be unduly constrained. It is argued that in a society where for cultural and historical reasons, workers are reluctant to be assertive – and against a background of high unemployment and pervasive job insecurity – labour law should seek to sustain rather than constrain trade union activity. Otherwise, the public promotion of social dialogue, consultation with social partners, and mechanisms of conciliation in the workplace, encouraged by both the ILO and the EU – and publicly advocated by the Lithuanian government – may prove ineffective (Woolfson and Beck, 2002-03).

The clear benefits that derive from a comprehensive system of social dialogue in development planning are well illustrated by the case of Denmark (Box 3.2). In that country the overwhelming majority of employers are affiliated with business federations and almost the entire workforce is unionised. Reliance on legal instruments to regulate economic activity is minimised by a tradition of negotiated agreements between the social partners. Local and regional government are endowed with a great deal of power that enables them to engage fully with the social partners in formulating and implementing the development agenda in their areas. This exemplary model of participative planning is facilitated by a national framework policy and agreed structures and procedures that promote the derivation of locally adapted responses to meet development challenges. The combination of high rates of participation in the labour force, high levels of pay and social security, low levels of unemployment, and a robust economic performance testify to the success of this approach. The sophisticated system of consultation and decision making with respect to employment policies that prevails in Denmark is indicative of international best practice in this sphere. The social partners have a strong degree of legitimacy associated in large measure with their very high degree of penetration and their national and regional organisational structures. The clear emphasis on partnership in public policy making improves governance and enhances the effectiveness of development policies.

Box 3.2. **Labour market policy in Denmark**

The Danish employment system is acknowledged as having performed remarkably well in recent years. This is evidenced by a fall in the unemployment rate from 12.3% in 1994 to 6.2% in 2003 and an increase in the employment rate from 70.3% to 73.5% over the same period (source: Statistics Denmark). The Danish system is characterised by liberal and flexible labour market conditions in which unemployment benefits are high but disincentive effects of generous benefits are counterbalanced by active labour market policies, strict rules governing availability for jobs and relatively weak employment protection regulation.

Box 3.2. **Labour market policy in Denmark** *(cont.)*

Labour market reforms introduced in Denmark in 1994 improved the functionality of the system and made a significant contribution to the strong economic performance since then. A prominent feature of the reform package was a decentralisation of policy implementation to regional labour market councils that were empowered to adjust programmes to meet local requirements. In practice, this means that while overall policy goals are set at national level, the specific combination of measures and detailed specification of targets is decided at regional level. The reforms also included a comprehensive range of measures aimed at increasing access to the labour market, facilitating the acquisition of job-related skills, stimulating job creation, and supporting the function and capacity of the labour market in general.

Regional labour market councils are responsible for defining the policy initiatives to be implemented at the local level. Through them negotiations take place between the representatives of employees, employers, and the relevant public authorities; the three groups are equally represented on the 22 member councils. This tripartite construction is considered an important factor in establishing a flexible and well-mediated labour market. The councils discuss issues germane to economic development, the labour market, the employment and living conditions of disadvantaged groups, and other related issues. The outcomes of their deliberations are considered essential input to the design and implementation of policies that reflect and respond to local conditions and needs.

The Public Employment Service is the executive branch that implements labour market policy. As such, the 14 regional offices serve as secretariat to the regional labour market councils, and together they seek to collaborate with all actors relevant to the labour market in and around their respective regions. Operational functions are discharged through a network of local offices that deal directly with the public. Some weaknesses in the national administrative framework – relating mainly to unsuitably small municipalities and regions, and insufficient co-ordination of policies in related fields – are being addressed, and new reforms are taking full effect from 2007. The decentralised Public Employment Service offices are to be further integrated with the enlarged municipalities, and will retain extensive authority to define employment policy within broad national guidelines. The social partners will remain closely involved.

Source: Hendeliowitz, 2005.

Employment and regional development policies

Regional disparities in levels of development are not as pronounced in Lithuania as they are in many other countries of the Baltic rim. The location of the three major urban centres of Vilnius, Kaunas and the port city of Klaipéda in the east, centre and west of the country, respectively, has facilitated a reasonably balanced geographic spread of development in the past. The central economic planning during the Soviet era included a policy element to develop the regions and generally promote even development. For a variety of reasons, however, regional disparities have been increasing in recent years. Indeed, a recent exploration of the geographies of the post-socialist states found a clear pattern of emerging spatial unevenness in the distribution of economic activity, indicating that this trend is a characteristic feature of market liberalisation in these countries (Stenning and Bradshaw, 2003).

An emphasis on policies of economic liberalisation led to major industrial restructuring in Lithuania. Considerable decline occurred in some traditional sectors of the economy, including agriculture. Many enterprises were insufficiently competitive to succeed in the new business environment and needed to make considerable adjustments, including downscaling of the workforce, in order to survive. Others were unable to make the necessary adjustments, which led to closure and large-scale redundancies. This was reflected in a sharp decrease of the order of 20% in national employment between 1991 and 2001, by which time the unemployment rate peaked at just over 16%, amounting to 237 000 people in absolute terms. Various other indices of unemployment, including long-term and youth unemployment, all show a deteriorating trend during this period. Levels of unemployment varied significantly from one part of the country to another, with ten municipalities having a rate in excess of 20% by 2001.

This situation has improved considerably since then, however. The expansion of the economy, as reflected in impressive increases in GDP since the mid-1990s, initially was associated with increased labour productivity, but since 2001 it has translated into a marked increase in employment. The unemployment rates among men, among young people under the age of 25 and in general have all decreased rapidly. Preliminary data for 2004 indicate a national unemployment rate of 11.4%, or almost 5 percentage points lower than the peak rate of 2001, and only two municipalities had an unemployment rate in excess of 20% by the beginning of that year. These recent improvements in the labour market in Lithuania compare very favourably with trends in other European countries and generally throughout the European Union.

Economic growth and increased employment were achieved through the creation of favourable macroeconomic conditions and the pursuit of policies that assisted businesses and promoted entrepreneurship. Government policy emphasised an endogenous approach to economic development and consequently sought to stimulate the establishment and growth of SMEs. A special support agency, INVEGA, was incorporated in order to financially assist businesses through micro loans, loan guarantees, venture capital investment, interest subsidies and other financial instruments. During 2001-04 INVEGA provided 446 guarantees in respect of over LTL 100 million of loans, thus helping to create more than 2 200 jobs, mostly in small companies.

Active labour market policies tailored to the needs of the economy were also introduced. An important initiative in this regard was the *Employment Increase Programme of the Republic of Lithuania, 2001-04*. It sought to promote employment through privatisation and industrial restructuring that would lead to sustainable employment opportunities, developing business infrastructure in the regions (including rural areas) and generally supporting entrepreneurial initiatives. Important legislative changes were enacted, including *Laws of the Republic of Lithuania on Investments and on Concessions* that addressed obstacles to business formation and auxiliary measures in support of employment creation. The state would also deploy special measures in support of business development in territories with acute levels of deprivation.

The promotion of entrepreneurship among unemployed people is another objective supported through labour policy measures in Lithuania. Local labour offices working in conjunction with the municipal authorities identify shortcomings in the provision of services in the local economy and assist business start-ups by unemployed people that address these gaps. The labour offices agree co-operative working arrangements with various other local actors – including INVEGA (the SME agency of Lithuania), the Association of Rural Tourism, the Chamber of Agriculture, the Agricultural Consultancy Service, business incubators and consultancy services – to decide priority areas for business development and supports for new businesses. These arrangements help to ensure that substitution and displacement effects associated with assisted new businesses are minimised as they are concentrated on providing goods and services that are not being made available locally because of market failures.

Prospective entrepreneurs are offered basic business organisation courses and modest start-up incentives, including small interest-free loans to assist in realising a business opportunity. Municipalities also may reduce or forgo company registration charges and local business taxes in the case of new companies that address special local needs. The legal process of establishing a business entity has been simplified by introducing special business certificates, and the reduced costs associated with obtaining these have rendered them highly popular with the unemployed. In 2004 for example, 14 500 unemployed people obtained business certificates on the recommendation of local labour offices. The extent to which these translate into viable companies is not yet clear; in order to facilitate that process there are plans to introduce added incentives that accelerate progress from being self-employed to company establishment and, ultimately, to the recruitment of employees other than oneself.

Another consequence of the economic reforms and associated increase in unemployment has been a sharp increase in inequality, as income transfer programmes – such as social insurance payments and targeted subsidies – failed to match the fall in real income of many people (Hossain and Jensen, 1999). The negative consequences of industrial restructuring were particularly pronounced in regions where the more traditional industries prevailed and where opportunities for innovation and regeneration were more limited, and that contributed to the widening regional disparities observed in recent years. A downward spiral of economic decline in some regions has led to out-migration of generally younger, more educated and more entrepreneurial people. The result is a residual ageing declining population increasingly unable to sustain many essential services, leading to further cumulative decline. Though geographic mobility in the labour force may be construed as evidence of a flexible and responsive labour market, the largely outward flow from some regions is seen as requiring a counterbalance.

Many sectors of the economy are recognised as having an important contribution to make to Lithuania's regional development. Some sectoral development policies may exacerbate regional disparities in that their impacts are likely to be proportionately greater wherever the potential for development is greatest. Concern was expressed that in certain circumstances even the structural funding of the European Commission could contribute to increasing regional disparities, as suitable projects and the necessary matching funding would be more likely to emanate from the more developed regions than from lagging regions. It was pointed out that as the European Commission views Lithuania as a single region, there is danger of an insufficient focus on internal disparities in implementing the *Single Programming Document*. Foreign direct investment also tended to be heavily concentrated on the larger urban centres, particularly Vilnius, and thus it too tends to exacerbate regional disparities for that reason. However, the declining role of foreign investment in the Lithuanian economy was also noted.

The government of Lithuania fully acknowledges the country's growing regional disparities and the need to counter these in the interests of equity, economic efficiency and conservation of the physical environment. It is recognised that there is a real danger that support for the economic reform programme will wane if inequalities and spatial disparities are allowed to grow. Accordingly, through its Ministry of the Interior, it is elaborating and implementing a set of policies aimed at promoting a more geographically balanced pattern of development. The emerging policy is primarily characterised as a horizontal set of measures extending to all economic ministries, and seeking to create favourable conditions for development, consistent with the principles of equity and economic efficiency, throughout the country. The regulatory environment is being reformed in a manner that is more favourable to enterprise creation.

Regional development policy finds expression in several national-level planning documents that define the overall framework for development in the country. These include the *Long-Term State Development Strategy*, the *Single Programming Document*, and the *General Plan of the Territory of Lithuania*, all of which have been adopted by government in the course of the past few years. The *Programme of the Government of the Republic of Lithuania for 2004-08* has a specific objective relating to "reducing regional disparities in economic and social development" and proposes to use permissible state aids including taxation and other financial instruments to achieve that end. Regional development plans have been prepared for each of the ten counties. In all regions there is a particular focus on creating conditions favourable for the growth of SMEs. Measures being pursued are in line with the Lisbon Strategy of stimulating innovation and generally supporting endogenous development. These include physical infrastructure projects, human resource development initiatives, financial and other supports for business start-ups, and special measures aimed at enabling the long-term unemployed and other socially excluded groups to re-enter economic circuits and generally improve their living conditions.

Special planning interventions have been enshrined in law in the case of particularly problematic areas, such as the Ignalina region where a nuclear power plant is being decommissioned with significant socio-economic ramifications for the entire region. In this instance a dedicated decommissioning fund, to which public and private bodies contributed, was established to support implementation of an integrated development programme in the area. Ignalina Nuclear Power Plant Regional Council, comprised of the governor of Utena (where the plant is situated), the mayors of the municipalities concerned, and other public officials, oversees the implementation of an agreed programme by Ignalina Nuclear Power Plant Development Agency. The main strategy is focused on the creation of alternative employment opportunities through the establishment and growth of SMEs. The programme envisages support for approximately 50 projects, leading to the creation of *circa* 270 jobs locally. Two phases of the programme are already implemented and 106 jobs have been realised. Financial support up to 50% of the total project cost is provided from the dedicated fund and averages LTL 14 400 per job. This project demonstrates an admirable attempt by local and regional authorities to work together for a common cause and in a manner that optimises the use of available funding. The role of the social partners and other local stakeholders in the programme does not appear to feature prominently, however.

Public works are used as an active labour market policy initiative to support economic activity in areas of particular need, defined as those areas in which the unemployment rate is in excess of 1.5 times the national average.

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They are designed to support the provision of social infrastructure and cover a wide range of activities relating to education, health, social services, the environment and public utilities. The choice of projects in a particular area is decided by the municipal authority and takes account of the skills and qualifications of the unemployed as well as the infrastructural weaknesses in the locality. Every effort is made to be as inclusive as possible as regards potentially employable local people. The public works are initiated through a tender procedure and are available to all prospective employers, though non-profit economic entities and other organisations undertaking to create permanent jobs are favoured. In order to stimulate the uptake of opportunities afforded through these measures by unemployed people, and the creation of permanent jobs in the process, vocational training is provided as required by the nature of the work performed. This recent innovation is designed to convert a measure previously concerned with supporting temporary employment into one that is more oriented toward the creation of permanent employment opportunities in areas of high unemployment.

The deployment of labour policy measures in a manner that selectively focuses on geographic areas of special need was reinforced in 2001, with the introduction of the *Procedure for Implementing Local Employment Initiative Projects* as a supplement to the *Law on the Support for the Unemployed*. Eligible areas include those neighbourhoods of municipalities in which the unemployment rate is, again, in excess of 1.5 times the national average. They are agreed through the Tripartite Commission, which supports labour market policy formulation and implementation in Lithuania. Although approved projects for 2005 extend over 19 municipalities, most of them are located in particular neighbourhoods of only a handful of these municipalities, indicating a marked degree of spatial targeting on particularly deprived areas.

Central to local employment initiatives as they are conceived in Lithuania is the notion that new business opportunities in a particular locality are best identified and realised by local actors working in a spirit of co-operative endeavour. Local labour offices are considered to be in the best position to organise concerted local action to support employment initiatives and to meet local social needs. To this end it was recognised that they needed to be able to respond in a flexible manner to local conditions, entailing the transfer of certain competencies from central government to the local level. Selection of eligible projects for support under this initiative is undertaken by broadly based local committees acting in support of the local labour offices.

Municipal authorities in Lithuania have established a special fund to support local employment initiatives; their focus is especially on the role of SMEs in creating wealth and employment in their territories. Municipal funding is not made available directly to businesses but is used to support business information centres, to provide assistance with the preparation of business plans, to defray consultancy costs, to partially sponsor investment projects, to subsidise loan interest charges, to offset training costs, and generally to promote company formation. Total funding provided by 58 participating municipalities in 2004 amounted to LTL 6.7 million or approximately LTL 115 000, on average, per municipality. The inadequacy of this funding is indisputable and reflects the financial constraints under which municipalities have to function. Raising additional financial resources in partnership with other local stakeholders is considered essential.

Over 200 projects were realised through these local employment initiatives by the end of 2004, resulting in the recruitment of approximately 2 000 people from the ranks of the unemployed. They extend over all sectors of the economy, but industrial and service sector projects predominate. Projects based on wood and metal production, textiles, furniture, transport, construction, wholesaling and retailing, food products, hotel and catering, tourism and agriculture illustrate the broad range of economic activities supported under the umbrella of local employment initiatives. Financing of the local employment initiatives increased from LTL 2.75 million in 2001 to LTL 13.4 million in 2004, as the number of projects receiving support was expanded. The average cost of each workplace created during 2001-03 is estimated to be in the range of LTL 18 000 to LTL 20 000. As the employer is obliged to meet not less than 50% of the cost, pubic funding sourced in equal measure from the sponsoring municipality and the employment office approximates LTL 9 000 per job. It is estimated that the financial support from the state is returned to the exchequer within three years.

The *Local Employment Initiatives Project* as implemented in Lithuania has met with considerable success. Through it a significant number of economic and employment opportunities have been realised in communities where the level of economic activity is at a low ebb and where poverty and social exclusion are most prominent. Significant local multiplier effects are associated with these projects and it is known that many of them have indirectly led to the creation of additional jobs in their vicinities. Very often, the success of the projects acts as a stimulus for further co-operative endeavour and generally strengthens the pulse of the local economy. The case of the school of graphic design in Anklam, Germany illustrates the strategic impact that a well-conceived local initiative can have in a particular locality (Box 3.3). In general, such initiatives help to create new hope in neighbourhoods characterised by apathy and a sense of powerlessness in the face of economic and social decline. Not surprisingly, the local initiatives project in Lithuania is rated very highly by employers, who regard it as an essential instrument in establishing successful enterprises in areas of economic deprivation.

Box 3.3. **A local area-based partnership in Germany**

A school of graphic design, initiated and developed by local actors, is making a major contribution to the economic regeneration of the Anklamer region in the northeast corner of Germany. Situated in the district of Pomerania, the city of Anklam, in which the school is based, has a population of 16 000 people. Although the Anklamer region has well developed physical infrastructure that affords good access to the outside world, it is undergoing a great deal of economic restructuring and decline, leading to an unemployment rate of 25% and associated selective out-migration of mainly young people, resulting in a residual imbalanced ageing population.

Founded in 1994, the school was conceived as a pivotal project for the economic revival of the region. A rich tradition of artistic expression that was cultivated in the region for centuries, but that had been somewhat in abeyance due to mono-cultural impositions of the socialist regime of the GDR was conceived as an asset upon which innovative and regionally differentiated design products could be based. The commercial exploitation of traditional art forms requires sensitivity to local culture and its incorporation into the training programmes of the new generation of designers. The founders of the school, mainly professional instructors in the fields of art, graphics and design, originally came from the area but were in employment outside the region. They recognised the development potential of this concept and sought to exploit it through the establishment of a graphic design school that would provide relevant training for local people and stimulate the establishment and growth of local enterprises in this sector.

Critical to establishing the school was the support of a local bank in providing unsecured funding. This is attributed to the foresight of the bank's steering committee, comprised of members of the municipality, local entrepreneurs and representatives of local trade associations. This partnership committee appraised the bank of the significance of the school, not just in terms of its direct economic impacts as a training institution but also in terms of its wider and potentially much greater role in pioneering design-led initiatives in the region. The municipality provided and equipped an old dilapidated industrial building of considerable architectural merit for the school. Also important to the successful launch of the school was the relative freedom the promoters were given by various regulatory bodies to pursue their goal without unnecessary bureaucratic constraints. The school already has graduated several hundred students, the vast majority of whom has secured gainful employment in their area. Graduates from the school are less prone to emigrate from the region, as they tend to cultivate local ties in the course of their study programme. Several local enterprises are collaborating with the school in furtherance of their own business interests, Box 3.3. **A local area-based partnership in Germany** *(cont.)*

and some graduates of the school already have established businesses of their own. The school is also networking with a range of cultural projects, including theatres, museums, and festivals. Viewed holistically, this project, begun by a small group of local visionaries and supported by an area-based partnership of key stakeholders, represents a model example of local development in action.

Source: Kuhle, 2005.

Systematic monitoring of employment and local development initiatives and co-ordination of these measures across the full spectrum of government departments and between the different tiers of government is strongly advocated. Improving the functioning of local government is considered a prerequisite in this regard. The need to enhance the financial independence of the municipalities so they may act more decisively and with a greater degree of flexibility in support of local and regional development is emphasised. Decentralisation of policy functions to local levels would allow interventions to be adapted to local conditions with likely added effectiveness and efficiency. Unless local authorities are given more autonomy they will be unable to engage fully with the private sector and or other partners in promoting development in their areas. Without powers that would facilitate a broader form of involvement, local authorities are likely to be seen more as bureaucratic organisations that regulate development than as entrepreneurial organisations that lead the development agenda locally. In the former role, local authorities may inadvertently find themselves cast as bodies that frustrate rather than facilitate local development within their jurisdictions.

Added impetus to business development and related measures in lagging regions is believed to be necessary in order to stem the widening territorial disparities now developing. Ministries with economic portfolios are urged to prepare and pursue action plans for their sectors that are consistent with regional development policy. The creation of favourable conditions for business in up to nine centres strategically located throughout the country and the development of clusters of related industries in each of these centres are considered desirable. Special measures such as exemptions from certain taxes, differential levels of grant aid, and other allowable state aids are also advocated in order to stimulate innovation in the regions.

Cross-border co-operation and networking

Cross-border co-operation involving Lithuania is typically organised at local or regional level and involves projects extending over land or sea across international borders. The actors are often structured as Euroregions *i.e.* specially built platforms for local development – such as, for example, the *Country of Lakes* Euroregion extending over parts of Lithuania, Latvia and Belarus. Activities are usually integrated horizontally and they generally embrace economic, social, cultural and environmental dimensions. The underlying rationale for such initiatives is that many problems (environmental degradation, for example) and many development opportunities (tourism promotion, for example) do not respect international borders and are best addressed on a cross-border basis and in a spatially defined setting that circumscribes the problem or opportunity being targeted.

The Euroregion concept provides a vehicle for a significant degree of self-governance and independent decision making by local stakeholders with regard to matters germane to the initiative in question. In this way it enables local knowledge and expertise to be brought to bear on issues common to the newly defined region as a whole, and it allows concerted cross-border action to take place in a manner that generates significant synergistic effects and added value. Other forms of cross-border co-operation in which Lithuanian actors take part are organised on the basis of projects such as town twinnings and networks of NGOs, and are often deigned to address specific issues including divided communities and problems associated with peripheral locations.

The Nordic Council of Ministers (NCM) is a co-operation organisation of the governments of Finland, Iceland, Norway and Sweden with a tradition of promoting cross-border co-operation. Founded in 1971, NCM has a rotating presidency (Denmark in 2005) with headquarters in Copenhagen, in which it has a secretariat of approximately 100 employees organised into seven separate divisions. With the establishment of sub-offices in Vilnius, Rīga, and Talinn in 1991 and one in St. Petersburg in 1995, NCM has become established as the lead organisation in promoting cross-border co-operation and networking among the Baltic states.

Mindful of the potential contribution of these activities to local and regional development, the government of Lithuania has strongly endorsed the endeavours and is an active participant in a number of cross-border projects that are supported financially through European Community initiatives such as INTERREG and other means. Two NCM-led projects involving Lithuania are being concluded at the present time. One, *Regional Cross-Border Co-operation, 2001-04* involves a network of 12 cross-border co-operation regions in the Baltic Sea area. It has been primarily concerned with facilitating an exchange of knowledge and experiences among Nordic and Baltic cross-border co-operation organisations established in the Euroregions concerned. Specific measures include training seminars, twinning arrangements, websites, newsletters and the promotion of new contacts between various stakeholders throughout these regions. The second NCM-led programme, *Development of*

Local and Regional Administration, 2002-04, consists primarily of Nordic support for the enhancement of local and regional authorities in the Baltic states. Almost 20 small grants (up to EUR 20 000) were awarded annually throughout the lifetime of the programme in support of training seminars, study visits and related activities. This programme was concluded with an international conference in Hiiumaa, Estonia in April 2005. A final evaluation report is not yet available but indications point to significant benefits accruing to Lithuania and other Baltic states from both of these initiatives.

Accordingly, the office of the NCM in Vilnius is acting as lead partner in an initiative building on the two previous programmes that was scheduled to commence in September 2005, subject to a successful application for funding to INTERREG IIIB. This programme focuses on spatial planning of the entire Baltic Sea region and consists of a network of *circa* 40 cross-border co-operation structures or Euroregions dispersed throughout the area. It also involves central government partners responsible for spatial planning such as the Lithuanian Ministry of the Interior. The purpose is to enable border regions to exercise significant influence in determining spatial planning issues affecting their territories. The proposed programme is structured into four work packages extending over two to three years. These are: *a)* seminars on topics of interest to all parties, *b)* targeted competence-building measures for specific areas and addressing specific needs in those areas, *c)* national round-table meetings involving all key stakeholders in spatial planning, and *d)* the construction of network durability tools (such as websites) designed to ensure sustained beneficial impacts after completion of the various elements of the programme.

This programme has considerable merit. It represents a "soft" initiative designed to enable transfer of the sophisticated processes of spatial planning long established in Finland and Sweden to Lithuania and other Baltic countries. It has the potential to effect permanent positive changes in the way Euroregions are integrated from now on into local and regional planning practices. With a likely strong emphasis on participatory planning processes that are characteristic of the Nordic countries, it affords a great opportunity to enhance a culture of participation in spatial planning at all levels of decision making in Lithuania and elsewhere. As such it has the potential to stimulate greater horizontal and vertical integration of planning in the Euroregions concerned and more generally throughout the Baltic Sea area. Finally, in facilitating the development of a more sophisticated approach to spatial planning in Euroregions straddling the Baltic Sea, and in promoting consensual solutions to cross-border issues in these regions, it has considerable potential to foster developing links and relations across the entire area into the future.

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Conclusion

In the relatively short period since its independence, Lithuania has made great strides along the road to a free market economy and a functioning democracy. Initial exposure to global competition exacted a heavy toll in many sectors of the economy and undoubtedly resulted in a great deal of hardship for large numbers of people who were made redundant as the industries in which they were employed adjusted to the new economic environment. Businesses that were unable to effect the necessary adjustments collapsed in the face of stiff competition from abroad. The steep rise in unemployment that ensued led to a disaffected populace disenchanted with the new regime, and this contributed to political instability at national level and a sense of powerlessness and social exclusion in many blighted local communities. There is clear evidence, however, that Lithuania has weathered the worst of the economic storm and is now on the road to economic recovery. Impressive growth in GDP since the mid-1990s and, more recently, a dramatic improvement in the rate of creation of new employment opportunities have led to marked improvements in various unemployment parameters that compare most favourably with other countries of the European Union.

The enhanced economic performance has been facilitated by government reforms and a more sophisticated approach to economic planning; these have led to a more favourable environment for business. Various policies have been introduced to promote entrepreneurial activity, and special labour market measures have been targeted at depressed areas throughout the country. There is widespread evidence of new economic vitality, with a burgeoning growth in small local businesses that are targeted primarily on local niche markets. The integration of Lithuania into the global economy was boosted considerably through the country's recent accession to the European Union. The financial support made available through the structural funds of the European Commission represents an additional revenue stream to implement an integrated development programme that bolsters competitiveness and optimises the benefits derived from the new and challenging economic environment.

The economic benefits arising from Lithuania's relatively successful transition to a free market economy have not reached everyone in society. Widening social disparities are a cause for concern and even though regional disparities in Lithuania are not as pronounced as elsewhere, there is a need to promote a more geographically balanced pattern of economic development. Indeed, inequality is potentially the most intractable problem associated with the adoption of free market economic policies. And Lithuania is not unique in this respect. Low levels of employment, generally high rates of unemployment but especially among youths, and widening social and regional disparities are seen to be all too prevalent in Europe.

The revised Lisbon Strategy of the European Commission recognises the overall positive effects that flow from globalisation. Opening up markets brings economic growth and ultimately more employment. However, the new emphasis on territorial cohesion and the new social agenda complementing the strategy focus on ensuring that the benefits of the European Union's growth and prosperity reach everyone in society. Through the revamped Lisbon Strategy, the Commission has declared growth and jobs as its top priority. Without more jobs it is not possible to deliver on social policy goals. But the new European social model is based on the premise that good social and regional policies strengthen the prospects for growth and jobs. They are regarded as essential for combating exclusion and creating a fair society. Providing disadvantaged and socially vulnerable groups with skills and opportunities is a fundamental plank of the European Commission's new social agenda. The EC seeks to work in partnership with member states, the social partners and civil society in advancing that agenda (EC, 2005). The government of Lithuania is anxious to avail itself of this opportunity; with the support of the Commission, it has already embarked on a wide range of measures designed to reduce regional disparities and combat social exclusion, as part of its overall development programme.

New forms of governance designed to enhance the development process are evolving in many countries (Giguère, 2004). Primarily, there is an attempt to make the whole process much more inclusive of all stakeholders. By including representatives of civil society and the social partners as well as public authorities and government agencies, the potential for concerted and co-ordinated action targeting key dimensions of local development in accordance with an agreed programme is enhanced, and synergistic effects are generated. Lithuania has made great progress in creating a functioning representative democracy. Local government has been reformed and considerably enhanced although it still lacks financial autonomy and the capacity to act flexibly in supporting development. Efforts to involve the social partners and other stakeholders in the development process are noted but need to be redoubled in order to create a form of governance that is truly participative as well as representative.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 4

Reforming Both Local Government and Local Governance: the Challenge to Latvia

by
Mike Geddes

The challenges for local governance in Latvia are similar in important respects to those identified for more advanced economies. The shift from government to governance is seen as a means of including all actors and sectors in governance processes in order to pool knowledge, expertise and resources, share risks and improve outcomes. Like other OECD countries Latvia is recognising the importance of regional strategies in promoting economic development, but is still in the process of developing strong regional institutions that can provide a "platform" for both increasing economic competitiveness and reducing regional disparities. In Latvia the need is twofold: to reform and strengthen the core institutions of local government, while at the same time building around these institutions a framework of partnership involving business interests, citizens, and voluntary and third-sector organisations.

The broad context of governance

The concept of governance is now at the core of the debate on ways to improve the effectiveness of policies.

The emergence of the term "governance" is related to a number of factors that are seen to be affecting Western societies. These include a rise in societal and political fragmentation, a blurring of the boundaries between the public and private spheres, and the emergence of a "network society" and with it the increased prominence of policy networks. The term governance implies that these are major changes to the traditional pattern in which government was the unchallenged centre of political life, and hierarchy was its preferred mode of operation.

Stoker's widely quoted set of five propositions (Stoker, 1998, p. 18) seeks to define the shift to governance in terms of the involvement of institutions and actors drawn from within but also beyond government, and the blurring of boundaries and responsibilities for tackling social and economic issues. Governance implies that the capacity to get things done does not rest solely on the power of government to command or use its authority. Whereas government is "the activity of the formal governmental system which takes place within specific administrative boundaries, involves the exercise of particular powers, duties (and) public resources [...] under clear procedural rules involving statutory relationships between politicians, professionals and the public governance is a much looser process of steering which is multi-sectoral and in which networks, alliances and coalitions play an important part (and) may become formalised into structural arrangements such as partnerships" (Hambleton, Savitch and Stewart, 2003, p. 12). Governance highlights processes and outcomes instead of placing trust solely in institutional structures (Soos and Zentai, 2005).

However, the so-called "shift from government to governance" has stimulated substantial debate. While some see "government" and "governance" as polarised alternatives, others prefer to envisage a continuum, from traditional hierarchical government to networked governance. For many commentators, moreover, "governance" does not imply the end of more traditional forms of government, but a new mix of "government plus governance", in which traditional state institutions work under new rules and in new conditions.

Finally, it is clear that context matters: the extent of the shift towards governance is strongly influenced by the political, economic and social context of the country concerned. This latter consideration is of particular importance in considering issues of government and governance in post-communist countries, where the context is very different from that in "the West". Here, new local governance systems are still very much in the making, replacing the old hierarchical territorial structures of the single party state. Soos and Zentai (2005) suggest that in some post-communist countries, local governments still remain in a very transient state; their autonomy is frequently only formal and mandates and governance structures are undecided or unstable. In some countries, however – notably the new EU member states – reforms (including constitutional and legal changes, elections, institutional and public finance reforms) started more than a decade ago and have resulted in different but more or less democratic governance systems. Everywhere, however, there is the danger of reform becoming "stuck" as a result of the frailty of political institutions, slow-moving public administration, and party political disagreements.

Despite such differing (and dynamic) contexts, today the development of more effective local governance is everywhere considered a key determinant of the outcome of economic development strategies and action to improve the quality of life (OECD, 2004). Local and regional governance mechanisms are seen as ways of improving regional competitiveness; making labour markets work more efficiently; and building social capacity. This means that increasing attention is being devoted to a number of questions. Is the level of government currently responsible for a given policy area the most appropriate one? What roles should civil society and business play? Which aspects of policies should be co-ordinated? What is the role of national government in supporting governance and partnership at regional and local levels? How can the outcome of co-ordinated actions be evaluated? Are the frameworks covering public accountability adequate?

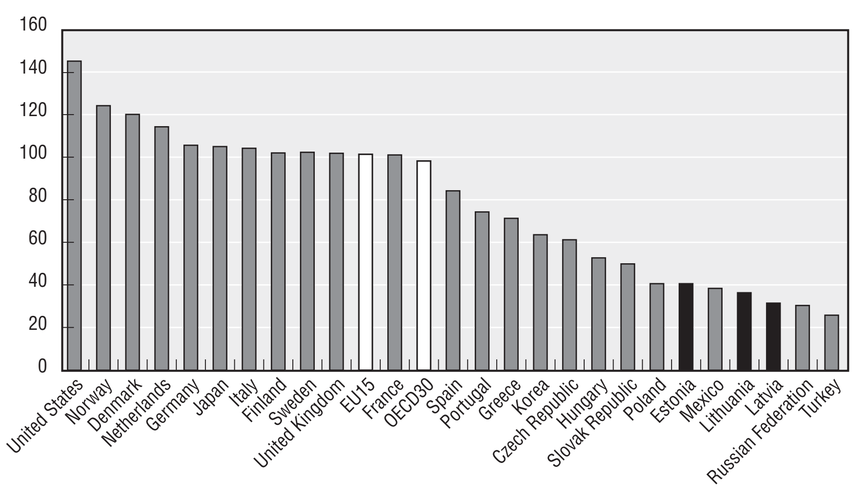
These and other questions are frequently asked by the actors in various policy domains. In some areas, such as economic development, there is now a consensus that action must be co-ordinated at the local level, and ideally also with related policy areas, to stimulate synergy, avoid conflicts, and make the best possible use of the information available. Improving local governance – *i.e.* the way policies are co-ordinated, adapted to local and regional conditions and oriented in partnership with civil society and business – has thus itself become a goal of government. It is now clear that improving local and regional governance enhances the effectiveness of certain policies and takes full advantage of the resources and energy of business, civil society and the other levels of government in the pursuit of common objectives. That is the broad context in which this chapter considers the development of local and regional governance in Latvia.

Change in Latvia and the Baltic states

Following a decade of rapid change, the Baltic states are among the most successful of the formerly planned economies. As the chapter by Vanags in this volume makes clear, during the early 1990s all three Baltic states suffered a severe "transitional recession" with cumulative output declines in the region of 40-50%. Growth resumed around 1995 and since then real GDP growth has been remarkable. Cumulative real GDP growth for the period 1996-2003 has been 59% for Latvia, 51% for Estonia and 52% for Lithuania. Growth in the Baltics has been better than in the EU's new member states as a whole and much better than in the EU15. The Latvian economy has performed strongly since 2000, with GDP growth rates significantly above the EU average. The employment rate has also increased, and even that for older workers is above the EU average. High growth has contributed to lowering the unemployment rate, although this (at 13% in 2003) is above the EU average. Labour productivity in Latvia, while increasing rapidly, remains the lowest in the EU. Overall however, there is a long way to go to achieve catch-up with the EU and other OECD countries, as Figure 4.1 shows. The Baltic states remain three of the four poorest EU member states, with Latvia in bottom place.

Figure 4.1. **GDP per capita in 2001**

Based on OECD estimates of Purchasing Power Parities



Source: OECD estimates of PPPs in 1999 and the subsequent real GDP growth, OECD, 2003.

Moreover, as will be discussed further below, a major problem is that of regional disparities. Regional labour market data indicate deep and persistent structural problems at the regional level. Regional employment rates in Latvia range from 66% in Rīga to 52% in Latgale. These differences are reflected in regional differences in GDP per capita. Thus in 2002 Rīga had a GDP per capita at 182% of the national average, while no other region exceeded 83% of the average and Latvia's poorest region Latgale had a GDP per capita income at 48% of the average.

Political and institutional change has of course also been both rapid and far-reaching, as Soviet and communist institutions have been replaced by those modelled – though in different ways – on those of the Western capitalist democracies. As Vanags suggests in this volume, any assessment of the institutional aspects of development in the Baltic states must take into account their shared history of 50 years as Soviet republics. Not only did they possess none of the institutions of a modern market economy, but also – in contrast to other Central and Eastern European countries – they had no experience of independent statehood or of independent policy making. The role of the international institutions in the first instance, and of the EU subsequently, has been crucial in the institutional development of the Baltic states. The international institutions steered the three countries away from what they regarded as "extreme" solutions. Subsequently (after 1995 when the three countries applied for EU membership and were accepted as EU associate countries), the EU accession process has provided a template for many institutional developments, and in the view of some commentators has intensified tendencies towards political, financial and administrative centralisation. Policy making in all three Baltic countries has by and large originated with central government, with the involvement of other actors – local governments, social partners, etc. – coming at a later stage. Thus while local government played a very important role in the secession of Latvia from the Soviet Union, its prominence has declined significantly since then.

Challenges for governance in Latvia

In summary, all three Baltic countries have been growing exceptionally rapidly since the mid-1990s. In Latvia living standards have risen and employment has also improved, especially in recent years. However, convergence of living standards remains a long way away and unemployment remains high. A major and persistent problem is that of large regional disparities. While political and institutional reform has been substantial it remains incomplete; there are still many blockages on the path to democratisation and modernisation, from financial constraints to entrenched interests and public distrust of the state (King *et al.,* 2004).

Figure 4.2. **Map of Latvia**

Source: http://encarta.msn.com.

Thus at a broad level the challenges facing Latvia are:

- To maintain economic growth at rates that will move towards convergence of living standards with the rest of the EU.
- To address regional disparities and wider issues of social inclusion.
- To ensure that the processes of modernisation and democratisation of government continue. This includes the need to counter the current centralised nature of the governance system and create strong and democratic local and sub-national governance institutions capable of playing a proactive role in shaping future patterns of development.
- To maximise the potential of the country's participation in the European Union.

Local and regional government in Latvia

Substantial local government reforms have been undertaken in Latvia, as in the other Baltic states. Indeed, the implementation of local government reform is seen as one of the most important tasks in the transition period from a command to a free market economy.

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During the 50 years of the Soviet regime, local government in real terms did not exist, although formally local residents elected local councils. In practice the nomination of candidates was not democratic, there was no competition between candidates and local government had no real power, because decisions were made by the Communist Party and higher levels of the state. However, local government was a focus of the independence movements in all three counties even before the break-up of the Soviet Union led to restoration of full independence. Thus national-level democracy was preceded by democracy at the local level when in 1989 the local government elections were the first democratic elections of the postwar period. These were the first elections in which seats were contested and in which the principle of majority rule was accepted. Since then, the goals of local government reform have been to promote the further democratisation and decentralisation of state power and administration, to improve the quality of public services, and to involve local residents in the processes of local government. So far, however, the reform process has achieved only partial success.

Unlike the other two Baltic states, Latvia has two levels of local government. Governments in the first tier (municipalities, including towns and villages) are governed by elected councils. The second tier of local government consists of 26 *rajons*, or districts. Seven large towns and cities also function as districts. Before 1997, district councils were directly elected and hence had a political identity separate from the municipalities (except in the republican cities, where the council took on both sets of responsibilities). Since then the districts have been governed by councils made up of the mayors of the municipalities within their territory. The districts perform a largely co-ordinating role and have few independent functions of their own. Municipalities have quite wide-ranging responsibilities for a set of municipal services, from water and waste disposal to education, health, social support and economic development (King *et al.*, 2004).

Box 4.1. **Local government (municipal) functions**

Providing municipal services	Promotion of entrepreneurship
Regulating the use of public land	Prevention of unemployment
Provision of education	Maintenance of public order
Promotion of culture	Management of construction in accordance with plans
Assurance of healthcare	Statistical records
Delivering welfare programmes	Civil defence
Public housing	

For finance, municipalities rely mostly on the personal income tax, followed by grants from the central government. However, the financial resources available to local government to provide social and economic infrastructure are insufficient, and the municipalities do not have access to the private capital market. Their access to professional and administrative skills is also inadequate (Začesta and Pūķis, 2005). The transition process in Latvia in many ways placed more pressure on local government than on central government, as local governments were assigned responsibilities for which they were not well prepared and for which they did not receive commensurate funding (World Bank, 1995).

There are about 550 Latvian municipalities, thus most are very small – more than 70% have a population that is less than 2000. A main aim of reform has been to promote the amalgamation of municipalities to form units large enough to enable the provision of high-quality services as well as well as promote local economic development. This reform was envisaged as voluntary in the first instance. Two options have been offered – amalgamation of units, or more effective collaboration between local governments. However, a number of factors – shifting government proposals, concerns about local autonomy, doubts about the financial implications – have meant that the take-up has been modest. There has been opposition from local politicians as well as a degree of popular cynicism, and so far governments have not been willing to press change through in this context. As a result of the hesitancy of the reform process, public participation in local government decisions is still limited, and the local profile of political parties is weak. A particular cause for concern is the exclusion of Russians who are not Latvian citizens (King *et al.,* 2004).

Currently, the larger tier of Latvian local government is the district (county). As districts are run by indirectly elected councils formed by the mayors of the constituent localities, they are politically weak. They also have relatively limited functions and are economically weak, with no dedicated tax base. There is recognition that the current local government structure is not suitable to ensure balanced and sustainable development, or (especially) to make best use of EU and other international funds (E. Vanags, 2005), and therefore that regional strategic planning must be strengthened. The current solution to this problem has been the creation by the Regional Development Law of 2002 of five planning regions. Each of these has a Regional Development Agency and these agencies have prepared regional development plans. So far effective mechanisms for the implementation of these are lacking, although there is now a proposal to create another tier of local government at the level of the planning regions.

EU accession has had a major impact on the issues facing regional and local government. It is argued (Začesta and Pūķis, 2005) that EU integration has been a force for political and financial centralisation, and the further erosion of power and responsibility from local government. During the period leading up to accession, the main focus was on improving the performance of national government, and this led to a further weakening of local and regional capacity. For example, the use of pre-structural funds was dominated by the centre.

In summary, in Latvia the continuing problem is a local government structure with too many units that are too small to function effectively. This is coupled with the limited resources at their disposal to undertake their functions. Funding limitations are exacerbated by the absence of economies of scale and of the ability to attract high-quality professional staff. At the same time, the regional tier of governance is underdeveloped. These problems, King *et al.* show, are compounded by continuing issues of arbitrary exercise of power and limited popular trust in local government institutions, demonstrating the need for further progress in democratisation.

Modernising local and regional governance in Latvia

The rest of this chapter explores some of the possible ways to improve local governance in Latvia. The discussion that follows focuses on five main issues:

1. Modernising local government.
2. Regional disparities and governance at the regional level.
3. The need for a "new localism" to resolve more effectively and positively the relationships between national, regional and local tiers of government.
4. Local governance and local partnership – increasing the involvement of all actors in governance at the local level.
5. Improving the capacity of the governance system to monitor and evaluate new initiatives and developments, in order to learn from good practice both within and outside the country.

Reforming local government

The debate on local government reform in Latvia can sometimes seem to be reduced to one on territorial reform – the creation of a smaller number of larger local government units. This is of course a crucial aspect of the problem – but as has been shown, the problem of scale interacts in the Latvian case with a number of other important problems: of trust and democracy, of professional and technical capacity, of financial resources, and of decentralisation and local autonomy. Latvia is of course not alone in facing these problems, and the experience of Estonia in modernising local government draw some conclusions relevant to both countries (see Box 4.2).

In Latvia the most recent reform proposals have been more radical. Whereas previously the intention had been to create about 100 new larger

Box 4.2. **Reforming local government in Estonia**

Like Latvia, Estonia (an even smaller country with a population only two-thirds the size) also continues to have a bottom-tier local government structure of very small municipalities. Estonia has 241 municipalities in a country with a population one million less than that of Latvia, with an average size of 2 000 inhabitants. The ineffectiveness of this pattern is widely recognised, and the Estonian case demonstrates that reform is necessary not only for reasons of efficiency, but because the current structures inherited from the Soviet period are democratic in principle but not necessarily in practice.

One response (which will be discussed below) is the creation of a stronger regional tier of government. But there is also a clear need for reform at the local level. In the first place, despite the separation of the roles of central and local government in the Constitution, it is not clear whether the position of local government derives from state-centric or community-based principles. Secondly, the amount of work undertaken by local government has increased but state funding has not increased commensurately.

Three attempts to reform Estonian local government have been made over the period 1997-2004. Government proposals have been to reduce the number of municipalities (in the first proposals, from the current 240 to about 100; in the second proposals, to a significantly higher minimum population size of 3 500 or 4 500). At the same time, the reforms were seen as a way of tackling structural problems, rigid hierarchies, inadequate professional training, and lack of staff motivation and co-ordination. However, there were only low levels of support from municipalities for the first and second sets of reform proposals. A third attempt at reform, aiming again to enhance administrative capacity and improve the quality of public services, is currently under way, with some financial inducement for municipalities to adopt the reforms.

Source: Jauhiainen in this volume.

municipalities, in 2003 it was proposed by national government to move to seven city governments and 26 much larger local government units. However, this move met with widespread criticism, and the territorial reform process remains blocked.

The conclusion to be drawn from this experience is not that the concept of reform is flawed. Rather, the difficulties in implementing local government reform have indeed meant that there has been more time for the inadequacy of the current structures – in both Latvia and Estonia – to be demonstrated. Jauhiainen in this volume concludes that implementing the reform remains essential, but that territorial reform alone is not enough. Professionalisation

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of administrative, management and leadership skills is needed, along with greater decentralisation of decision making, clearer independence of local budgets from state funding, and more intensive inter-municipal collaboration. He concludes that a major obstacle to reform has been the management by government of the reform process, resulting in a keen mistrust of local governments toward government.

The difficulties of territorial reform of local government are a graphic illustration of the fact that, in the process of modernising local governance, context does matter. In both Latvia and Estonia, the hostility of local government to the centre, combined with the lack of popular trust in local government – factors rooted in the post-communist context – have so far negated attempts at reform. There is however evidence that this path-dependence is not unbreakable. In Lithuania, a reform pressed through at an early stage has resulted in the restructuring of a similarly large number of small municipalities into a current figure of only 60, creating units that furnish much better population thresholds and critical mass to provide public services more effectively. It seems clear, though, that while such a reform was possible in the early days of independence, it is much more difficult now.

Here it is worthwhile noting that in some countries that have long possessed large-sized local government units, such as the United Kingdom, the need for some form of governance arrangements at the very local or neighbourhood level is increasingly recognised, because of the remoteness from the population of local governments when they become "big business" (Office of the Deputy Prime Minister, 2005). The neighbourhood (or parish) level of the governance system is seen as vital in terms of direct public involvement in governance, and as a level where service provision by a range of providers needs to be co-ordinated if services are to be genuinely responsive to local needs. Might it be, therefore, that one path to successful reform in Latvia would be to recognise the important role that the grassroots, village or neighbourhood level can have within a wider restructured and modernised local government? Also, if continuing difficulties in implementing reform across the country seem likely, consideration might be given to a pilot process in a limited number of localities. This would enable attention to be focused on localities where the case for reform was more widely accepted, and so provide a demonstration for other areas of the value of reform. Such a pilot process might also try out more than one model of reform, to assess what seems to work most effectively.

Regional disparities and regional governance

As noted above, regional disparities in Latvia are severe. While the population has been declining in all regions, this decline is much more acute in some – especially the eastern region of Latgale, where in 2003 the population declined by nearly 9%. Rīga leads all other regions in terms of higher education levels, number of enterprises per head of the population, and other indicators (E. Vanags, 2005). In terms of GDP per capita Rīga again leads, followed by the Kurzeme region which contains the port cities of Ventspils and Liepeja. In Latgale GDP per capita is nearly four times less than in Rīga.

In the recent period these disparities have been exacerbated by at least three factors. Economic decline in industrial areas whose previous *raison d'être* was linked to the wider Soviet economy has devastated towns such as the second city, Daugavpils. Secondly, the advantages to inward investors offered by Rīga as the capital city have accentuated centre-periphery dynamics between the capital and much of the rest of the country. Thirdly, agricultural decline following the collapse of collectivised agriculture has contributed to rural depopulation. Combating regional disparities is therefore one of the factors behind pressures to create stronger regional governance institutions; at the same time, strengthening the regional tier of governance can be seen as a way out of the impasse on local government reform. The two forces come together in the view that current local government units are not competent to promote entrepreneurship and economic development or to tackle unemployment, poverty and social exclusion, and that that requires the creation of stronger regional governance arrangements. This is why the five new planning regions have been created and a new regional policy developed, with three main objectives:

- To close the gap between the level of development of Latvia and the EU average by increasing the competitiveness of the country and its regions.
- To equalise living, working and environmental conditions among the regions, and crate a level playing field in terms of the preconditions for entrepreneurship and balanced regional development.
- To promote the development of the capital city region to close the gap between it and other comparable EU cities.

These objectives are being pursued through the National Development Plan (2007-13), the Spatial Development Plan, Sectoral Development Programmes, and regional spatial and development programmes. All regions are involved in the current preparation phase of the NDP. Financial and other support for regional development comes from a Regional Fund; a programme for Specially Assisted Regions is financed from sectoral development funds and from support given to the regional development agencies. The latter programme in turn provides finances for the promotion of entrepreneurship and tax allowances for enterprises that advance the three policy objectives (Kuznieks, 2005), although it should be said that the resources involved in these initiatives are rather small.

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In this regard, Latvia may be able to follow the example of Sweden's regional growth agreements, which provide a strategic platform to pursue economic and employment development in the regions (see Box 4.3). Regional strategic platforms are emerging as the main instrument for coherent planning and organisation of the economic development activities of an area, and often prove useful to strengthen innovation processes (Giguère, 2004).

Box 4.3. **Regional strategic platforms: the case of Västerbotten (Sweden)**

The region of Västerbotten provides a good example of regional governance arrangements that combine and strengthen efforts to promote economic and employment development. Sweden's Regional Growth Agreements (RGAs) promote partnership between regional governments, county labour boards, businesses and business organisations, and other interests to develop and implement regional industrial policies by improving intersectoral networking and enhancing institutional capacity.

Västerbotten is a vast, rural region – the size of Denmark but with only 260 000 inhabitants – in Sweden's less prosperous north. The aim of the 2000-02 growth agreement – similarly to Latvia's regional development goals – was to achieve the same level of economic development as in other comparable European regions and attain full employment; to establish more firms and to expand existing ones; and to broaden access to existing markets. The agreement covered five main areas: education and R&D; technology development; international markets; business development; and quality of life. Finance came from central and local government, universities and foundations, and EU funds.

The success of the growth agreement lay in its capacity to engage partners and the consequent development of alliances and networking, for example around transport and IT education. It has become embedded in local economic and social networks, which has helped both to reveal new needs and to provide innovative responses. The subsequent agreement covers the 2002-07 period.

Source: Morgan and Sol, 2004.

The current weakness of the regional level of administration in Latvia has led to calls for directly elected governments at that level. Začesta and Pūķis in this volume show how the development of various models of regional government has contributed to the modernisation of the sub-national state across Europe over recent decades. The current structure of regional development agencies and regional development plans, as well as proposals for regional tripartite councils, would be greatly strengthened by the creation of a regional tier of government. This would assist in implementing regional development strategies and ensuring their political legitimacy. Regional authorities should be in a position to play a lead role in drawing together partnerships between state agencies, businesses and business interest groups, trade unions and other actors, to promote growth, competitiveness and employment. Strengthening the regional tier of governance would also help ensure that strong projects are put forward to EU funding streams and programmes. However, if regional institutions are to have a leading role in dealing with issues of economic growth and competitiveness and regional economic disparities, then such institutions need to be adequately, democratically accountable. Elected and effective regional authorities could have a positive impact on public perceptions of government; political parties would have to restructure and energise their activity in the regions, bringing national policy closer to the grassroots. They would also have to ensure more effective representation of Latvian interests in the EU Committee of the Regions (Začesta and Pūķis, in this volume). Clearly, there is not a need for both a regional tier of government and the current district level, so any move towards regional government would be another spur for local reform. At the same time, experience in many countries shows that there is a real challenge for national government to cede sufficient powers and resources to the regional tier to ensure its autonomy. Without that autonomy, a new tier of government will appear to citizens merely as another layer of bureaucracy.

A highly important issue is the position of the capital. The dominance of Rīga needs to be recognised not only as a potential threat (to other parts of the country, but also to Rīga itself if growth/congestion is not well planned) but also as an opportunity if Latvia is to maximise its international competitiveness by drawing to the full on the capital's advantages. The creation of more effective and accountable regional institutions would be a major step in countering the negative aspects of Rīga's dominance, but at the same time it must be the responsibility of national government to ensure that economic growth is channelled in such a way as to reduce regional disparities.

A strengthened regional tier of government thus has considerable advantages as part of the modernisation of governance in Latvia. The form this takes, however, still involves decisions on a number of important issues (Začesta and Pūķis, *op. cit.*). These include:

- The size and number of regions.
- The position of Rīga.
- The implications of new regional institutions for current local government structures.

More broadly, the introduction of regional institutions raises the question as to the relationships between centre, regions and localities within a system of multi-level governance. Concepts of governance clearly imply that this relationship should be constructed around principles of networks rather than hierarchies.

A new localism?

One of the themes underlying the case for local government reform is the need for more effective devolution and decentralisation from central government. Similarly, one of the key elements in the concept of modern governance is that it needs to be multi-level, with joined-up policies spanning tiers of government from the supranational (the EU) through national government to the regional and local levels. Consistent with this perspective, the concept of a "new localism" is one that seeks to build a new, more positive and more equal relationship between national and local government (Corry and Stoker, 2002). One objective of a new localism is to accommodate the importance for central government of the power to determine key national standards and priorities, and ensure that these are implemented by regional and local tiers of government. Another, however, is to devolve to local and regional governments a greater degree of flexibility and autonomy consistent with local accountability, in order to ensure that policies can be responsive to local needs. A new localism thus has implications for both national and sub-national tiers of government. It involves not only the potential reallocation of powers and resources between tiers of government, but also organisational and cultural change within government at all levels.

In Latvia, the Ministry of Welfare is developing a welfare strategy embracing issues of employment and inclusion as well as social services and social security with the following priorities:

- Increasing the employment level via active labour market policies and lifelong and professional education.
- Reducing illegal employment.
- Reducing poverty and exclusion.
- Addressing pension issues.
- Improving social services provision, including issues of gender equality and regional disparities.

It is recognised that this ambitious strategy crosscuts both vertical and horizontal organisational boundaries and requires joined up, crosscutting activity not only between national, regional and local levels within government but with actors from the private and voluntary sectors and civil society. It involves shared responsibilities between central and local government in the social services sector. Currently, central government is responsible for:

- State social benefits.
- Social care institutions for people with disabilities.
- Social rehabilitation of children with social problems.
- Professional training.

Local governments are meanwhile responsible for:

- The local administration of benefits.
- Home care.
- Daycare and night shelter centres.

In addition to collaboration between central and local government, the strategy requires partnership between the Ministry of Welfare, NGOs and the social partners – the Latvian Employers Confederation and the Free Trade Union Confederation of Latvia. The ministry recognises that the capacity of partners to work together, including their access to information and knowledge, needs strengthening if joined up, crosscutting approaches are to succeed. On employment issues, there needs to be a more consistent pattern of regional plans below the national action plan. On the other hand, some issues – such as pensions and social services – are seen by the ministry as non-negotiable in that there cannot be sub-national differences in provision (Alliks, 2005).

This partnership-based welfare strategy thus illustrates both the potential for a "new localism" in which local government plays a key part, and the need for modernisation if local authorities are to be fit for this purpose. Modernisation needs to include a more effective and less rigid approach to management and professional training and a new focus on effective performance management at the local level, with a supportive rather than controlling role for national government. It can also be argued that if local policy makers are to be proactive agents in multi-level governance processes, with sufficient resources and autonomy, some reallocation of responsibilities from the national to the local level – in the fields of health and social care for example – may well be necessary. Reform of local government finance and financial management, including access to the capital market, may also be necessary (Začesta and Pūķis, 2005).

Local governance and local partnership

The foregoing discussion has demonstrated the need to modernise Latvia's local government if it is to play its full part – alongside national government and possible new regional institutions – in tackling issues of economic and social development and of trust in government itself. In tandem

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with a reformed structure of municipalities, local partnerships have a crucial role to play in implementing national economic and social strategies "on the ground". The message of the new local governance in and beyond Europe is that effective solutions to the complex, "wicked" issues facing policy makers today demand co-ordinated action from public authorities, the private sector, voluntary organisations and citizens, and communities themselves.

Experience elsewhere, such as that in Ireland, shows how local area-based partnerships can deliver multidimensional local strategies that bring together economic and social policy objectives and directly involve all key players including local communities and civil society organisations (see Box 4.4).

Local partnerships can play an important role in ensuring:

- That governance mechanisms connect with the grassroots.
- That all key players in local economic and social development are brought together at the local level.

Box 4.4. **The Irish partnership model**

In Ireland, local partnerships play a crucial role in local development. Several factors were important in encouraging their development. These included the context of social partnership at national level; the role of EU Structural Funds; the need for better co-ordination in the delivery of state services; and the need for reform of local government.

The advantages of the partnership approach has been that their practical, problem-solving approach, needs-driven agenda and action orientation have resulted in the provision of new and enhanced services and facilities, which have directly assisted many poor and unemployed people. They have brokered informal alliances and cross-sectoral networks that have improved both the flow of information between functional authorities and co-ordination of their employment and social programmes.

Irish partnerships now have a proved track record in building the capacity of communities to participate in local governance; in strengthening social capital at the local level; in leveraging funding; and in influencing policy at the national level.

An important part of the framework of partnership in Ireland has been the role of a national agency, Pobal (previously Area Development Management, ADM). Pobal provides programme management; strategic and developmental support; and expertise in performance management and the monitoring and evaluation of progress.

Source: Byrne, 2005.

Latvia's institutions of local governance are still in the process of being rebuilt, and as yet are lacking in legitimacy and popular trust. In this country particularly then, local partnerships can perhaps serve as a way of buttressing local government itself, and demonstrating that all actors are working together. In addition, local partnerships can – in the context of regional strategic plans – play an important part in implementing policies to tackle regional disparities.

EU programmes are likely to provide a positive context for the development of local partnerships, as many require a framework of partnership to develop and deliver local action. However, as the Irish experience shows, national government is also very important in supporting local partnerships. The Latvian authorities may wish to consider developing programmes or other mechanisms that encourage and foster local partnerships, and that help ensure that the lessons emerging from local partnerships about local needs and the effectiveness of policies "on the ground" are taken on board within wider systems of governance.

Learning from good practice

There is acknowledgement that, in modernising local and regional governance structures, Latvia needs to learn from good practice elsewhere, especially perhaps through cross-border co-operation with neighbouring countries (Radvilavicius, 2005). Enhanced cross-border collaboration can take a number of forms, including participation in cross-national programmes and collaboration on specific projects and twinning arrangements. However, a particularly relevant form may be "Euroregions", which cross the boundaries of nation states. Such regional initiatives could furnish a partnership platform linking local, national and regional authorities, NGOs, businesses, educational institutions and other partners. They may be especially relevant to solving the problems of peripheral regions that are marginal within national boundaries; here, cross-border collaboration may help deal with obstacles to development where social groups and communities are divided by boundaries. The EU INTERREG project to establish a Baltic Euroregional network provides a context in which this form of cross-national learning and development can occur.

However, it is also important to have effective mechanisms in place for learning and development within Latvia itself, in the fields of local governance and modernisation of local government. Other countries have recognised the importance of disseminating good practice by establishing specific institutional arrangements and practices to promote learning, development and continuous improvement. These include national and/or regional institutions, websites (on which good practice examples can be posted and discussed), and programmes enabling local governments and other organisations to benchmark and review their activity against their peers.

It is worth noting that the Irish experience can be replicated in other institutional contexts. Finland was notably keen to learn from Ireland when it was struck by high unemployment in the 1990s. The Central Uusimaa Partnership is a good example of partnership created during that period, inspired by the Irish model (see Box 4.5).

Box 4.5. **A case from Finland: Central Usamaa**

Central Usamaa is an area of 160 000 people near the capital city, covering six municipalities. There are few jobs available there and unemployment tends to be longer term than nationally. The Central Usamaa Partnership has been formed to tackle employment and economic development issues. The Partnership, which takes the legal form of an association, has a staff of six. Its main objectives are:

- To create joint responsibility and more positive attitudes on the part of all actors to support employment.
- To support the creation of new businesses, especially in domains such as culture, health and social services.
- To create new models of co-operation to support employment and fight against exclusion.
- To strengthen the individual resources of the unemployed.
- To co-ordinate as an "umbrella" local activities targeted at local development and employment.

The Partnership is taking a regional strategic approach that involves using co-operation among municipalities as the basis for local co-operation and innovation. Key sectors targeted are services, culture, social services and healthcare, construction, and low productivity industries. The objectives of the regional strategy are to identify the area's strengths and weaknesses, define and promote common ventures, and support innovation through transnational co-operation via REIIES – the *Réseau européen d'initiatives d'intégration économique et sociale.*

The lessons learned so far by the Central Usamaa Partnership emphasise the need for all actors to be involved from the start; the need to agree on the rules of the "partnership game" and on shared vision and values. The Partnership has developed a bottom-up approach to regional strategy – and it is clear that developing the strategy is only the first step towards outcomes.

Source: Lindberg, 2005.

Conclusion

The challenges for local governance in Latvia are similar in important respects to those identified for more advanced economies. The shift from government to governance is seen as a means of including all actors and sectors in governance processes, in order to pool knowledge, expertise and resources, share risks and improve outcomes. However, context matters: the issues facing Latvia are often more severe than those in many OECD countries because of the historical context of totalitarianism from which the country has only recently emerged. Like other OECD countries, Latvia is recognising the importance of regional strategies in promoting economic development, but is still in the process of developing strong regional institutions that can provide a "platform" for both economic competitiveness and the reduction of regional disparities. Like other countries, the modernisation of local government and the introduction of modes of local governance enabling state agencies to work more effectively with partners from the private, voluntary and community sectors are seen to be central to national policies. In Latvia, the need is twofold: to reform and strengthen the core institutions of local government, and simultaneously to build around these institutions a partnership framework involving business interests, citizens, and voluntary and third-sector organisations. Like all other countries, in moving forward Latvia will need to learn from other countries, but also to ensure that it is able to learn from good practice within the country itself.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 5

Consolidated Local Governments in Partnerships: a Key to Promoting Economic Development in Estonia

by

Jussi S. Jauhiainen

Ensuring successful local economic, employment and social development require an efficient organisation of local government duties combined with sound local governance mechanisms involving co-operation between public, private and non-governmental sectors. Estonia, however, has a fragmented territorial administration at regional and local level. Policy initiatives to reform territorial and public administration have had mixed results due to a lack of attention to governance mechanisms. Increasing attention must be paid to inter-municipal and public/private/NGO networks that would enhance service provision at local level. Equally important is the need to ensure the accountability of such networks.

Governance, especially local governance, is in vogue in the European Union. Local governments face challenges of economic and political accountability in addition to demands of inhabitants and the law. The traditional postwar mode of governance is accused – both by the New Right and the New Left – of being too rigid, bureaucratic, centralised, expensive and inefficient for rapidly changing societies. Governance, *i.e.* self-regulation beyond traditional hierarchic government, is seen as a chance to provide better, faster and more competitive local development. Municipalities with co-operative networks between public, private and non-governmental actors could become economically and politically stronger.

This chapter examines the development of local government and governance in the Republic of Estonia, one of the new European Union member states by the Baltic Sea. How policies and initiatives in Estonia promote regional economic development, employment and social inclusion is a question of high importance. The chapter begins by briefly highlighting the crucial aspects of local governance from these perspectives, paying particular attention to Estonia's administrative-territorial division.

The geographical and geopolitical location of Estonia has an influence on the country's development. There are land and water borders in the east with Russia, land borders in the south with Latvia, and sea borders to the west with Sweden and to north with Finland. In terms of size (45 227 km^2) and population (1 351 000), Estonia is among the smallest countries in the European Union. Nevertheless, as Vanags makes clear in this volume, the economy of Estonia has been profoundly modernised in the past decade: it has been privatised, the service sector has become the major employer, the amount of foreign direct investment has grown substantially, and the majority of trade is oriented to the European Union. Despite the rapid economic growth from the mid-1990s onwards the size of the Estonian economy is modest, with a GDP of EUR 10 500 million in 2005, *i.e.* less than 0.1% of the GDP of the European Union (Statistical Office of Estonia, 2006).

The chapter describes how local government developed in Estonia, from its re-establishment during the last years of the Soviet Union to the recent reorganisation towards decentralisation and local governance following the European integration. Despite the small size, Estonia has 15 counties at regional level and 232 municipalities at local level (see Vanags in this volume for more details). The median amount of population of a county is

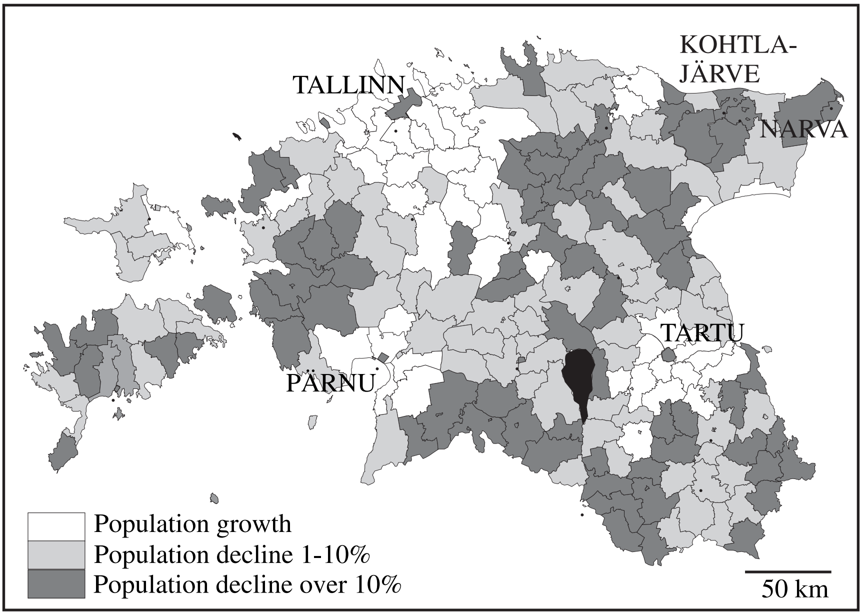
30 000 inhabitants. On average, in a municipality there are 2 000 inhabitants and over four out of five municipalities have less than 5 000 inhabitants. Strong, efficient policies for local governance are needed for Estonia to become more competitive in the economic and social spheres. Critical issues relating to the efficiency of such policies are addressed, especially territorial and public administration reform. The chapter concludes with the future challenges and the main considerations for Estonia from the perspective of local governance.

Socio-economic context of Estonia

There has been a dramatic transformation regarding employment in Estonia. Between 1990 and 2000, 254 300 jobs were lost – that is, more than every fourth job. The most dramatic reductions took place in rural municipalities: in primary sector 75% of jobs were lost. The decline also concerned heavy industry and 41% of jobs disappeared in secondary sector. Only a modest growth of 8% growth took place in jobs in tertiary sector (Statistical Office of Estonia, 2006). In recent years there have been changes that influence the development of municipalities. From 2000 to 2006, the decline in primary sector employment has continued and 6 900 jobs have been lost. This means that many rural municipalities are still losing employment opportunities in their traditional activities. There has been a modest growth in employment in industry (+8 600 jobs); however, that growth is very selective, limited to only a few industrial activities. If the amount of workers in the assembly line of the Finnish-owned information technology company Elcoteq, located in the capital Tallinn, is not counted, the employment growth in the secondary sector has been very small. However, the production volume in the secondary sector has grown considerably, meaning a rapid increase in the productivity of industry. A substantial growth in employment, 44 200 jobs (20 400 in public services and 23 800 in private services), has taken place in the tertiary sector (Statistical Office of Estonia, 2006). However, again the largest absolute growth is concentrated in the largest urban regions. This means there is a divergence in employment and economic development within Estonia, and a particular demand for economically efficient local governance.

Estonia's major challenges are demographic. Due to out-migration and natural population decline the country has lost over 200 000 inhabitants (a decrease of 14%) since 1990. Figure 5.1 shows that the majority of rural municipalities have lost more than 10% of their population between 1989 and 2000. With few exceptions, the only municipalities with a growing population have been those near three major towns, Tallinn, Tartu and Pärnu. In addition, all towns lost population between 1989 and 2000 except two small ones near to Tallinn (Figure 5.1). This development has continued in 2000-06: the only population growth areas are in the immediate vicinity of Tallinn,

Figure 5.1. **Demographic development of Estonian rural municipalities, 1989-2000**



Source: Modified from Tammaru, 2001, p. 37.

Tartu and Pärnu (Statistical Office of Estonia, 2006). The demographic pressure is evident at both national and local level. For example, the age cohort that entered higher education (universities, specialised vocational schools) in the latter 1990s – 18-20 years old – will be diminished by half by 2010. According to projections of the United Nations Population Division (2003), a further loss of 200 000-400 000 (a decrease of 15-30%) will take place by the year 2030. The most serious loss of population is taking place in those areas that are economically most vulnerable, *i.e.* peripheral municipalities, rural municipalities further away from larger towns, and industrial towns undergoing extensive restructuring. Examples of the latter are towns in Northeastern Estonia in which the vast majority of population do not speak Estonian at all. About one-third of the population in Estonia are not ethnically Estonians; most of them speak Russian or other Slavonic languages (Statistical Office of Estonia, 2006). Population decline is an especially serious challenge for local governance.

So far there has not been a positive emphasis on the urban dimension in Estonian regional policy; to a certain extent, policy has been hostile even to the fastest growing urban areas, especially to Tallinn. The Estonian regional policy guidelines – the first established in 1990, the second in 1994, the third

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in 1999 and the fourth in 2005 – have emphasised that all areas within Estonian territory should be populated and that access to basic services such as healthcare and education should be guaranteed everywhere. The major task in regional policy has been redistribution and equalisation of social and economic development opportunities. Implementation of regional policy has taken place through various programmes and projects; funding was quite modest until the integration phase to the European Union (Jauhiainen, 2000).

In spite of implementation of redistributive regional policy lasting over a decade, regional disparities exist in the economy, and they are growing. The average income per household and the unemployment level measured at county level exceed those set in regional policy (see Vanags, in this volume). The average salary in the capital region is 20-40% higher than that of other counties (Statistical Office of Estonia, 2006). Since 2004, implementation of European Union structural policies and the use of structural funds have opened possibilities to set a necessary platform for activities that would create economic growth, employment opportunities and social cohesion. Yet so far, regional economic development trends show more divergence than convergence.

Territorial organisation of government in Estonia

The territory of Estonia is administratively divided into counties at regional level and into towns and rural municipalities at local level. In 2006, territorial powers are still traditionally and hierarchically divided between central, regional and local administration. Organisation of public policies through networks has not yet occurred, and instead of governance the prevailing approach in local and regional economic development is government. Counties belong to the state administration, whose tasks are carried out in counties by county governors and government agencies. The tasks of local government and its administration are set forth in the Constitution and in the Local Government Organisation Act, both of which set forth functions, responsibilities and organisation of local government and relations among local governments and between local governments and the state (Table 5.1).

To consider the opportunities for successful organisation of economic and employment growth at local level, one has to think of territorial or local governance in a broader context. Territorial governance pertains to forms of management of territorial resources at regional and local levels. It increasingly involves trans-scalar and inter-jurisdictional dimensions, which stress the limits of effectiveness of given geographical rationales for governmental and administrative activity (Gualini, 2001). The new regionalism of governance in the European Union member states means a division of powers between the public and private sectors such that the most important aspects of local,

Table 5.1. **Local Government Act**

Chapter 1:	General provisions (§§1-15)
Chapter 2:	Council (§§16-26)
Chapter 3:	Government (§§27-31)
Chapter 4:	Participation of rural municipality or city residents in exercise of local government (§§32-33)
Chapter 5:	Economic affairs and budget (§§34-39)
Chapter 6:	Administration (§§40-53)
Chapter 7:	General principles of local government service (§§54-55)
Chapter 8:	Formation and procedure of rural municipality and city districts (§§56-58)
Chapter 9:	Repealed-23.11.1994
Chapter 10:	Co-operation of local governments (§§62-64)
Chapter 11:	Relation with state bodies and supervision (§§65-66)
Chapter 12:	Implementation of Act (§§67-75)

regional, national and supranational levels are taken into account (Table 5.2). Such multi-level governance can create general-purpose jurisdictions with non-intersecting memberships in which lower tiers are nested into higher ones to solve the challenges of governing. Another possibility for multi-level governance is to have special-purpose jurisdictions focused around particular policy challenges (Bache and Flinders, 2004, p. 195). At the same time one is increasingly paying attention to regional development policies based on networks. The networks contain mutual and interactive exchanges in a polycentric European Union consisting of metropolitan nodes as well as self-contained relations of social capital and locally embedded knowledge in place. The conditions of possibility and actions of networks participants are defined by their relationship with other participants rather than by their own inherent characteristics (Leitner and Sheppard, 2002).

Table 5.2. **New regionalism of governance**

Economic-territorial governance	Political-territorial governance
Globalisation *Economic competition and policy choices*	Rescaling the state *Interaction of economies, institutions, identities*
Untraded interdependencies *Firms and soft institutional infrastructure*	Multilevel governance *Tensions between national and regional identities*
Industrial districts *Reflexive and learning regions*	Growth politics *Innovative milieu, urban boosterism*
Post-fordism and regulation theory *Flexibility, specificity, individuality*	Governance and networks *Uneven institutional development*

Source: Modified from Herrschel and Newman, 2002, p. 13.

Successful organisation of territorial powers has to be based on good governance, in Estonia as elsewhere. Good governance is the keyword of the new political economy and an "umbrella" for various public and private issues. There is no single principle or mode of organising governance. Governance suggests *inter alia* policy networks, co-ordination of sectors of the economy, public-private partnership, corporate governance, and the reform objective of "good governance". Governance is seen as a dynamic process involving hierarchies (idealised mode of democratic government and public bureaucracy), markets (arenas for economic actors), networks (self-regulatory structures within particular policy sectors) and communities (organisation of development without state government) (Pierre and Peters, 2000, pp. 14-27).

Regional level

The government of the Republic of Estonia is actively present at the regional level. Government agencies are divided into two categories: state agencies and central government agencies. The state agencies include regional offices of ministries, other agencies of executive power, and local offices of Tax Board, Statistics Board, etc. The last-named provide services to the central government agencies and perform state functions in cultural, social and other areas. The main function of the state-financed central government agencies is to exercise governmental power. The agencies are accountable to the government or to the corresponding minister, who directs and co-ordinates their activities and supervises them. Specifically, these agencies are the ministries, the State Chancellery and the county governments as well as executive agencies and inspectorates and their regional offices (Galligan and Smilov, 1999, p. 77).

According to the Government of the Republic Act, the central government representative at the regional level is the county governor, appointed to the office by the government for a term of five years. The county governors in 15 counties are the link between the central government and local governments. The governor approves the staff of the county government and directs their work. At the local level (*i.e.* municipalities), the county governor:

- Represents the interests of the state in the county and oversees the comprehensive and balanced development of the county.
- Co-ordinates regional offices of ministries and other agencies of executive power and municipalities in the county.
- Concludes, by authorisation of the government, administration contracts with municipalities for their performance of state obligations.
- Supervises the proposed legality of secondary legislation of the councils and governments of a given county's municipal units, and the legality and purposefulness of state assets used or controlled by municipal units.

- Informs the government and municipalities on regional policy and other issues concerning relations between the central administration and the municipalities.

Furthermore, Estonia is divided into five NUTS III statistical regions for particular European Union purposes. The central authorities have defined these regions, namely Western (Lääne, Pärnu, Hiiu and Saare counties), Northern (Harju county), Northeastern (Lääne-Viru and Ida-Viru counties), Central (Viljandi, Jõgeva, Järva and Rapla counties) and Southern (Tartu, Põlva, Võru and Valga counties) Estonia. While these regions do not have political accountability, they are significant because they are used for structural policies of the European Union.

Recently the county governors have argued for directly elected and politically more autonomous county councils. This argument has been put forward due to a weak local level and the need to establish a politically and economically competent sub-national authority in Estonia, especially regarding regional policy (Sahk, 2003). Inherent in the formation of local governance in Estonia are different power interests between central, regional and local authorities. This collective demand by the county governors for more substantial power over local authorities does not facilitate the formation of stronger political or economic governance or networks at local level. However, granting such a concentration of power to the elected regional (county) councils would require a change in the Constitution.

Local level

The principles of local government have been stipulated in the Constitution, which was adopted by referendum in 1992 and entered into force in 1993. It has been amended frequently, *inter alia* over local government topics. The relevant legislation for the local level is the Law on the Election of a Local Government Council; the Law on the Organisation of Local Government; the Law on the Local Government Budgets; the Law on the Organisation of County Government; and the Law on the Relation between the Local Government Budget and the State Budget. There are other laws that touch on local affairs, such as the Law on Elementary and High School, the Law on Social Welfare, the Law on Construction, the Law on Planning, etc.

The fundamental rules pertaining to local government are laid down in Chapter XIV of the Constitution (§§154-160). According to the Constitution, administration of local governments and supervision of their activities are provided by law. All local issues are resolved and managed by local government, which operates independently. Local government is exercised by democratically formed legislative and executive bodies and, with regard to local issues, by means of opinion polls, referendums or public initiatives. The basic principles of local government are the independent and final resolution of local issues, and the organisation thereof.

The Constitution indicates the separation of tasks of the central and local authorities (Table 5.3). Local governments resolve and organise issues assigned to them by law if these are not assigned by law to other persons for organisation and resolution. Finally, local governments fulfil state functions, which are assigned to them by law and which arise from a contract between an authorised state body and a specific council. Nevertheless, the principle is that decision-making power in local everyday matters is decentralised to local government. This follows European principles of local self-governance present

Table 5.3. **Tasks of central and local governments in Estonia**

Issues	Central government	Local government
Defence	Entire responsibility	No direct responsibility
Justice/internal safety	Entire responsibility	No direct responsibility
Police services	National police	No direct responsibility
Foreign economic relations	Entire responsibility	No direct responsibility
Education	All universities and research institutions; teacher training; textbooks; some investment grants	Construction, operation and maintenance of primary and secondary schools, kindergartens and art schools, sport facilities, houses of culture, community centres, vocational and sport schools; teacher's salaries and social security; school transport
Health	Research, medical institutes, special service hospitals and tertiary hospitals	Capital investment and maintenance for municipal hospitals; municipal doctors
Roads	Construction of national highways; maintenance of state highways and any other roads linking cities and villages	Maintenance of local networks and streets of municipalities
Public transportation	Intercity buses by state enterprise; airports; railway subsidy, subsidy for local transportation	Local public transport
Fire protection	Fire protection services	Emergency services
Culture	National library and museums	Local libraries, cultural centres, museums, and sport centres
Sanitation	No direct responsibility	Garbage collection and street cleaning
Water and sewage	Some investment grants	Operation and capital expenditures
Public utilities	Electricity and gas provided by state enterprises	District heating
Housing	No direct responsibility	Housing maintenance and communal services
Social welfare	Unemployment benefits, subsidies to local governments for other welfare; national environment issues	Elderly care, home visits and other social services, allowances; local environment issues

Source: Local Government Act; Reiljan *et al.*, 2003, pp. 44-45.

in the European Local Government Charter, ratified by the Parliament of Estonia. Therefore local authorities do not have to ask counties or other government representatives how to solve local development issues or implement local policies. However, it is not clearly expressed whether the position of local government derives from principles and theories of community or those of state-centrism (Olle, 2001, pp. 71-75). Haav (2000, p. 1) claims that Estonia inherited the autocratic Soviet model of public administration that only imitates democracy. Reiljan *et al.* (2003, pp. 43-45) point out that the amount of tasks undertaken by local government has increased in several areas despite the lack of commensurate state funding. These are examples of current tensions between the central and local governments in shaping local governance.

The units of local government in Estonia are rural municipalities (currently 199) and towns (33). All local governments have the same rights and obligations regardless of their size. The largest city is Tallinn with 397 000 inhabitants, and the smallest rural municipality is Ruhnu with 64 inhabitants (Statistical Office of Estonia, 2006). Over half of Estonian municipalities have less than 2 000 inhabitants and most rural municipalities are successors of former soviet villages, whose establishment was not based on history or economic rationality. Other units of local government may also be formed; however, the boundaries of these units cannot be altered without considering the opinion of the local governments concerned.

According to the Local Government Organisation Act, each local government has a council that is elected for a term of three years – since 2005, for four years. The elections are free, general, uniform and direct; there is, however, secret voting by inhabitants who reside permanently in the territory of the local government, have attained eighteen years of age, and have the right to vote. The residents have a right to participate in the exercise of local government. There are, however, specific legal requirements regarding language knowledge. Certain oral and written skills of Estonian are required to become a member of a municipal council. The required level is to understand the content of legislation and other texts, to present reports on agenda items and express opinions in the form of a speech or comment, to pose questions and make proposals, and to communicate with electors, respond to appeals and petitions, and answer inquiries. These requirements have an impact on those municipalities in which the populations of Russian- and other non-Estonian-speaking persons are high. This is especially evident in Northeastern Estonia but in Tallinn as well.

The legislation stipulates several essential tasks within the competence of municipal council, such as passage of the local budgets; imposition of local taxes and establishment of tax incentives; approval of local development plans; taking of loans for the municipality; election of the chairman and deputy chairman of the council; formation of rural municipality or town districts or their liquidation. The council forms the government of the municipality as its collegial and executive body. The government is confirmed to office for the period of the council and works under the same principles as the council. In addition, among the key actors is the head of local government administration – the mayor – who organises the work of local government, prepares for the council meetings of the municipality and represents the municipality in accordance with the competence granted by law, the statutes of the municipality and the council.

In a local economy it is important that local budgets are separated from the state budget. In Estonia this is indeed the case, yet the financial situation of Estonian municipalities has deteriorated during the past few years. The number of functions assigned to local governments has grown despite their lack of a stable legally determined income base that would enable them to make long-term local development plans. It has been estimated that the annual gap between the costs of responsibilities delegated to local governments and the possible source of income is EUR 130 million (Reiljan *et al.*, 2003, p. 6). In addition, the government is decreasing the income tax from 26% to 20% (currently 23%) and increasing the tax-free minimum wage. In this case the independent financial base of municipalities would decrease and their independence erode further (Raju, 2004, p. 202).

The independent balanced budget of a municipality consists of all the revenue and expenditure of its local government units for one budgetary year. The development of revenue and expenditure per capita in Estonian municipalities in 1996-2001 is presented in Tables 5.4 and 5.5. The budget expenditure is a set of appropriations to perform duties imposed by law; perform contractual obligations; finance other needs; and establish reserve capital in an amount equal to at least 1% of the budget expenditure. The budget revenue of Estonian local governments in 2002 (in percentage) was from: taxation (39); municipal enterprises (6); municipal agencies and municipal assets (3); financial support and revenue intended for specific purposes (33); loans and interest (8); and other revenue (1) (Statistical Office of Estonia, 2003). The role of taxation, *i.e.* direct and autonomous source of local revenues, has decreased from 53.2% in 1996 to 38.9% in 2002, and it is decreasing further (Tables 5.4 and 5.6).

The taxes paid into the budget of local government are divided into state taxes imposed by law, paid either in full or in part into the local budgets, and local taxes imposed by local councils. The mandatory taxes constitute the main taxation base of local governments. The taxation base includes individual income tax, land tax, and the fee for use of natural resources (*i.e.* resource tax). In some cases, disputes have arisen with regard to the lawfulness of certain fees, such as for parking and kindergarten. Besides state

Table 5.4. **Revenues for local government in Estonia, 1996-2001 (EUR)**

Average EUR per capita	1996	1997	1998	1999	2000	2001
Personal income tax	108	120	132	137	132	135
Land tax	9	11	11	12	13	14
Revenue from assets	8	15	15	16	28	55
Income from economic activities	6	9	9	10	11	11
Transfers from the State Support Fund	33	30	28	29	31	32
Loans	36	20	21	24	22	25

Source: Reiljan *et al.*, 2003, p. 29.

Table 5.5. **Expenditures for local government in Estonia, 1996-2001 (EUR)**

Average EUR per capita	1996	1997	1998	1999	2000	2001
General administration	26	26	27	28	28	30
Defence and public order	1	1	1	1	1	3
Education and science	85	88	97	103	97	102
Culture and art	14	16	20	21	20	22
Recreation and sport	4	4	5	7	9	12
Health	4	3	4	4	4	5
Social security and welfare	9	23	23	24	24	31
Economic affairs	56	52	54	64	60	74

Source: Reiljan *et al.*, 2003, p. 35.

Table 5.6. **Local government income in Estonia in 1996 and 2002**

Type of income (M €)	1996	Share (%)	2002	Share (%)
Taxation	170.46	53.2	309.93	38.9
Personal income tax	153.65	47.9	277.94	34.9
Land tax	13.49	4.2	26.95	3.4
Local taxes	3.32	n.a.	4.73	0.6
Property	11.86	3.7	84.90	10.7
Municipal enterprises	9.05	2.8	44.92	5.6
Municipal assets	63.54	19.8	24.65	3.1
Financial support	44.01	13.7	263.88	33.1
From state budget	n.a.	n.a.	239.37	30.0
Loans	50.98	15.9	60.70	7.6
Other	n.a.	n.a.	7.98	1.0
Total	320.54	100	796.97	100

Source: Reiljan *et al.*, 2003.

taxes, the local governments may impose local taxes, the role of which in local budgets has traditionally been small. These are sales tax (at the end of the 1990s implemented in 15 municipalities); boat tax (in 2); advertisement tax (50); road and street maintenance tax (14); motor vehicle tax (2); animal tax (5); and gambling tax (1) (Ainsoo *et al.*, 2000, p. 287).

Individual income tax is the most important revenue for local government and it is transferred to the local government of the person's residence. Residence is determined on the basis of relevant declarations submitted to the employer, who then transfers the individual income tax to the tax office. Pursuant to the declarations, the individual income tax is paid into the account of the respective local government unit. Currently, the municipalities receive a 56% share of the individual income tax, which is 24% in 2006 (Table 5.6).

Land tax, 0.8-2.0% of the assessed value of land, is paid in full into the local government budget. The concrete tax rate is established by the local government council, which has the obligation to disclose it to the inhabitants and the taxpayers in the respective local government. The role of land tax in the local budget is small (Table 5.6).

The fee for special use of water and natural resources as well as the method and amount in which they are paid into the local budget is established by government decree. The fees are revenue articles fixed to the budget of local government, and are taken into account upon calculation of the state financial support. The share of such receipts is minimal in the local budgets except in some rural municipalities of Northeastern Estonia, where oil shale is mined (Table 5.6).

Local government functions include dealing with issues that arise in the municipality regarding education, local roads, public transportation, fire protection, sanitation, water and sewage, public utilities, housing, social welfare and the environment (see Table 5.4). The expenditures of Estonian local governments in 2002 (in percentage) were education (44), economic services (14), general administration (9), social welfare (8), culture and art (7), and other (18) (Statistical Office of Estonia, 2003). Expenditure related to duties of the state imposed by law on a local government is funded from the state budget.

The economic position between Estonian municipalities varies significantly. The average personal income differences per capita between the richest and the poorest Estonian municipalities are over eightfold. In 2002, the annual revenues of over two-thirds of Estonian municipalities were under EUR 1 million. This limits their possibilities for development. The share of local governments of the national GDP is about 6-9% (Raju, 2004, p. 198). The average revenues for Estonian municipalities have changed between 1996 and 2002. In both of those years the individual income tax was the most significant for the municipality revenues but its role has diminished from 48% to 35% (Table 5.6). In 2002 the share of individual income tax in eight municipalities (Tähtvere, Saue, Saue, Jõhvi, Raasiku, Ülenurme, Rae, Viimsi) was over half of the total local revenue. Most of these municipalities are located next to the most economically significant cities, Tallinn or Tartu (Statistical Office of Estonia, 2003, p. 81).

Between 1996 and 2002, the external financial support for municipalities increased from 14% to 33%, especially the general state financial support (Table 5.6). Most Estonian municipalities depend significantly on state financial support and are not able to make major investments without it. There are 30 municipalities in which the subsidies from the state budget are three times more than the personal income tax generated (Statistical Office of Estonia, 2003, p. 81, pp. 100-131). Curiously, in 1996-2002, state financial support transfers were separated from real expenses (Raju, 2004, p. 206). From 2004 onwards the European Union structural funds will play an important role in major infrastructural investments in selected municipalities.

The importance of property as type of income for municipalities has increased from 4% to 11% and the role of municipal assets decreased from 20% to 3%. Loans for investments are one strategy; however, they easily become a burden for local budget if they are used for general purposes and not for income-generating activities. In relative terms, the share of loans in the local budget has diminished by half, from 16% to 8%; nevertheless, their absolute amount has increased (Table 5.6).

At the end of the 1990s only 38 municipalities (15.0%) were characterised as wealthy; almost three out of four (185, 72.8%) were poor or directly risked becoming poor (Noorkõiv, 2000, p. 77). In addition, the smaller the municipality is, the worse is its dependency ratio: the share of active labour force decreases along with the population figure. According to the law, the total of all unpaid loans may not exceed 75% of planned budgetary revenues in the current year. In 2002, there were 35 municipalities that had a loan burden on their total budget of over 50%, and 35 municipalities between 40% and 50%. For two-thirds of the most indebted municipalities the loan burden increased in 2002 (Statistical Office of Estonia, 2003, p. 81, pp. 100-131). The sources of investment funds vary in terms of the size of municipalities. In 2000, in Tallinn 99.7% of investment funds derived from its own resources. In towns with over 10 000 inhabitants 52.9% of investment funds originated from own resources and 24.7% from ministries. However, in rural municipalities with less than 1 500 inhabitants, 27.4% derived from own resources and 49.4% from ministries (Ainsoo *et al.,* 2000, p. 295). The smaller the municipality, the more dependent it is on central government support.

Local government and governance and their reforms in Estonia, 1989-2006

The development of local government and governance in Estonia can be divided into periods. The first started in the final years of the Soviet Union and lasted until the organisation of local government in newly independent Estonia. The second period in the mid-1990s is characterised by the consolidation of local government. The third period started in the late 1990s with the discussion about territorial and public administration reforms. The fourth period will begin when the reforms and local governance are implemented. However, in 2006 the reform process had yet to take place.

Re-establishment of local government (1989-93)

Political activities promoting the self-governance of local government emerged during the last years of Estonia under the Soviet regime. In 1989, local governments were elected in the first democratic elections in Estonia since the 1930s. By autumn of that same year, the Local Government Principles Act had been prepared. The Act, approved in 1990, introduced a two-tier local government system. One tier consisted of the former village councils and towns, which prepared their statutes, internal structure and socio-economic development plan, and submitted them to the expert committee on public reform. In the Soviet years rural municipalities and counties were abolished and the village councils were created as sub-municipal units representing the interests of the central government (Reiljan *et al.*, 2003, p. 11). Another tier consisted of 15 counties and six republican cities (Tallinn, Tartu, Kohtla-Järve, Narva, Pärnu, Sillamäe). The counties were formed on the basis of *rajons*, the former Soviet administrative units (Mäeltsemees, 1999).

Regarding the organisation of local and economic development, 1989 saw the early principles and objectives of regional policy formulated. In the background was the proposal for an economically more independent Estonia (IME), launched in 1987 by four Estonian activists. The first regional policy guidelines were adopted in 1990 and the first regional policy instruments introduced in 1991; both had paid much attention to local and regional economic development. Regional policy was based on zoning and implementation of corporate tax reductions and infrastructure investments in remote areas. To implement regional economic policy, local self-governments were analysed according to indicators of demographic and employment structure, unemployment, income, SME creation, and economic development (NEI, 1999). Also, the national regional associations of local authorities initiated their activities, which led to the establishment of the Estonian Association of Towns, the Association of Rural Local Municipalities and the Association of Estonian Local Authorities.

After independence was restored in 1991, the principles of the local government were fixed in the Constitution. By the Autumn of 1993, all the administrative units of the first tier – rural municipalities and towns – had acquired the status of local government. In total there were 255 local governments, of which 208 were rural municipalities and 47 towns. The majority of municipalities were small. In 1993 there were only 24 municipalities with over 5 000 inhabitants, five with over 50 000, and two with over 100 000. The largest town, Tallinn, had 450 000 inhabitants, *i.e.* 29.8% of the total population.

During the restoration of the Estonian local government system, the government provided only a few guidelines and financial support. This led to some confusion over initiatives and implementation, especially regarding local government. In general, local budgets were decentralised and division of taxation base between the two tiers of local governments mutually agreed. The main share of the local income base, the individual income tax, was at first fully paid into the local government in accordance with the location of the employer, because the places of residence were not ascertained until 1994. Part of the enterprise income tax was also paid into the local budgets in 1990-92. The first and second tiers of local government had the right to impose additional local taxes, such as an additional value added tax of up to 3% (Mäeltsemees, 1999). However, these were not widely applied due to their unpopularity and complexity.

Consolidation of local government (1994-97)

From 1994 a new local government organisation went into operation, which completed the administrative transition period. A number of laws regulating local government were adopted in 1994-95, including: the Local Government Organisation Act; Rural Municipality and Town Budgets Act; Rural Municipality and Town Budgets and State Budget Correlation Act; Local Taxes Act; and the Territory of Estonia Administrative Division Act.

The second regional policy guidelines were adopted in 1994, when the national economy had declined rapidly for four consecutive years. Regional policy covered the whole country and most support was delivered to special target areas. Former rural areas and industrial centres especially declined. Regional economic development policies were seen hierarchically as state activities to help regions overcome problems on their own and avoid crisis. The key issues regarding local and regional economic development were local self-reliance and creating a vigorous economy, facilitating structural changes through regional economic incentives, avoiding permanent subsidies except for island-mainland ferry traffic, local initiatives supported by central government initiatives, participation and support as the primary force of development, the existence of regional development and assistance programmes with minimal additions, and co-ordination of regional policy objectives with national sectoral and macro policies (Jauhiainen, 2000).

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The local government system began functioning at one tier consisting of rural municipalities and towns that now had the functions, competence and obligations arising from respective laws. Several former functions of local government were transferred to the state when the counties became the regional administrative units and the county governors became the representatives of the state in the counties. This administrative reform was clearly a political decision. The former six independent cities obtained the status of local government. The status of Tallinn as the capital of Estonia was formally approved in 1995.

Rural municipalities and towns immediately became subject to the taxation system. The structure of taxes paid into local budgets changed; the taxation base of local government narrowed. The main local source of revenue was the individual income tax, of which 52% – from 1996, 56% – was paid to local authorities. In 1994 a land tax was established and from 1996 this tax (0.8-2.0%) is fully paid into the local budget. In the beginning the state regulated the assortment and conditions of local taxes, and the right to collect the individual income tax was given to the State Tax Board. The result was that almost 90% of the revenues of local budgets were received through the state budget and the State Treasury (Mäeltsemees, 1999). From 1997 the share of individual income tax was again paid into the local budgets without the mediation of the state budget. Following this, the balancing of the income base became the main mechanism for state budgetary support.

The year 1995 saw the creation of a legal possibility for local governments to amalgamate. In the beginning the idea was not to put territorial and public administration reforms together. Also initiated was discussion to provide state subsidies for municipal merging. Actually financial resources were limited, and the government was not able to keep such promises; hardly any territorial reform took place (Reiljan *et al.*, 2003, p. 12).

Towards local governance (since 1997)

The period from the late 1990s onwards has been one of attempts to conduct a comprehensive administrative-territorial reform. According to the law, all local governments have the same rights and responsibilities regardless of size. The government has repeatedly argued that the low administrative and financial capability of local governments is partly due to their very small size and the low number of qualified and experienced officials in them. Therefore the reform must go through, as Minister of the Interior Tarmo Loodus made clear in 2002: "Merging of local authorities in the near future is unavoidable and necessary. It would improve the quality of services offered by local authorities and would also increase their coping ability."

Increasing demographic and economic pressures at local level paved the way towards administrative-territorial reform and local governance. According to the law, the alteration of administrative-territorial organisation consists in forming one or several new administrative units from one or several existing administrative units. This process may be initiated by the government or the councils concerned. The boundaries of an administrative unit are altered under those circumstances: a part of the territory of one administrative unit is assigned to another administrative unit, or the boundaries are altered according to land readjustment, building and planning needs. The local governments and state government agencies concerned cover the expenses according to their competence and as agreed by the interested parties. In case of alteration of administrative-territorial organisation, the opinion of the residents is obtained in all relevant local governments, and in case of assignment of a part of the territory of one administrative unit to another administrative unit, the opinion of the residents is obtained in the relevant part of the territory.

Significant for the formation of local governance was the integration of Estonia into the European Union. In 1997 Estonia was invited to the direct negotiations for its EU membership. The evaluation concluded that in Estonia people do not trust the public services even though the legal basis of those services is sound; their structures require extensive reforms (European Commission, 1997, p. 99). The negotiations stressed the need to align Estonian legislation and practices with those of the European Union member states.

The first attempt towards new local governance took place from January 1997 to February 1999. Studies were conducted, organised discussions held and models proposed for administrative-territorial reform of the local government under the PHARE Public Development Programme (PHARE, 1998). The government argued that the expensive and ineffective administrative system was a problem for the development of Estonia. The public sector suffered from rigid hierarchies, inadequate professional training and administration, and lack of qualification, motivation and co-ordination (Haav, 2000, p. 8). Research showed that the more distant a municipality is from the capital, the weaker is its socio-economic development potential. The municipalities over 200 km from Tallinn had about 40% lower development potential than the municipalities surrounding the capital (Suvi, 1999, p. 13).

The project on local government amalgamations focused on local possibilities for and obstacles to voluntary amalgamations. A methodological handbook entitled "Municipality and Town Want to Amalgamate" and the research report "Administrative-Territorial Organisation of Estonia" were published. These documents claimed that the number of local governments in Estonia could be reduced by about 100. In 1999, of 252 Estonian municipalities, 138 had over 2 000 inhabitants, only 34 had over 5 000 inhabitants, five had over 50 000 inhabitants, and two had over 100 000 inhabitants. The largest town, Tallinn, had 404 000 inhabitants, *i.e.* 29.3% of the total population (Table 5.7). The government indicated the need to reduce significantly the amount of municipalities while not altering their political role.

Table 5.7. **Municipalities in Estonia, 1999 and 2003**

Number of inhabitants	1999 municipalities	1999 share of total (%)	2003 municipalities	2003 share of total (%)
1-999	23	9.1	27	11.2
1 000-4 999	197	77.6	170	70.6
5 000-9 999	19	7.5	30	12.4
10 000-49 999	10	3.9	11	4.5
50 000-99 999	3	1.2	1	0.4
100 000-	2	0.8	2	0.8
Total	254	100	241	100

Source: Statistical Office of Estonia, 2003.

Besides amalgamation, another possibility to strengthen the local level was to increase municipal co-operation. According to the Constitution, local government has the right to form unions and joint agencies with other local governments. Municipalities may, on a contractual basis, express, represent and stand for common interest, and perform joint tasks. In fact, Estonian local governments considered many co-operation forms desirable. Examples are joint activities (cultural events arranged by several municipalities), joint officials (personnel shared by several municipalities), joint institutions (schools), joint enterprises (waste management), services to neighbours (entrepreneur-model), and joint municipal funds (NALAD, 1999). Many Estonian municipalities had also contracted out for delivery of local public services in transport, water supply, rubbish collection and social care. Despite the sound rationale for change, this first step towards local governance and the reform was halted by the change of government in March 1999, leading to the abolishment of the Ministerial Committee for Public Administration Reform (Haav, 2000, p. 7).

The second attempt towards local governance began when the new government took office in 1999. That same year the third regional policy guidelines were adopted. The context was that the Estonian economy had been growing rapidly for five consecutive years and negotiations for European Union membership were in progress. In the late 1990s the industrially most diverse regions in Estonia had enjoyed the highest income levels. However, high specialisation with a small number of industries lowered those levels. There was a decrease in industrial specialisation in the peripheral regions due to the relocation of industrial production closer to less expensive regional resources, increased FDI into these peripheral regions, and development of regional infrastructure (Fainstein and Lubenets, 2001).

Regional policy was an explicit activity of the public authorities and industrial development was one particular issue of regional economic development. As mentioned, employment in industry declined in the 1990s; however, towards the end of the decade industry productivity increased, especially in Northern (including Tallinn) and Northeastern (including Narva, Kohtla-Järve and Sillamäe) Estonia. Northern Estonia had 77 400 (30.5% of all employed in Northern Estonia) employed in industry and its industrial input was 42% of Estonia's total. It is the most industrially diverse region in Estonia. According to Fainstein and Lubenets (2001, p. 279), the high level of investment and rapid economic development in Northern Estonia induced the cost-minimising enterprises in the country to relocate their production to the Northeast. The increasing demand for fixed production factors (labour, mortgage) increased production costs, so several cost-sensitive enterprises relocated to more peripheral Estonian regions. However, the region continued to be the most significant location of FDI and foreign enterprises, and its role in the tertiary sector was overwhelming. Northeastern Estonia had 50 200 (50.2% of all employed in Northeastern Estonia) employed in industry and its industrial input was 23% of Estonia's total. It has a particular industrial character due to many companies functioning as natural monopolies based on economies of scale. According to Fainstein and Lubenets (2001, p. 280), the diversification of industries did not vary significantly in the 1990s, partly due to modest FDI into the region. The relative specialisation, *i.e.* concentration on a few industrial products, declined in the late 1990s due to the substantial decline in the Russian market-oriented large industries.

In the beginning of 2000, the Estonian Regional Development Agency defined regional policy as "a system of targeted activities of national authorities for the improvement of preconditions for development in regions and for the direction of regional development in the state. It comprises both conscious directions of the regional effects of sectoral policies and additional specific activities targeted at the development of regions" (ERDA, 2000). The objective of regional policy was to create possibilities for development for all the regions of the state, and to balance socio-economic development with the interests of the regions and the state as a whole. Nevertheless, the idea of local governance started to filter into regional policy issues. The structural policy principles of the European Union – concentration, programming, partnership, and additionality – became institutionalised, and a monitoring and evaluation system was put in place. The funding for regional policy was scarce – about EUR 5.3 million in 1999 – and its achievements were limited.

The regional policy principles included subsidiarity and partnership as modes to organise local and regional economic development, as well as the need for a competent sub-national entity to implement these principles. From this it was clear that administrative-territorial reform remained among the political priorities of the government. The Prime Minister himself headed the newly founded Committee of the Public Administration Reform.

In 2001 the government approved the programme for administrative-territorial reform with the aims of achieving a quality, novel, flexible and efficient local government. According to the reform, the general minimum number of inhabitants in municipalities would be 3 500 and 4 500 for those municipalities located near larger towns. The immediate hinterland of the municipal centre should belong to the same municipality. The proposal for this reform was sent to 232 municipalities, of which 225 answered. The majority (52%) were against the proposal and only 30 municipalities (13%) directly in favour, 70 conditionally in favour (31%), and 8 without opinion (4%). The reform had failed again.

One reason for the reform failure related to the critical remarks and discussion in the media, which influenced the general opinion of the inhabitants in smaller municipalities. In the end a deep disagreement regarding the reform arose between the government coalition parties, and the Prime Minister left office in 2001. The reform ended in January 2002 when the government resigned and the reform initiative collapsed. Reiljan *et al.* (2003, pp. 12-13) argue that the main weakness of the reform initiative was its poor design of organisational structure in relation to the requirements and opportunities of local government. The main argument, however, was the size and overall number of municipalities.

The third attempt towards local governance was started in 2002 and is currently progressing slowly. A thorough analysis of previous reform processes was conducted to avoid the earlier mistakes. The administrative weakness and economic inefficiency of local government were still the main argument. In fact, the burden of administrative costs was largest for small municipalities. The share of general administration on total municipal expenditure was on average 19.0% in rural municipalities with less than 1 500 inhabitants, 12.7% in those with over 3 000 and 8.0% in towns with over 10 000 (Reiljan *et al.*, 2003, p. 56). Opinions were expressed that the number of municipalities should be reduced by at least half. In fact, over half (51.9%) had under 2 000 inhabitants and four out of five (81.7%) under 5 000 inhabitants. There were 44 municipalities with over 5 000 inhabitants, three with over 50 000, and two with over 100 000. In 2003 the largest town, Tallinn, had 397 000 inhabitants, *i.e.* 29.3% of the total population (Table 5.7).

In 2004 the government approved the decree to co-ordinate and promote the voluntary merger of local governments. The aim is to enhance the administrative ability and efficiency of project applications of local governments, to improve the availability and quality of their public services, and to develop their co-operation ability. Jaan Õunapuu, Minister of Regional Affairs, said in 2004 that the main objective of determining the merger areas is to offer the activity trend for the local governments who plan to merge, how the local people would gain most from the merger and how to avoid weak local governments suffering due to the stronger governments.

The 65 merger areas involved between two and thirteen local governments. In determining the merger areas consideration was given to historical grounding, the merger's effect on the living conditions of the inhabitants, the demographic situation, organisation of transport and communication, the business environment and the education situation. In addition, the positions of county governors and local governments were decided upon. The prepared merger list did not include 14 bigger cities, 5 island-parishes and 17 local governments because these local government units had sufficient management potential and good socio-economic ratios. The local governments that join for the local elections in 2005 receive the maximum sum of merger support established by the law, which is EEK 500 [EUR 33] per inhabitant of the merged local government and not less than EEK 1.5 million and not more than EEK 3.0 million [from EUR 100 000 to EUR 200 000] per local government. However, despite this support, the number of municipal amalgamations was small.

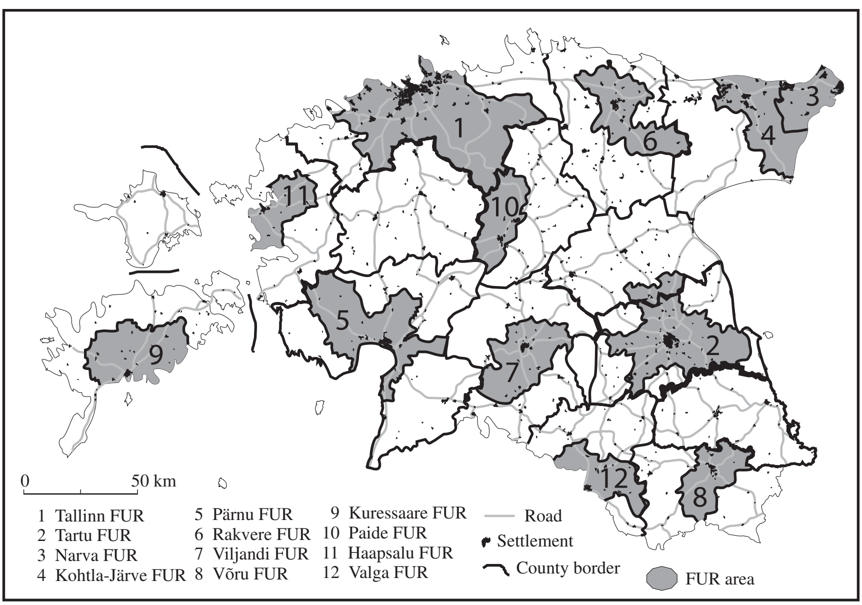
One particular aspect of administrative-territorial reform failure is related to the election of the President of the Republic. Due to very complex legislation, representatives of all municipalities are also involved in the election. Since a certain political party is in majority in small rural municipalities, it also possesses power in the presidential elections – as was seen again in 2006.

An important development for local economic and employment policies was the adoption of the fourth regional policy guidelines in 2005. The entire territory of Estonia is covered with central authority-led regional policy initiatives. Statistics show that in the early 2000s most peripheral areas have lost significantly in population and even more in economic viability. One aim of regional policy is to maintain a population balance throughout the country. Regional fund transfers are used to subsidise the development of peripheral areas – a rather traditional approach for regional policy. Despite these policy attempts it seems that most financial and social capital is being concentrated on Estonia's major urban areas.

Globalisation of the economy and the need to be innovative and competitive at international level mean that major opportunities for innovations and economic growth seem to be in strong functional urban regions. A novel aspect of the new regional policy guidelines is the consideration of specialised urban areas and competing and co-operating urban networks as possibilities for innovative regional development. Were this urban policy to be combined with proper territorial and public administration reform, local governance could be taken seriously in implementing regional and local economic and employment policies.

In Estonia, one can distinguish 12 functional urban regions (FURs) that hold 70% of the national population (Figure 5.2). There are five major and seven minor FURs in the country. The FURs are based on daily labour areas, *i.e.* each FUR includes municipalities from which at least 25% of those employed work in the largest town of the FUR. Tallinn FUR has 501 000 inhabitants, four-fifths of whom live in Tallinn itself. The FUR has 40% of the national population; it is wealthy in Estonian terms, well above the national average; up to two-thirds of the national GDP is produced there; and it is the most important area for foreign direct investments. The second largest, Tartu FUR (134 000 inhabitants) in the Southeast, is a significant university town but its economic development is lagging well behind Tallinn and the GDP per capita is barely the national average. The third largest (Narva, 73 000 inhabitants) and fourth largest (Kohtla-Järve, 67 700 inhabitants) FURs are located in the Northeast; they are characterised by major challenges in

Figure 5.2. **Functional urban regions in Estonia**



Source: OÜ EURREG and Jauhiainen, 2002, p. 42.

industrial restructuring and by a majority of non-Estonian-speaking population. The fifth, Pärnu FUR (65 000 inhabitants) in the Southwest, is significant in the regional economy and also nationally due to its specialisation in leisure and tourism. The rest of the Estonian FURs have less than 40 000 inhabitants and have minor potential in the global economy; however, they are significant as motors for regional development and possible sites for proper organisation of local economic and employment policies (OÜ EURREG and Jauhiainen, 2002; Jauhiainen, 2006).

Conclusion: the main challenges for Estonian local governance

Estonia is a small country with few economic and human resources; it can never play a major role in the global economy. It is therefore crucial how these few resources are organised. For such a compact country with few inhabitants, Estonia also has a fragmented territorial administration at regional and local level. On average, the 232 municipalities count 2 000 inhabitants and the median population in 15 counties is 40 000. It is expected that the population figure in Estonia will decrease by 10-30% in the coming decades. Successful local economic, employment and social development can be implemented only if the municipalities are economically competent with political accountability. That competence requires efficient organisation of local government duties through implementation of local governance with co-operation among public, private and non-governmental sectors.

One significant initiative in Estonia to promote local and regional economic development, employment and social inclusion has been to conduct reform of territorial and public administration. Since 1997 three attempts have been made and have failed, mostly due to poor management of the reform process by central authorities and a failure to focus on essential issues in co-operation with local authorities and non-governmental organisations. Poor implementation of reform initiatives has resulted from a mistrust of government and also partly from mistrust of counties as regional representatives of the government. And there are other issues related to party politics that matter. In the European Union, member states implement self-regulation beyond traditional hierarchic government, but in the administrative-territorial reform of Estonia one finds legacies of the Soviet past. The limits of effectiveness of given geographical rationales for governmental and administrative activity in Estonia are obvious. Furthermore, in recent years the government of Estonia has imposed increasing duties on local authorities, lowered personal income tax and increased minimum income taxation. Since taxation is the most significant direct source of local revenues, the local authorities have become more dependent on central authorities and other external sources for funding – for example, sales of municipal property.

The new regionalism of governance requires an appropriate and interactive co-operation between public, private and non-governmental sectors at local, regional, national and supranational levels – a particular multi-level governance. In Estonia there are and will be in the coming decades serious challenges to coping with the rapidly decreasing population. Facing these economic, human and employment challenges, greater attention must be paid to development policies based on co-operative networks at regional and local level. To organise compulsory service provision at local level efficiently, there needs to be a significant number of mergers of current local authorities to save money on administrative costs. However, the merging does not mean that there would not be a need for co-operation among larger new local authorities. Quite an opposite: increasing attention must be paid to inter-municipal and public/private/NGO networks that would enhance service provision at local level. It is also important that attention be paid to the political accountability and responsibility of such networks.

For new local economic and employment policies in Estonia, one should consider the 10-12 largest functional urban regions (FUR). These FURs would be organised based on amalgamation of municipalities which are economically, socially and functionally tied together. The largest of these FURs are strong enough to develop economic and employment policies that would make the region competitive in the European Union and elsewhere. On the one hand, the urban regions contain interactive networks of Estonian localities that fit in with the polycentric European Union with its metropolitan nodes. On the other, such urban areas foster networks that are based on self-contained relations and nodes of social capital and locally embedded specialised knowledge in Estonian municipalities. Therefore, current central authorities-driven regional policy should take into account the possibility of viable local economic and employment policies within urban regions. The challenge is much greater in the more peripheral rural municipalities, but there too broader administrative-territorial units, co-operative public/private/NGO networks and targeted economic and employment policies based on strong local governance are necessary.

A broad territorial and public administration reform is likely to be conducted in Estonia soon. Implementing local governance in Estonia does not mean a simple and substantial reduction in the amount of administrative-territorial entities. What is important is to guarantee the necessary economic autonomy of local authorities. Other significant issues of local governance include a necessary professionalisation of administrative, management and leadership skills, decentralisation of decision making in regional policy towards sub-national level, and the clear independence of local budgets from state funding. More intensive inter-municipal and inter-regional co-operation needs to be established whatever the initial local, regional or national opposition. Co-operation is needed, along with the identification of initiatives to generate better economic and social outcomes of development policies. Clearly, territorial and public administration reforms are obligatory for effectiveness – but they are feasible only if they enhance local governance, subsidiarity and democracy.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 6

The Governance of Economic and Employment Development in North West Russia

by
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The North West federal district is generally regarded as one of the more dynamic parts of Russia. If some of the features are similar to those of other regions around the Baltic Sea and elsewhere, the underlying challenges are different. The main problems are the lack of job creation and of mobility within the Russian labour market across regions and sectors. Both stem from institutional imperfections of a more structural nature. The employment and skills strategies meant to tackle these issues are impeded by the limited financial independence of regions, the limited development of active labour market policies, and postponement of local government reforms. The current governance framework, rigid and centralised, is not conducive to developing local initiatives or implementing joined-up solutions to complex issues.

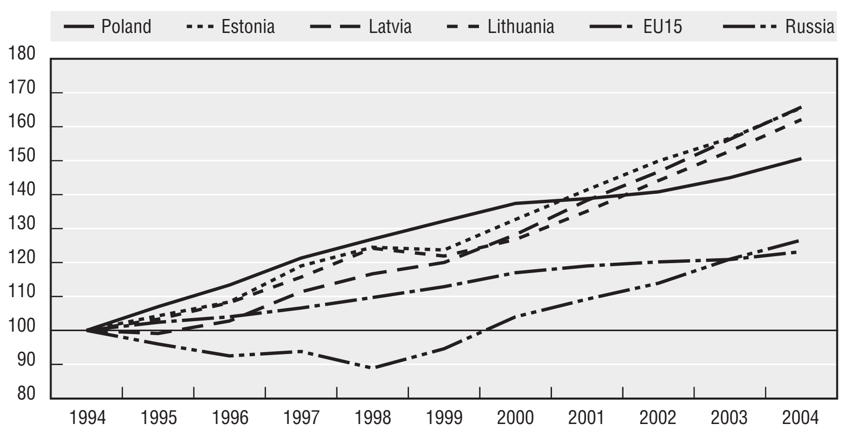
Economic and employment context of the region

Macroeconomic performance

The Russian economy has been through a tremendous transformation over the past decade. The output drop following the transition from plan to market was deeper than in the transition countries in Central Europe; the restructuring started later, and was strongly affected by the financial crisis in 1998. Since then however, the Russian economy has been enjoying very rapid grow, outpacing most countries in Europe.

Figure 6.1. **GDP growth, 1994-2004**

1994 = 100



Source: EBRD, Eurostat.

Recently, growth has been shaped by strong domestic demand, increased investment and a strong currency. Although the Russian economy has been very strong over the past seven years and is likely to continue growing rapidly in the short to medium term, there are important concerns about the sustainability of that growth. Approximately 40% of Russian GDP is made up of energy exports, and the need to diversify the economy into other sectors remains an important challenge for the Russian government. Many other sectors are suffering from the appreciation of the rouble, and growth in the industry, transport and construction sectors decreased recently (World Bank,

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2005). Incomes and wages continue to grow faster than GDP, with the result that retail trade is booming. Although the average level of income has increased throughout Russia and the level of poverty has been reduced over the last decade, substantial differences remain in terms of output, income, employment and prosperity across and within regions.

The North West federal district is generally regarded as one of the more dynamic parts of Russia. Although the North West is ranked first among the seven federal districts in terms of real gross regional product (GRP) growth, it is important to note that there exist substantial differences within the district. Leningrad oblast and St. Petersburg are ranked first and second of all regions in Russia in terms of GRP growth, whereas the Komi Republic and Murmansk are ranked at the bottom (69 and 71).[1] Kaliningrad oblast (13) and Archangelsk (17) are ranked in the top quartile and Pskov (27), Novgorod (30), Vologda (36) and Karelia (43) are ranked in the middle. The ranking measures growth between 1999 and 2002; the North West as a whole grew by almost 50% during that period.

A similar picture emerges when looking at industrial production growth, which grew twice as fast in the North West (13.4%) as in Russia as a whole (6.1%) in 2004. For the past three years, Kaliningrad, St. Petersburg and Leningrad have grown the most – between 10% and 35% annually – whereas the regions in the North such as Murmansk and Karelia have shown modest or even negative growth of industrial production.

The Russian economy is to a large extent dependent on natural resources in general and oil and gas in particular. The oil- and gas-rich regions therefore dominate in an economic sense. Together with Moscow, which is the dominant commercial, economic and financial centre, these oil and gas regions make up a significant share of the Russian gross domestic product. As a result, the North West is only the fifth-largest district in Russia in terms of nominal GRP. In 2002, it made up about 10% of Russian GDP. The Central district, dominated by Moscow, is the largest region, followed by Volga, Urals and Siberia. Although only one of the 20 largest regions (from an economic perspective) is from the North West, the majority are from the European parts of Russia. The western gravity can, to a great extent, be explained by large cities like Moscow, St. Petersburg, Samara, Yekaterinburg, Kazan, Nizhny Novgorod and Perm.

From a standard of living perspective, GRP per capita may be a more interesting indicator. The immediately striking factor is that the spread within Russia is enormous. The most prosperous region is 35 times wealthier than the poorest one. The differences are less extreme in the North West, but Komi (USD 3 000 in GRP per capita) is still three times wealthier than Pskov (USD 1 000). Apart from Komi, only Murmansk and St. Petersburg are wealthier than the Russian average of about USD 2 000. It is interesting to note that the economically smallest and slowest-growing regions (Komi and Murmansk) in the district are still the wealthiest in terms of GRP per capita. One possible explanation that the populations are small, but figures on per capita income support the GRP per capita differences. In fact, Komi is reported to be the fourth-richest region in Russia in terms of income per capita. Also, Murmansk and St. Petersburg are among the top ten regions and above the Russian average. Karelia, Archangelsk and Vologda are close to the average whereas the other regions in the North West are poorer in terms of income.

Industrial and employment structure

The restructuring of Russian industry has been slower than in many other transition countries, but parts of the economy are starting to resemble those of a more modern market economy. Today the service sector makes up more than half of the economy, whereas industry is contributing less than 40% and agriculture about 5%. It is also the service sector that is the most competitive and productive. Agriculture still employs about a quarter of the population and is thus rather unproductive. Total employment in Russia decreased by almost 14% between 1989 and 2003. Relative employment in industry decreased 38% during the same period. Almost all new jobs are created in service sector.

There is no such thing as a common industrial or employment structure in the North West. Industry makes up somewhere between 20% and 40% of the gross regional production. Archangelsk and Karelia are typical forest, timber and pulp and paper regions, whereas Leningrad, St. Petersburg and Pskov are strong in food and beverage production. Fuel is the largest industry in Komi, ferrous metals in Vologda and Murmansk, and chemicals in Novgorod. The service sector is increasing in terms of both value-added and employment. A breakdown of employment in different kinds of enterprises shows that there are 927 000 small and medium-sized enterprises in the North West (of which 298 000 are medium-sized, 17 000 farm enterprises, 476 000 individual entrepreneurs and 136 000 small enterprises).[2] These firms make up 93.4% of the economic activity in the North West (compared to 94.3% nationally), exactly half the employment (48.8% nationally), and 48.5% of sales revenues (46.9% nationally).

Labour markets

The Russian labour market is characterised by regional segmentation, inefficient forms of labour mobility and a slow pace of job creation, especially of well-paid jobs. The labour market adjustments to transformation shocks are known to go mainly via real wage reduction, with unemployment moderate in size. Employment adjustments through job-to-job movement without moving

Figure 6.2. **Map of North West Russia**

Source: www.competitiveness.ru/images/Northwest-map.JPG.

to unemployment are believed to be responsible for the continuing presence of bad jobs on the labour market. As many as a third of employees are low paid: the percentage of full-time employees classified as such – with earnings below two-thirds of the national median – increased from 18% to 34% between 1989 and 1999.[3] This is very high compared to the 14% OECD average and 19% in Poland. As a result, working people amount to more than 40% of poor people in Russia. The existing labour market adjustment pattern likely stems from poor enforcement of bankruptcy regulations and effectively lower-than-survival levels of unemployment benefits.

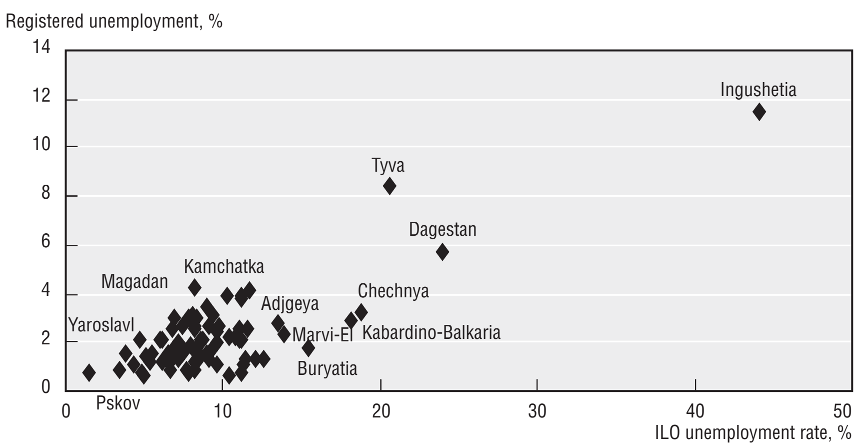
Economic growth since 1999 has facilitated job creation. Brown and Earle (2002) report a significant increase in job creation after 1998. Together with decreased job destruction that implies positive growth in net employment, job creation is reported to have increased mainly in the sectors that benefited from devaluation (Broadman and Recanatini, 2001). Job destruction, while diminished, has remained at high levels. There is, however, indirect evidence that only few good jobs, *i.e.* with high productivity and wages, are being created.

Industrial output is reported to have increased by one-third during 1999-2003; industrial employment did not change to the same extent. Moreover, employment at large and medium-sized enterprises in particular have decreased during the period, one of the main reasons being high turnover costs (Gimpelson, 2004). It is argued that it is mostly the informal sector that increased employment recently, while the formal sector did not. This could incur problems of non-sustainability.

Unemployment – both ILO-defined and officially registered – is at a moderate level in Russia. The all-Russia average level was 8.6% for general and 2.3% for registered unemployment in 2003. There is, however, substantial variation across regions. Regional variation in ILO unemployment rates was as high as 0.42 (0.39 excluding the North Caucasus) in 1999 – to be compared with 0.27 across the United States in the early 1980s. The economic and non-economic barriers to mobility are the main reasons why the variation persists over years.

The unemployment rates in the North Western regions are below the Russian average: the ILO-defined unemployment rate was 7% on average in the district compared to the 8.6% all-Russian average in 2003. The relevant figures for registered unemployment were 1.7% in the North Western regions and 2.3% for all of Russia. There is however significant variation in unemployment rates across the regions in the district: ILO unemployment in 2003 was 11.9% in Komi and 10% in Murmansk, while it was only 4.1% in St. Petersburg, and about 5% in Vologda and Novgorod oblasts.

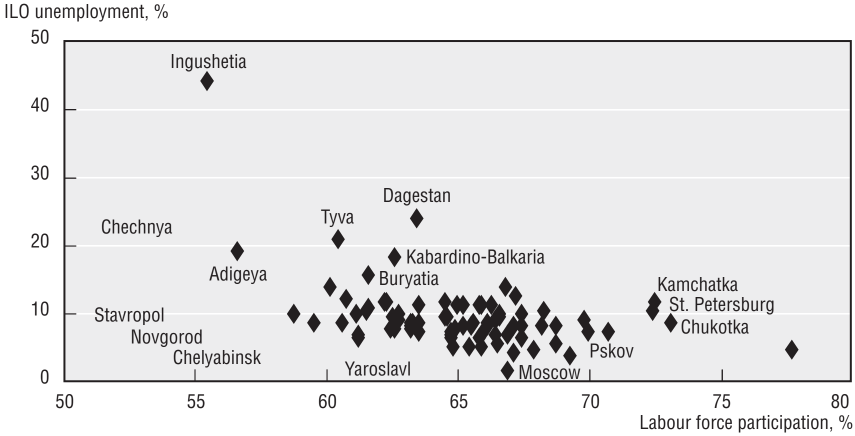
Figure 6.3. **Regional unemployment, 2002**



Source: Goskomstat (2003), "Russian Regions", pp. 115-116.

It is noteworthy that regions differ with respect to the labour force participation rate: from 55.2% in Ingushetia to 77.5% in Chukotka in 2002. This implies that regions are non-homogeneous with respect to household behaviour in labour market patterns. The lack of homogeneity has implications for social policy, including how to stimulate employment in order to alleviate poverty.

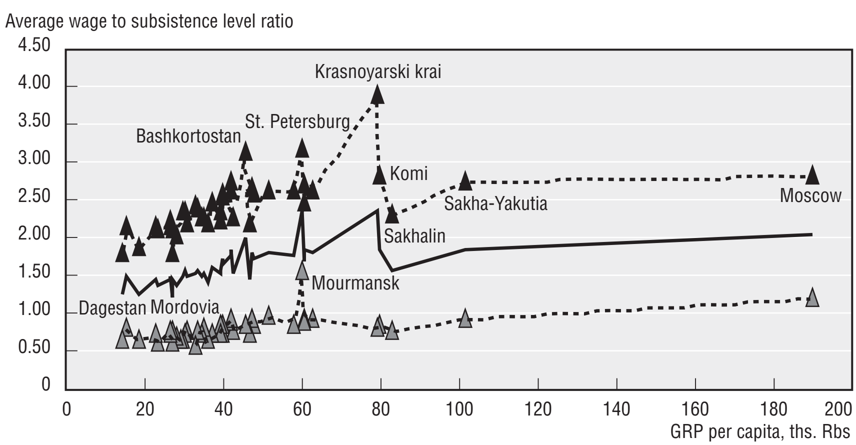
Figure 6.4. **Regional labour force participation and unemployment rates, 2002**



Source: Goskomstat (2003), "Russian Regions", pp. 98-99, 115-116.

The North Western regions of Russia are characterised by a higher-than-Russia-average level of labour force participation: 67.7% in 2003 as compared to the 65% national average, with a 73% participation rate for men and 63% for women. Regional variation within the district is also significant. The labour force participation rate is as high as 72% in Murmansk and as low as 63% in Pskov.

Figure 6.5. **Real wage in regions: mean and variation**



Source: Centre for Economic and Financial Research (CEFIR) calculations based on the NOBUS database.

There is also significant variation in terms of wages, with real average wages higher in more developed regions with higher GRP. Median wages in the 2003 NOBUS database[4] varied from 2.2 subsistence levels in St. Petersburg and 1.71 in Moscow to 1.01 in Mordovia. The variation in wages is found not only across but also *within* regions. The magnitude of regional variation implies that restructuring should include significant regional reallocation of resources, including labour migration.

Institutional aspects of economic development and labour market policy

Underpinning the discussion in this chapter are two established notions: that labour markets are imperfect and so some kind of institutional intervention is needed; and that good governance and effective institutions benefit economic growth.

The importance of institutions has been studied extensively; that they are important prerequisites but no guarantee of economic growth has been confirmed by transition and development economists.[5] Institutional reform has accordingly become a central policy objective in the transition process from plan to market. But designing good institutions is not enough, as these new or modified institutions will have little impact until they are actually implemented. In Russia, as in many other transition countries, implementation has proved to be quite a challenge.

Overview

The overall institutional framework in Russia is not very well developed. Compared with the transition countries in Central Europe that became EU members in 2004, institutional development in Russia has been rather slow over the last decade. But the institutional framework there is also less developed than the average of countries at the same stage of economic development. The World Bank has developed a series of governance indicators – voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption – that are being measured every fourth year.[6] The most recent survey shows that Russia is behind the other lower-middle-income countries in all indicators but one: government effectiveness.

It is also that indicator that has improved the most in Russia over the past six years. Rule of law and control of corruption have also improved somewhat since 1998, but voice and accountability have meantime weakened considerably. Political stability and regulatory quality have basically remained unchanged during the same period, which is troubling given the low level of development. Moreover, there are indications that corruption has increased substantially lately.

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The governance structure is to a certain extent set by the federal government; it may be difficult to find equally strong regional indicators. The Expert Rating Agency has, however, been rating the investment attractiveness of Russian regions over several years by developing a set of regional investment components, including legislative, political, economic, financial, social, criminal and ecological risks.[7]

The regions in the North West that stand out for their low risk are Novgorod, St. Petersburg and Vologda, which are among the ten least risky regions for investment, according to Expert. Leningrad, Kaliningrad, Archangelsk and Murmansk are also ranked in the top half of all the Russian regions whereas Pskov, Karelia and Komi are ranked in the bottom half. It is clear from the agency's ranking that investment risk differs not only among the North West regions but also (and widely) within each. St. Petersburg, for instance, has very low economic, financial and social risks, but the political and legislative risks are among the highest in the country, suggesting poor quality of governance. The North West on average scores rather well in economic and financial risks. The criminal, political and ecological risks are above the average whereas the social and legislative risks are below the average.

Federal, regional and local government

It is natural for a large country like Russia to have a federal structure, but the relationship between the federal centre and regional and local entities has changed considerably over the years. In the 1992 Constitution Russia was divided into 89 constituent entities,[8] which were equal before the law but rather different in composition; *oblasts* and *krays* are entities in which the Russian population is a majority; *republics* are ethnically based entities; and there may also be *autonomous districts* and *sub-regions* within other entities.

During his first term the former president Boris Yeltsin initiated a decentralisation process involving both political and economic transfers of authority from the federal centre to the regions in exchange for political support for federal economic reform policies. One important outcome of this decentralisation was a constant bargaining game between the centre and the regions. The process was however reversed when Vladimir Putin assumed the presidency. He has gradually centralised much of the authority back to the centre at the expense of the regions. The first initiatives were the formation of seven federal districts (Central, North West, Southern, Volga, Ural, Siberia and Far Eastern) and the appointment of special representatives for these districts thereby increasing control from the centre. Putin has also seriously weakened the influence of regional governors, by changing their representation in the Council of Federation and by replacing regional gubernatorial elections with presidential nominations. All these initiatives have served to centralise power within the Kremlin and make the regional governors subject to the approval of the president. This has effectively put an end to the bargaining game that evolved during Yeltsin.

The third tier of the system – the local or municipal level – is still lacking resources and (thus) bargaining power in determining priorities in local development as compared to both regional and federal authorities. A municipal reform aiming at redistribution of policy instruments between regional and local tiers has long been discussed but is still far from taking concrete shape. (Some directions of reform are discussed below.)

Regional variation in business development and labour markets

Russian regions are not homogeneous as regards conditions for business development, and for small business development in particular. The variation comes not from the difference in regulation, which to a large extent is determined at federal level, but from the way regulation works at regional and local levels.

Monitoring of deregulation of small business development, conducted by the Centre for Economic and Financial Research[9] in 20 regions of the Russian Federation, covers two regions from the North West federal district, St. Petersburg and the Komi Republic.[10] According to the Centre's 2005 survey, the North West regions demonstrate average or lowest levels of administrative costs compared with regions in other federal districts. In particular, time spent on company registration, the number of inspections per firm, and time spent on inspections in Komi are average compared with other regions. Moreover, the financial costs of registering a business and the share of firms feeling pressed to offer bribes during inspections in Komi are among the lowest. St. Petersburg is an average region in terms of financial costs of registration, the number of inspections per firm and the share of firms feeling pressed to offer bribes during inspections. Moreover, St. Petersburg shows one of the lowest time costs spent on registration of business and on dealing with inspections.

Another interesting survey is carried out by OPORA and VCIOM[11] on conditions and factors of entrepreneurship development in Russia.[12] According to the survey, the North West federal district has the lowest level of time cost and an average level of financial cost of registration. In the North West federal district a majority of firms pointed out that inspections do not hamper their businesses. Pskov, Archangelsk and Vologda oblasts are noted as the regions with the lowest average number of inspections, ranked 8, 11 and 12, respectively. Novgorod oblast has one of largest number of inspections per firm (ranked 67). Karelia and Komi Republics, Murmansk, Kaliningrad and Leningrad oblasts, and St. Petersburg are in the middle of the list (ranked 48, 63, 53, 60, 63 and 55).

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There are large regional differences with respect to labour market structure: some local markets are known to be rather competitive while others are monopsonistic. As a result, the bargaining power of employers against employees varies significantly. This is reported to affect the employment outcome in regions. Researchers report that the severance pay and settlement of wage arrears stipulated in the Labour Code resulted in labour shedding. This took the form of "forced voluntary" separations stimulated by wage arrears or happened through voluntary quits in regions where employers had high bargaining power; in regions where they had less bargaining power it was demanded that employers formally lay off workers (Pinto *et al.,* 2001).

The North Western regions are known for moderate industry employment concentration ratios. In 2003 the employment share of the four largest industrial enterprises in the region, CR4, was in the range of 17-30%, with the exception of the Komi Republic (39%), the Vologda region (38%) and the Murmansk region (53%). Ideally, increased mobility together with the development of small business would reduce monopsonistic power and stimulate competition on regional labour markets. In the medium term however, some regulation to reduce employers' bargaining power seems to improve welfare.

The Russian labour market suffers from regional segmentation. The danger there is that primary and secondary labour markets could be created, with more secure high paying jobs concentrated in the former and very restricted if any mobility from the latter to the former. A formal *vs*. Informal labour market and labour markets of metropolitan areas *vs*. the rest are believed to be dimensions of segmentation in Russia: unavailability or inaccessibility of well-paying jobs is reported to be a problem for certain groups and in certain regions.

Employment protection regulation

The Russian Labour Code will remain restrictive compared to those in OECD countries even in its new revised version. In particular, if calculated according to OECD methodology, the index of employment protection legislation in Russia is 3.3 compared to the OECD average of 2.0 and the EC-15 average of 2.4. The code places strong restrictions on employers' adjustment to technological changes and economic shocks through labour shedding or wage reduction by imposing high turnover costs. If formal rules are respected, then the response to high separation and hiring costs would be a decrease in demand for labour, and a decline in turnover.

If the Russian labour market is formally rather restrictive, it is effectively rather flexible. Many of its restrictive norms, including those in the revised code, are not enforced, allowing labour market participants to bypass the restrictions.

Box 6.1. **Regional variations in labour adjustment costs**

Akhmedov *et al.* (2005) have studied variation in adjustment costs across regions that may arise from regional differences in industrial structure, including the degree of industry concentration and/or differences in elasticity of final demand for products. The estimation of labour demand elasticities shows that they vary not only across industries, but also across regions. Overall, the authors find higher labour demand elasticities in the north eastern parts of Russia. The differences seem to arise from differences in industrial structure – including the degree of industry concentration – on the one hand, and from differences in elasticity of final demand for products on the other.

Let us consider for example two regions: the Northern and the North Western regions. The estimates clearly show that the Northern region has higher elasticities as compared to the North Western region: 0.34 as opposed to 0.22 for output labour demand elasticity, and –0.55 as compared to –0.18 for wage responsiveness. It is believed that the difference is driven by the presence of a significantly larger share of industries exposed to trade shocks, and hence ones with more volatile employment industries in the Northern region: the share of metallurgy, petrochemical and timber industries in the region amounted to 58% in 1999, with the fuel industry share at 16%; the respective shares in the North Western region were 19.4% and 6.2%.*

* Goskomstat (2000), "Russian Regions", Table 13.3, pp. 372-373.

Informal employment without contracts and forced voluntary quits are among the most often cited ways to overcome high turnover costs stipulated in the code. Moreover, formal contracts are often violated with no penalty.

At the same time, there is evidence of the influence of institutional restrictions on participants in the formal labour market. Gimpelson (2004) argues that the observed decrease in employment at large and medium-sized enterprises in recent years is due to high turnover costs of enterprises in the formal sector. It is the informal sector that increases employment. The social tax, which while being reduced is believed to be rather high, is blamed for the widespread use of grey wage payment schemes. It is also likely to reduce labour demand, and hence employment.

Low job security combined with ineffective unemployment insurance is likely to affect regional labour mobility. It is suggested that perceived job security and fringe benefits may be important determinants of workers' migration decisions (Grogan, 2000).

The persistent presence of bad jobs is believed to result from a lack of bankruptcy regulation enforcement and effectively lower-than-survival levels of unemployment benefit (Brown, 1997). Those two factors are also viewed as principal determinants of the Russian pattern of employment adjustment, which is mainly through job-to-job movement without entering unemployment. It is a question whether the pattern is better or worse than that in Eastern Europe, especially if potential social conflicts are taken into account. There is little doubt, though, that the Russian pattern has prolonged the adjustment period and exposure to poverty.

The revised Labour Code introduced some changes aimed at lowering turnover costs. In particular, trade unions no longer have a right to veto in separation decisions. The financial costs of separation are kept high, however. Fixed-term contracts, which are expected to replace open-ended contracts and to reduce labour turnover costs, are specified in the new code. The sole reasons justifying this type of contract are specified as well. The code preserves significant obligations for the employer with respect to tenured employees, *i.e.* those with open-ended contracts.

The new code is believed to favour large trade unions at the expense of small but independent ones and to emphasise firm-level resolution of labour disputes (Bureau of Economic Analysis, 2002). This is expected to redistribute formal bargaining power to employers, already informally very strong on the Russian labour market because of the mixture of decentralised bargaining and poor law enforcement.

Collective bargaining institutions are still weak: trade unions do not reflect interests of employees, and employers' organisations lack support from employers. At the same time, a better representation of workers in the bargaining process could not only increase labour share in profits, but also help to increase the amount of on-the-job training and to improve working conditions.

Researchers studying the reaction of enterprises to the new Labour Code by interviewing managers from about 300 enterprises found that only 26% of them believe that the new code introduces more flexible labour relations, while 36% believe that it introduces additional problems for managers and the rest do not see any changes (Gimpelson *et al.*, 2003). The new code is seen as more flexible mainly by new small private enterprises in a good financial position and located in small towns. As far as enforcement is concerned, only 24% of managers expect the code to stimulate greater compliance, about 70% do not expect any changes, and 5% expect even less compliance.

There are some positive shifts mentioned: almost one-third of managers indicate that it is easier to use fixed-term contracts now, and more than 18% find it easier to fire employees. However, more than half of respondents do not recognise any improvements. The bargaining power of employers is estimated to shift upwards at the expense of employees, but to a much lower extent than was expected.

Surveys looking specifically at labour market regulations (difficulty in hiring and firing, rigidity of working hours and employment, and firing costs) through assessments of laws and regulations by domestic companies, suggest that the Russian labour market is effectively more flexible compared to most other markets in the Baltic Sea region (Table 6.1).

Table 6.1. **Rigidity of the labour market**

	Difficulty of hiring index	Rigidity of hours index	Difficulty of firing index	Rigidity of employment index	Firing costs (weeks of wages)
AVERAGE	**26**	**57**	**33**	**39**	**35**
Denmark	0	40	10	17	39
Russia	0	60	20	27	17
Poland	11	60	30	34	25
Lithuania	33	60	30	41	34
Sweden	28	60	40	43	24
Estonia	11	80	40	44	33
Finland	33	60	40	44	24
Latvia	78	20	50	49	42
Germany	44	80	40	55	80

Source: World Bank, Cost of Doing Business Database, *www.doingbusiness.org*.

Centralisation and decentralisation

Wage and employment bargaining is highly decentralised in Russia. Formally, there are collective bargaining institutions. They are underdeveloped however, and in the majority of cases leave the employee on their own to bargain job terms and conditions with their employer. The situation is obviously much worse in the shadow sector.

Large enterprises are also still involved in the provision of social services, which tend to restrict mobility in the labour market. In the planned economy, industrial firms were made responsible for supplying a great variety of social benefits, such as housing, medical services and daycare. Despite the opportunity to divest social assets run by firms to municipalities in the mid-1990s, many Russian firms still actively provide such benefits. The data from a survey of 404 middle-sized and large manufacturing firms from 40 Russian regions carried out in April-June 2003 reveal that a great majority of firms still provide at least some form of social services (Haaparanta *et al.,* 2003). Some firms continue to keep social assets although on a much smaller scale, while others have switched from keeping assets to other forms of support such as subsidies to the employees for acquiring services. In particular, 56% of the firms provide housing or financial assistance for obtaining housing, 91% provide medical care, 26% provide or subsidise daycare services and 73% of the firms have recreation facilities or support employee’s recreation activities.

Thirty-six per cent of firms spend between 1% and 5% of their payroll on social service provision; another 31% spend between 5% and 20%, and 4% spend more than 20%.

The motives behind provision can differ considerably across firms and regions. To some extent social service provision is affected by firms' relationships with local authorities, as shown by the difficulty of divesting assets to the municipalities, and by the fact that some firms still provide financial support to the already transferred assets. Juurikkala and Lazareva (2005) explain provision of social benefits to employees as a strategic choice of firms in an imperfect labour market. They find strong evidence that Russian industrial firms use social services to reduce the costs of labour turnover given tight labour markets. At the same time, the share of non-monetary compensation decreases with improved access to regional social infrastructure.

Social partners and tripartism

At the present time, there are more than 150 trade unions in Russia.[13] The total number of unionised workers exceeds 31 million, *i.e.* 42% of the labour force or 46% of the employed. The trade unions are consolidated into trade union centres, the largest being the FNPR (Federation of Independent Trade Unions of Russia). The FNPR includes many trade unions which used to be part of the old system as well as some that have emerged in recent years. It consists of 42 nationwide trade unions uniting workers of particular industries and 78 regional trade union organisations. Overall, the FNPR and its associates who have inherited the network of branches from the old system encompass about 30 million people, or 96% of trade union members. Besides membership fees, returns from the stock of real estate are a significant source of finance for the FNPR.

Trade unions at the firm level are independent from the FNPR. There is some evidence of co-operation between trade unions and employers at enterprises (Komarovsky and Sadovaya, 1997). There are several possible explanations for this: in some cases trade unions co-operate with employers in pursuing the unions' strategic goals of protecting employees, in others they are simply forced to by employers. There are a number of trade union centres aside from the FNPR, which together count a total of 30 member trade unions.

The numerous local strikes that have occurred in recent years have demonstrated the increasing strength of emerging new trade unions (members and non-members of the FNPR). Their own memberships are relatively small but they are better organised and quite strong in protecting the interests of particular groups of workers. The most effective of these new trade unions were formed by coal miners (the Independent Trade Union of Coal Miners, NPG) and air traffic controllers (FPAD), which have refused membership to managers and have been effective in organising a number of strikes. Before the emergence of these trade unions, workers and managers were members of the same trade unions.

Mostly, however, Russians view the unions as relics from the Soviet period and do not trust them to defend the workers' interests. Ideologically weak, adhering to the official government policy, the FNPR leaders contribute to these views. Unions have significant rights under current legislation; in many enterprises the existence of an efficient union would give leverage to the employees.

Employers associations emerged only recently. There are now more than 60, with about 30-35 functioning in practice (Komarovsky and Sadovaya, 1997). The most comprehensive of these associations are the Russian Union of Industrial Employers and Entrepreneurs and the Federation of Producers of Goods. To a large extent, employers' associations are still oriented towards lobbying for special interest groups.

The General Agreement sets general principles regulating labour relations in the Russian Federation. It is signed every year by the Russian Tripartite Commission. The Commission includes representatives of the government, the all-Russian trade unions, and the all-Russian employers' associations.

The most recent General Agreement was signed for the period of 2005-07. It consists mainly of non-enforceable directives on labour and social policies. It also sets the indexation rules for wages in the budget sector and sets targeted limits for the country's unemployment rate. A list of disagreements between associations of employers and employees has been attached to the General Agreement, including disagreement on the level of minimum wage.

At the federal level, the so-called Sectoral Tariff Agreement and the Professional Tariff Agreement may also be signed. They define the labour conditions and social guarantees for specific sectors and professions. Some sectoral agreements also set minimum wages for a particular sector, which can substantially differ from the minimum wage in the country. For instance, the sectoral agreement in textile, light and faience sector for 2003-04 stipulated that the lowest tariff rate should not be less than the regional subsistence level, while there is no such restriction in the federal agreement.

Sectoral agreements are not binding for employers: if an enterprise does not sign an agreement, then it need not follow its rules. However, the legislation is biased towards forced participation. If a sectoral agreement at the federal level is adopted the federal officer in charge of the labour policy has a right to offer employers of other enterprises to join the agreement. If employers or representatives of employees have not declared they would not participate within 30 days, they are considered to be involved in the agreement (The Labour Code, Article 48). Naturally, there were cases when enterprises did not respond in time and as a result were compelled to join the agreement.

Regional institutions sign a collective agreement at the regional level following the General Agreement. Employers' associations at that level, as well as their regional trade union counterparts, report to their central authorities but have the right to stipulate special conditions and to add articles to the agreements that take into account regional specifics. The centre-region hierarchies are not rigid.

By the end of 2004, there were 57 sectoral agreements at the federal level. In practice, sectoral agreements are often quite formal and simply reproduce labour legislation norms. The employers' associations are still rather weak. As a result, one party – representatives of employers – is often missing in the negotiation process and is replaced by state ministries and structures. Out of 25 sectoral agreements sent for registration to the Federal Labour and Employment Service, only five were signed on behalf of employers by their associations. Another problem with agreements' enforcement concerns the power parties have. Trade unions are often weak and passive in defending their members' rights.

Practically all Russian regions have general regional agreements, and many enterprises have collective agreements. The content of agreements and the degree of their enforcement varies a great deal across regions, reflecting differences in economic development.

The North Western regions' collective agreements have the status of regional laws. There is some variation in the content[14] of the general agreements across these regions. For instance, the agreements on St. Petersburg and Leningrad oblast are reminiscent of programmes from the central planning era: achievement of planned GRP growth rates and eleven other indicators are taken as the criteria of success and effectiveness of the collective agreement, and programmes are named as the main mechanism of achieving the set targets. In contrast, the regional agreement in the Komi Republic is more focused on wage and employment bargaining issues, though it is still too general.

On the employees' side, the decision whether or not a particular company participates in a collective agreement is voluntary. The decision to conclude a collective agreement is to be made by the general meeting of employees or by their representatives. The proposal is then discussed by a commission, which consists of the representatives of employees and the employer. If the parties do not agree, the procedure of the collective settlement of disputes comes into force.

Monitoring and control for law enforcement are carried out by state labour inspectorates at regional, local and enterprise level, and by trade unions. The former group comprises the Federal Labour Inspectorate system under the Federal Labour and Employment Service. The functions of the Inspectorate include: monitoring violations of the labour legislation; screening employees' claims and taking measures towards their solution; analysing the cases of legislation violations and suggesting ways to improve legislation; developing legislative initiatives and disseminating information about the existing labour legislation.

Labour inspectorates may also be formed within trade unions at sectoral, professional and enterprise level. Labour inspectors and representatives of trade unions may enforce the observance of the legislation, put forward claims to the courts and take binding decisions to stop enterprise activities when working conditions endanger life and health of employees. Employers who violate the labour legislation incur administrative, disciplinary and criminal liabilities according to the legislation. In spite of a large scope of rights provided by the legislation, the Labour Inspectorates have proved inefficient in labour law enforcement. This is caused, to a great extent, by an overall enforcement problem.

There are no specialised labour courts in Russia; cases are ruled in civil courts. In 1995 the Federal Law on Collective Settlement of Disputes was passed and dispute resolution functions were given to the Service for Collective Settlement of Disputes. The Law on Collective Settlement of Disputes does not accord any privileges to trade unions in the settlement, stating that only employees themselves or their representatives can participate in the settlement.

If a dispute is not resolved by the above procedure or the employer does not fulfil the dispute resolution the employees have the right to organise meetings, demonstrations, pickets and strikes according to Article 37 of the Constitution. Participation in such actions is voluntary and it is a punishable offence to force participation or non-participation in strikes. Employers are not allowed to organise or join strikes. Lockouts are prohibited.

Assessment of the collective bargaining framework

As already mentioned, labour market bargaining is *de facto* highly decentralised in Russia, though there are (weak) institutions of collective bargaining. In spite of attempts to reform the labour institutions, there still exists an institutional vacuum with respect to trade unions and employers' associations. Trade unions are disorganised and in many cases influenced by powerful firms pursuing their own interests. Employers associations are also undeveloped, and do not fulfil their function as participant in collective agreements.

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Reading through collective agreements, one cannot help thinking that the very instrument of collective bargaining is not well understood. In particular, many collective agreements are very formal and do not aim at bargaining better terms and conditions. For instance, the main goal of employers in collective agreements is commonly claimed to be business growth, and the main task of trade unions to set labour discipline and a favourable working climate in the collective. As a result, collective agreements fail to provide leverage for labour rights protection.

Labour market institutions

In 1996 the Ministry of Labour and Social Development was established as the principal agency of the federal government responsible for labour and employment policies. Aiming at better co-ordination, the government amalgamated the former Ministry of Labour, Ministry of Social Protection and the Federal Employment Service (FES) into a single body. In 2004 yet another reorganisation and centralisation took place: the Ministry of Labour and Social Development became the Federal Labour and Employment Service under the Ministry of Health Protection and Social Development of the Russian Federation.

The Federal Labour and Employment Service operates through its central body (with seven departments for the main activities), 89 territorial bodies on employment (regional departments of the Federal Employment Service), 89 territorial bodies on labour protection (regional inspectorates), and nine territorial bodies on settlement of collective disputes. The Federal Labour and Employment Service is financed through the federal budget.

The organisation of regional labour market institutions follows the federal structure of Russia. Each of Russia's 89 regions has its own elected or appointed governor and his/her administration (government). Within the administration there is a single labour department dealing with labour issues in the region.

The formerly independent Federal Employment Service now reports to the Department for Employment Policy in the Federal Labour and Employment Service. The FES registers the unemployed and directs them to job vacancies offered by employers. The number of vacancies relative to the number of unemployed fluctuates around 2 unemployed per vacancy. According to Rosstat, the ratio decreased from 6.6 in 1998 to 1.6 in 2000, and increased slightly to 2.3 in 2003. There is significant variation in the ratio across regions. For instance, the ratio is as high as 10.3 in Neneckii AO and 5.3 in Murmansk region, and as low as 0.8 in Leningrad oblast and 0.9 in St. Petersburg.

The FES pays unemployment benefits, provides consultancy and arranges public works and professional retraining. The FES used to be financed through the Federal Employment Fund – which received mandatory payments from employers – but has been financed directly from the budget since 2001.

There exist a number of newly created recruitment/employment agencies and many foreign private ones that provide recruitment services for a fee (usually a proportion of salary, *e.g.* two months' salary). These agencies are especially common in financial, trade and computer industries as well as among international businesses. The private agencies are growing in number and importance, but they operate with respect to a limited number of occupations, *e.g.* professionals, interpreters and secretaries. For the time being they are not considered to play an important role in combating unemployment.

The Federal Migration Service (FMS) was founded in 1992. In 1999 the FMS joined the Ministry of National Affairs and became the Ministry of Federal Affairs, National and Migration Policy. Following reorganisation in 2002, the Federal Migration Service became a part of the Ministry of Internal Affairs of the Russian Federation. It comprises of the central body and the network of regional departments on migration and on visas and registration. The FMS will be regulating immigration, including labour immigration. Regulation and facilitating internal labour migration is not a part of FMS mandate now. Some facilitation is attempted by the regional departments of FES instead. Programmes of financial support to the migrants are of limited size.

Civil society institutes are known to be very weak in Russia. They play no role on the labour market.

Labour market policies

The number of policy instruments used to regulate the labour market is limited in Russia. They include minimum wage setting, participation in the collective bargaining process, provision of unemployment benefits, provision of consultancy and services to facilitate job search, arrangement of public works and professional retraining of the unemployed. Local labour departments are also to generate and publish forecasts of changes in local labour demand so as to facilitate employer/employee matching within a given time horizon.

Wage regulation in Russia is established mainly by setting minimum wage levels and minimum wage tariffs for public sector employees. The minimum wage is not binding though, and neither the wage level nor the minimum wage tariff provides protection from poverty. The ratio of minimum wage to average wage fell from 23% in 1990 to 5% in 1999. At the same time, both minimum wage and minimum tariff increased in real terms during the recent period of economic growth. The tariff wage system in the public sector is known to be very compressed, thus lowering labour motivation. Recent attempts to reform the system by introducing sectoral tariff systems have not yet worked.

The wage regulation instruments mentioned do play some role in the economy-wide wage setting, however. Kapeljushnikov (2003) reports that more than a half the enterprises in their sample use the minimum wage or minimum tariff or regional subsistence level when setting lowest wages at an enterprise. A large share of enterprises use either the old Soviet or the current Russian tariff system as a basis for creating compensation schemes for both blue collar workers (45% of respondents) and white collar workers (34% of respondents). This situation reflects the role of the state as a large employer in the economy.

Active labour market policies are very limited in scale in Russia, due both to the relatively small level of registered unemployment and to the poor and diminishing financing of programmes in operation: total spending on active

Box 6.2. **Evaluating the effectiveness of active labour market policies in Russia**

Benus *et al.* (2004) provide a comparative analysis of retraining programmes offered by public employment offices in Russia and Romania from micro perspectives. Net impacts of the programmes are estimated using a rigorous quasi-experimental evaluation technique. The study is based on follow-up surveys in two regions in Russia and one in Romania. Propensity score approach is utilised to estimate overall and group treatment effects.

The analysis reveals substantial differences between the two countries. It turns out that the impact of retraining programmes in the Russian regions is statistically not significant for all the four outcome measures. To put it differently, there is no positive overall effect found for the programmes, which contradicts the perception of the employment officers that this particular programme is for the most part efficient. There is no overall negative effect either, which is against the view of some experts that most of the public programmes in the area are harmful.

In contrast, the programme impact in Romania is statistically significant and positive for the three of the four outcomes. Such a substantial difference between the two countries – a surprise given the institutional underdevelopment in both – is likely to be attributed to the differences in existing institutional rules and selection procedures. The latter could be affected by the external anchor of potential EU membership for Romania and the absence of any such anchor for Russia: in anticipation of becoming a member of the EU, Romania has reformed its policy and regulations to get more closely in line with EU standards.

programmes was 0.07% of GDP in 1997 and has been reduced lately. A few studies of the effectiveness of active programmes in Russia show that their overall impact is often ambiguous, with some groups benefiting from programme participation and others becoming worse off.

Local labour departments are not very successful in their forecasts of local labour demand. As a result, there is a significant reported mismatch in skills and professions demanded and supplied in local markets, which increases the costs of transition from one job to another.

Current governance challenges

There are clearly some major institutional issues affecting the development of the Russian labour market. This section will briefly analyse the ongoing institutional reforms and the prospects for reform implementation over the next few years.

Overview

There are some obvious challenges for the successful development of local and regional employment strategies in Russia, such as available financing and co-ordination. These challenges are not unique to Russia, but may be more severe there given the limited financial independence of regions, the limited development of active labour market policies and the postponement of local government reforms. Many Russian regions are, in the meantime, preparing labour market strategies that can begin to be implemented as soon as the necessary funding and tools for co-ordination are transferred to the regions. The discussion will not go into detail about these challenges but will focus on the institutional environment in which the strategies are to be implemented.[15]

It has been repeated many times that Russia, like many other countries, needs to diversify its economy and develop new sources of growth and employment. Small firms need to grow into medium-sized enterprises, firms in the grey or black sector need to move into the official economy, and entrepreneurs need to turn their ideas into companies. In order for this to happen, the barriers to and costs of doing business need to be reduced. The institutional reforms affecting new sources of growth need to be implemented in order to reap the economic benefits.

The Russian reform agenda

The current reform process, referred to as the second decade of reform or the Gref programme, was adopted in 2001 and is mainly focused on state institutions. It is an ambitious reform agenda covering some very large and complex issues.

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It is not possible to go into detail about all the reforms in this chapter, but it may be useful to briefly look at the most important ones. The Centre for Strategic Research (CSR) in Moscow has put together an overview of the reforms with an assessment of the growth potential according to a number of factors.[16] It becomes clear that even if reforms are introduced according to declared intentions over the following two years, Russia will still be lagging behind the most advanced transition countries in many areas. A realistic assessment, taking the potential obstacles[17] into account, gives an even more pessimistic outlook except for trade, social and fiscal reforms. The World Bank argues in its latest assessment of the Russian economy that it is unlikely that the government will introduce any new major reforms before the elections in 2007 and 2008, but that it is still possible that more focus will be placed on reforms that have been launched already, such as those in the banking sector and government administration (World Bank, 2005).

It is becoming increasingly clear that the Russian Government has on the one hand acknowledged the importance of the institutional reforms and on the other lacks the capacity to implement all the reforms at this point. This will, at best, lead to prioritising and sequencing of the most urgent reforms. The Centre for Economic and Financial Research (CEFIR) in Moscow has been charged with monitoring the institutional reforms over the next three years and has singled out administrative/deregulation, the judiciary, law enforcement, restructuring of public sector, tax administration, healthcare, and education as the most likely reforms.

Local government reform

The weakness and underdevelopment of the third level of the government – at the local or municipal level – hinder development of territories and raise difficulties for further reforms in many areas, the provision of public goods in particular. The issue has been discussed for some time already, and a federal law on the new principles of local government was adopted in October 2003. The document applies a series of innovations to the current institutions and practices. The most important innovation is an introduction of the fourth level[18] – the level of settlements – to the structure of the government. The current structure of having discrete bodies of various types at the local level is to be unified. Every settlement should now belong to a municipality, implying that a number of new municipalities should arise where necessary. This suggests that a new map of settlements and municipalities should appear in Russia. Every municipality already has its governing bodies elected locally, and now each settlement should also have some form of self-government elected. Moreover, each settlement should form its own budget; in the current system many of the local governments have only estimates of their incomes and expenditure, which are controlled by the regional government. The settlements and municipalities should take control of local taxes, including property taxes (on individuals and enterprises) and land taxes. All the measures are designed to create fully fledged third and fourth tiers of government in Russia.

The majority of new articles of law were to come into force in January 2006, but are now planned for 2009, following the presidential election period.

Corruption and state capture

Corruption, which can be regarded as one of the most painful costs of doing business and an effective barrier for small firms' entry and expansion, is increasing rapidly in Russia. The Indem Foundation's most recent report shows that bribery has increased ten times over the last four years in Russia, costing more than USD 3 billion for citizens and more than USD 300 billion for companies every year. The average bribe has increased by 13 times, from USD 10 200 to USD 135 800 (Indem Foundation, 2005). These numbers may be somewhat inflated, but it is clear that bribery has increased dramatically over the past few years.

The Russian version of the market economy is often described as crony capitalism, a system characterised by a very close relationship between business and state institutions. Russia is also known as one of the more corrupt economies in the world. Transparency International ranks Russia 90 out of 145 countries on its corruption perception index. The combination of crony capitalism and corruption often leads to "state capture", a situation where powerful firms are able to influence the state institutions for their own interests, often at the expense of other companies or would-be companies. The magnitude of this problem can be illustrated by the notion that "every single important bureaucrat in Russian government or Russian administration is at the same time deeply involved in business or represents their interests".[19] Another illustration is that Russian businesses pay an equivalent of 266% of the annual Russian budget revenues in bribes (Indem Foundation, 2005).

It may be difficult to give one single reason for the emergence of state capture in Russia, but the weak accountability and frail institutional framework at the time the Russian market economy was established, in combination with the loans-for-share privatisation process, are probably the most important factors. The effects of state capture are widespread in Russia but are perhaps most significant at the regional level.

One would expect the level of state capture to be reduced during the Putin administration as a result of the increased centralisation and crackdown on big business, exemplified by the attack on Yukos. However, the extent of state capture, in terms of concentration of preferential treatment in a region, has not

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been reduced during Putin's first term (Yakovlev and Zhuravskaya, 2004). The captors have, however, changed from the financial-industrial groups involved in the loans-for-shares privatisation and connected to regional governments, to firms connected to the federal government. The nature of state capture also changed as the most common preferential treatment, tax breaks, was made more difficult after the tax reform in 1999. During Putin's first term in office, subsidies, subsidised budget loans, budget guaranties of credits and subsidised energy prices became the preferential treatments of choice.

In the North West, the level of state capture has been decreased in all regions but Karelia and Pskov during the Putin presidency.[20] These two regions also have the highest levels of state capture in the district. Although the levels have been reduced in Komi and Kaliningrad, these regions still have a relatively high concentration of preferential treatment. The most significant reduction of preferential treatment during the late 1990s (Yeltsin's second term) and the early 2000s (Putin's first term) in the North West was seen in Archangelsk and Murmansk. The level has lessened by four-fifths, and is today relatively modest by Russian standards.

Administrative barriers to SME development

CEFIR has been monitoring the level of regulatory burden on small businesses in order to analyse effects of the deregulation reform on actual administrative barriers to business. The so-called de-bureaucratisation package included new laws on inspection, licensing, certification, registration and tax administration, and has been adopted since 2001 (see Box 6.3).

The most important finding in the monitoring survey is that deregulation has had a positive effect on small business development but that two-thirds of the firms surveyed still consider at least one problem related to regulation to be very serious. In most regions the fastest growth of the small business sector took place in 2002, the year when most of the de-bureaucratisation laws took effect. However, the survey also found indications of a glass ceiling. Companies under a certain size had relatively modest problems with bureaucrats; the problems grew along with the company's size. Small business growth is exactly what Russia needs in order to diversify its economy and to achieve the goal of doubling its GDP, which is why the improvements are so encouraging and the indications of glass ceilings and other barriers so troubling.

In connection with the administrative reforms, Russia introduced a reform aimed at lowering and simplifying taxes, especially for small businesses. A simplified tax system[21] for small enterprises was introduced in 2003, and the positive results came immediately in terms of improved tax morale, larger tax revenues and significant improvement for small

Box 6.3. **Monitoring deregulation of small business development, rounds 1-5**

The first monitoring round of deregulation of small business development was carried out by CEFIR in the spring of 2002 and served as a benchmark. The survey was repeated in the Autumn of 2002, Spring of 2003, Spring of 2004, and (the fifth round in) the Spring of 2005. About 2 000 small private firms in 20 regions have been surveyed in each round. Before any of the deregulation laws took effect, practices in the areas of registration, inspections, licensing and certification were found to be very far from the benchmarks established in the new legislation.

The new laws on inspections (August 2001) and licensing (February 2002) have induced significant positive changes in these areas of regulation. The number of licence applications decreased during the survey period and the frequency of inspections by most actively inspecting agencies decreased. The new law on registration (July 2002) reduced the number of agencies to be visited during registration by one and made registration faster and simpler, but more expensive. The levels of administrative pressure on small firms in these (and other) areas remain high and far from the levels set out in the new laws, mostly due to poor enforcement.

Progress of reforms is not geographically uniform: better results were achieved in localities with better fiscal incentives, less concentrated production, and large initial pro-reform small business constituency.

enterprises. Their appreciation of the reform is reflected in a CEFIR survey: almost 60% of the surveyed firms already use the simplified tax system. Those firms have seen the number of taxes drop by almost 50% (from 9.56 to 5.72) and they regard taxes as less of a problem than do other firms (Zhuravskaya *et al.,* 2005). Moreover, companies now regard the tax *level* as a more serious problem than the tax *procedures*, which represents a positive step towards a well-functioning market economy.

There was a marked improvement in general perceptions of the business climate. Competition started to be perceived as a more serious problem than government regulations and tax administration. Fair competition and the tax level now share first place in perceptions of problems concerning the way of doing business. The survey also confirmed that the simplified tax system indeed simplifies tax administration.

Conclusion

Poor institutional development poses serious problems for economic and employment development in Russia. The current governance framework, rigid

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and centralised, is not conducive to the development of local initiatives or the implementation of joined-up solutions to complex issues. This problem is exacerbated by findings that the main challenge for the Russian labour market is not necessarily lack of work manifested by high unemployment figures, but rather institutional imperfections resulting in segmentation, barriers to mobility on the labour market, and barriers to small business development.

The poor quality of institutions is evident both in general terms and (especially) in labour market institutions. Several international surveys show that although there has been some improvement in Russian institutions and governance structures, the situation remains much worse than that of Russia's neighbours and economic peers. Similarly, labour market institutions have been improved with the new labour code but are still underperforming, partly because of poor implementation and enforcement. Labour regulation is restrictive on paper, which would ultimately result in a decrease in demand and a decline in turnover if implemented, but which is quite flexible in practice. The situation is leading to increased reliance on informal employment, low job security and bad unemployment insurance, which in turn is likely to affect labour mobility negatively. And the lack of mobility – or rather, ineffective forms of mobility – across regions and sectors is already one of the most important problems in the Russian labour market.

We have also seen that informal activities continue to play a crucial role in providing employment and that the reasons are both institutional (the poorly implemented labour code and high turnover costs) and market-related (high levels of corruption and administrative barriers). This is likely to affect small businesses and entrepreneurs the most, which are believed to be not only an important source of growth and the most important labour market winners in transition countries, but also an important constituency for further reforms. Russia seems to be stuck in a catch-22.

The fact that the quality of these institutions is in such a poor state, and that the prospects for comprehensive reforms in Russia are bleak, will certainly have a negative impact on economic growth.

Notes

1. The figures in the rest of this section are taken from Westin (2004).
2. Russian SME Resource Centre (2004).
3. UNICEF (2001), Figures 2-4, p. 30.
4. NOBUS is a nationwide survey of households and individuals carried out by Rosstat in April-May 2003. It covers about 44 500 households in 79 regions. It is nationally representative, and regionally representative for 46 of the 89 regions.

5. See IMF (2003) for an overview of the discussion about growth and institutions on the one hand (Chapter 3) and labour market institutions on the other (Chapter 4).
6. World Bank Institute Governance Indicators, see *www.worldbank.org/wbi/governance/govdata*.
7. Expert Rating Agency, part of the Expert Group, was founded in 1997 as the first such agency in Russia. It has been rating the investment climate in the Russian regions since 2000. See *www.gateway2russia.com/art.php?artid=218314&rubid=#data*.
8. Recent reforms have reduced this number to 86.
9. The project is carried out in collaboration with the World Bank and with financial support from USAID. See *www.cefir.org/index.php?l=eng&id=32*.
10. Results of the 5th round of monitoring are summarised in Zhuravskaya *et al*. (2005).
11. OPORA is an NGO to support small business in Russia. VCIOM is a nationwide state public opinion centre.
12. The survey was conducted in March 2005 and covered 80 Russian regions.
13. As of October 1997, 156 all-Russian trade unions were registered according to the Ministry of Justice.
14. Some of the agreements are available in Consultant-Regions Database, published by Consultant Plus, which collects legal documents adopted at federal, regional and local levels. See *www.consultant.ru*.
15. For an analysis of various local governance and co-ordination mechanisms, see Giguère (2005).
16. The reforms, listed in order of importance according to Mikhail Dmitriev at CSR, are: 1) administrative reform; 2) judiciary reform; 3) reform of law enforcement; 4) WTO accession; 5) restructuring of the public sector; 6) development of civil society; 7) reform of the welfare system and the fight against poverty; 8) regulatory reform: natural resources; 9) migration policy; 10) tax administration; 11 reforming monopoly in natural gas sector; 12) reforming the electricity sector; 13) railroads reform; 14) communal utilities reform; 15) healthcare reform; 16) education reform; 17) military reform; 18) reform of technical regulation.
17. CSR differentiates between obstacles at the policy development stage (special interests, insufficient effectiveness of the policy development process, and insufficient political prioritisation of certain areas of reforms) and obstacles at the implementation stage (ineffective design and legal implementation by the executive and judiciary system, lack of trust, and limited administrative capacity).
18. Or the fifth, if federal okrug level is taken into account. There are seven federal okrugs in Russia: Central FO, North Western FO, Southern FO, Volga FO, Urals FO, Sibirsky FO and Far Eastern FO. Each federal okrug encompasses several regions. The changes were introduced in 2001 and were to strengthen federal government representation in the regions.
19. Grigory Yavlinsky, quoted in *The Economist,* 25 June 2005.
20. It was increased in Karelia and maintained in Pskov. There are no data for St. Petersburg.
21. Instead of VAT, profit, sales and property taxes, small enterprises can pay one unified tax. New law (2003): 15% of profit or 6% of revenue, if revenues below RUB 11 million and employment below 100 people. Old law (1995): 10% of profit for federal and < 20% for regional budgets; 3.3% of revenue for federal and < 6.7% for regional budgets, if revenue below RUB 7.5 million and employment below 20 people.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 7

Area-based Partnerships as Forms of Collaborative Governance in Germany

by

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Germany has a complex institutional framework: various policies are managed simultaneously at different governance levels and by different stakeholders. One of the challenges at the local level is to fill the gaps and co-ordinate actions – tasks that are necessary if economic and social development is to be promoted successfully. Some areas in the Western Länder have long experience in tackling that challenge, and the lessons learned can help improve governance in the Eastern Länder and beyond in the broader Baltic Sea region. This chapter examines the functioning and results of partnerships for economic regeneration in North Rhine Westphalia and in Brandenburg. It compares achievements given differing degrees of difficulty and draws conclusions about the potential for transferring experiences to different contexts.

Local economic development represents an increasingly important field of action in Germany's regions; a great number of local initiatives and strategies are pursued throughout the country. Yet the fact remains that Germany is a federal state that applies the principle of communal self-administration[1] – a structure that does not in itself produce *local* economic approaches. When it comes to implementing labour market policy and financing economic development, the various government levels find themselves in a constant institutionalised bargaining process. Local-level actors are directly dependent on central government regulations in both these domains. Moreover, the two policy areas are compartmentalised at the federal level and run by different institutions, which makes co-ordination difficult.

Thus it is at the local level that the greatest effort is devoted to facilitating the necessary co-ordination between economic and employment development and labour market policy. Indeed, the local level is where the greatest pressure to foster that development arises. New forms of co-operation between a host of relevant actors are deemed necessary – but they can only be made possible through additional institutional arrangements to supplement the established bargaining processes and traditional actors. These needs are taking on greater urgency as the effects of ongoing economic structural change in western and eastern Germany are being felt with increasing intensity, making new approaches necessary.

The local actors, faced with the closing of companies and related loss of jobs and communal tax revenues, are struggling to come up with solutions. They are helped in this by federal and regional institutions and programmes. While that support mostly aims at cushioning the social consequences of restructuring, the actors in the *Länder* and in the communes are concerned with new economic development initiatives. Local development in Germany is carried out by a network of institutions and actors at different levels; the actors implement programmes originating at all federal, regional and communal levels, each of which influences the others. The aims and interests of the functional departments involved (economic development, social inclusion and spatial planning) carry different weight, according to the degree of influence they wield. The sector-specific content and interests in each case inform the programmes and approaches to the problem solving of the actors. Compatibility between them tends to be the exception – and incompatibility can result in governance failure.

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A common factor among cases where successful new economic developments overcame such failures was the presence of innovative regional or local partnerships. These partnerships supplemented the existing actors and programmes from the various levels and within the various departments. In functional terms, they serve as "translators", "catalysts", "lawyers" and implementers of the development opportunities existing within a region or locality. The partnerships allow a synergy of the different institutional approaches of the various political levels that are not *per se* compatible. Their strength and success record stem from their spatially concentrated and, in terms of content, overlapping method of operation. In other words, they operate with an immediacy and comprehensiveness that is impossible for the traditional actors. This involves instances where, despite the lack of financial and legal autonomy of the local levels in the German federal system, existing room for manoeuvre was used and proactively institutionalised.

A successful western German example of such a partnership is the development project "Internationale Bauaustellung (IBA) Emscher Park", the approach and experience of which inspired the "IBA Fürst-Pückler-*Land*" development project in eastern Germany. Each of these projects in itself offers a lesson in local development on the basis of partnerships arising from overlapping institutions and actors. But it is only when a comparison is made between the two that the success factors become clear. Rather than loose associations of actors, both partnerships have led to the creation of regionally specific and institutionalised development agencies.

This chapter discusses the preconditions for successful locally organised development partnerships by analysing the performance of the two mentioned. Success here is understood as the ability to compensate for, and develop innovative solutions to, shortcomings in the traditional institutional actor relations in favour of sustainable area development. First however, German institutions for local development will be explored in order to highlight the background and the challenges against which the two partnerships have developed.

Local economic and employment development in Germany as an aspect of "corporatist administrative federalism"

Economic promotion

The term corporatist administrative federalism – or co-operative federalism – describes a situation where in the majority of matters none of the levels – that is, neither the *Länder* nor the federation – is solely responsible. This primarily involves matters where decisions and agreements linked to bargaining processes are worked out between different levels. In particular, this applies to the area of regional economic promotion whose central instrument is the *Gemeinschaftsaufgabe zur Verbesserung der regionalen Wirtschaftsstruktur* (Joint Task for the Improvement of Regional Economic Structure).[2] This is one of a series of *Gemeinschaftsausgaben* (joint tasks), which are codified in the constitution and which determine the co-operation of the federation in matters of regional economic promotion in the *Länder*. The decisive influence on present-day policy was the recession that hit the West German economy in the second half of the 1960s and led to massive collapses in production for the first time, above all in the coal and steel industries. This affected regions within the *Land* of North Rhine Westphalia in particular. A further consequence of economic development was a rise in competition for investment among the *Länder*, with increasing recession and declining industrial investment. From this there arose a readiness on the part of the federation and the *Länder* to unify regional economic policy. It was agreed to integrate regional economic promotion measures into "Regional Action Programmes" for standardising the territories, determined in bilateral negotiations between the federation and the *Länder*. Since that time, the emphasis of economic promotion instruments has been on incentives to promote private and public-communal investments in selected areas.

Regional economic policy in Germany is above all committed to the goal of equality within and between the regions in the *Bundesrepublik*; equality is based above all on the duty of "protection of the uniformity of living conditions"[3] derived from the *Grundgesetz* ("Basic Law") of the federal constitution. However, it is difficult in practice to implement a regional economic policy based on estimated regional potential, while simultaneously promoting maximum growth and efficient use of production factors. This is because of the difficulty of calculating an "optimal regional structure" for the entire federal area. Those areas in which the resources are to be used are determined through a negotiation process between the co-financing federation and *Länder*. That said, pursuit of the growth target requires the promotion of the structurally weak areas. Thus the *Länder* must reconcile that goal with the promotion of their structurally strong regions (which will nonetheless have some trickle-down effect to structurally weak areas).

In determining their local development priorities, the *Bundesländer* themselves have to deliberate between the implied (and not always compatible) goals of economic promotion and federal assistance. In addition, they are forced to reach agreement with the federal government. The constitution obliges the federation and the *Länder* to co-ordinate overall planning. This means that typically, neither can carry out policy consistently. Only in rare cases can a compromise be reached between the goals of equity and growth, namely the promotion of local development projects for the moblisation of growth potential in areas with weaknesses arising from structural change.

The Joint Task for the Improvement of Regional Economic Structure was also the most important instrument in measures for economic development in the east German *Länder* immediately following the accession of the German Democratic Republic into the *Bundesrepublik*. As the central actor, the Federal Ministry for the Economy refrained from implementing the "measures for regional economic promotion towards the creation of a special programme" provided for in the Unification Contract (the document contractually regulating accession of the GDR). The aim, rather, was to transfer the instruments tested in West Germany to the new *Länder*. However, the Joint Task was not transferred unchanged. Especially noteworthy was the very first change: its use for non-infrastructure promotion. In regions that had been particularly affected by closures, grants for "consulting measures for investment promotion and project implementation" were available to the commercial as well as the infrastructural sector. This is relevant because with that change, the limits of the previous form of promotion, strongly predicated on capital mobilisation and growth from outside, became very clear. Moreover, the whole area of the former GDR was declared to be a promotion area. Thus the decision concerning regional emphasis, and whether policy would be oriented to stronger growth or to equalisation, was left to the east German *Länder* themselves.

Nevertheless – despite the entry of the east German *Länder* into the *Bundesrepublik* – an astonishing continuity can be seen in the case of regional economic policy. This is due above all to continuity in the actions of the relevant institutions and actors. The "Federal Ministry of Economics and Labour" (BMWA) in particular had from the beginning tightly controlled promotion policy in the new *Länder*. From the start, the new *Länder* had been forced into an institutional corset whose form decisively shaped further (independent) policy development in the area of regional and local economic promotion, and determined possible policy options.

Labour market policy

The unemployment insurance system is the responsibility of the *Bundesagentur für Arbeit* (the Federal Employment Agency) – formally the *Bundesanstalt für Arbeit* (the Federal Institution for Employment). This insurance system and labour market policy are designed to respond to temporary imbalances on the employment market. Unemployment benefits are only granted for a limited amount of time (previously for up to 36 months depending on age; following labour market reforms, for 12 months). The costs of income replacement benefits subsequent to this for the long-term unemployed – the former "social assistance" (*die Sozialhilfe*)[4] – were borne by the communes.[5] The problem for communes in regions particularly hit by structural change is that a quantitatively high proportion of those available for work cannot find employment and remain dependent on these communal income replacement benefits. Because a uniform national income guarantee would not be able to cover the structural risk of marginalisation on the labour market, financial burdens are left to the local level, to the communes and to charity organisations.

The financial burden for the communes is considerable – the higher the numbers of unemployed supported by them, the lower the resources that can be voluntarily raised for local economic development. On the other hand, the functional integration of the communes in policy supporting the unemployed also has a pragmatic justification: because marginalised groups can hardly be reached by global labour market policy measures, only a policy that aims directly at improving employment chances and creating employment opportunities can be of significance. To reach these target groups, it is not sufficient to determine eligibility rules and make financial resources available though centrally managed decisions. For this reason – and independently of the apportionment of income replacement benefits between the federation and the communes – centrally set benefits for the acquisition of qualifications and temporary employment programmes are tailored locally. The labour market is also therefore an area of concern for the local level.

In Germany the following actors are involved in labour market policy at the local level: the communes through public institutions and local employers; schools and centres for further education and qualification activities; the local employment offices (with their self-administration committees, including representatives from the local chambers of commerce and trade unions); other bodies responsible for implementing labour market measures (such as further education and vocational retraining courses); the non-profit sectors of charity organisations, social and church organisations and self-help groups; and state and communal actors representing the interests of the workforce or company management in business adaptation processes. These activities demonstrate that local opportunities for action – as well as the life situations of the unemployed – are dependent on central state regulation and finances. However, provision of various forms of services is actually determined by a constellation of actors.

The difficulty here is the absence of co-ordination among these actors – in particular between the Federal Employment Agency, the charity organisations and the communes. Co-ordination comes neither though hierarchical control nor through a market-price mechanism – nor *per se* though an automatic partnership of actors and institutions. The "partnership" is a strained one, because the very word implies a shared value orientation and a defined situation. Yet in this case for example, intermediate organisations and charity organisations are not subject to control through the commune or the employment agency.

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The way co-ordination of local employment market policy does take place is via "pluralistic negotiation systems". These negotiations are open only to the extent that clear relationships of hierarchy and instruction are lacking. In fact there is a selectivity in the consideration of issues. This is because the negotiations concern not only the co-ordination of strategies, but also the distribution of resources on which the existence and/or development of the organisations involved depends. Since local labour market policy reaches decisions within a bargaining process, policy lacks a centre of gravity at the local level. The problem is exacerbated by the fact that the interdependency between employment market policy and economic development is not necessarily reflected in this bargaining process, but dealt with in the respective negotiation systems between networks at the federal, *Land* and communal levels. Often, the two categories of programmes stand in marked contrast to each other, with virtually opposing rationales at the same local level.

Communal self-administration

One of the reasons communal self-administration has endured in Germany – however modified during the course of its history – is that it permits decentralised implementation of particular programmes in line with specific local conditions. But then even this system of governance, unique in international terms, does not in itself guarantee the successful implementation of proactive local economic development policy. In the constitutional model of the *Bundesrepublik,* the communes are granted a sphere of self-administration within which they are subject to specific functional assignments. Economic development, which goes beyond the creation of framework conditions (infrastructure, approvals for investment, planning and building permission), is not within this sphere. Economic promotion is a *voluntary* task of the communes. It must be remembered that communal budgets – aside from the fact that they are depleted through reduced taxes in times of economic contraction – are for the most part already tied to *mandatory* tasks – in particular, social tasks. There remain for them few moveable resources that they can use for voluntary tasks. While the communes or municipalities are administrative bodies of public law and thus not part of the state administration, they execute a large part of state activity, and the public investments supplied from budgets outside the communes are carried out mainly by the local administrative bodies.

The fact that the existing principle of communal self-administration makes independent local economic development policy impossible is due to a strong institutional integration between the state and the communes, which takes the form of corporatist committees. These were established at the federal level in the 1970s to carry out so-called global planning, to run the business activity and financial planning council, and to supervise laws promoting urban development and municipal traffic financing – laws through which communal budgets and their investment policies are integrated into microeconomic strategies. The communes can exert some influence on the implementation of programmes and laws decided at the federal level: they do, after all, participate in the development of such programmes. However, the leading political scientist Helmut Wollmann evaluated the effects from the point of view of the communes as merely "micropositive" (1982).

This situation is the result of decades-long developments. The opposition between local units and the nation state, still assumed to be the result of communal self-administration, is – precisely in respect of questions of economic and employment market policy – a fiction of the past. Historically, industrialisation was associated with the rapid development of interregional connections as well as economic activities and individual lives. As a result of economic structural transformation, demographic shifts, the emergence of new labour markets and interregional interest organisations, as well as the development of welfare state insurance systems, the significance of local social insurance systems declined continuously. In Germany these processes have also led – despite the historical principle of communal self-administration – to a "standardising of the 'communal individualities', to functional elements of a territorially encompassing state administration", as Ulrich K. Preuß wrote as early as 1973. The right to communal self-administration is thus largely ineffective – or, to put it more accurately, irrelevant – precisely with regard to questions of economic and employment development.

There are examples of successful developments that can be traced back to the initiatives of local institutions; these took place in spite of the narrow structural scope for action. They also do not involve mandatory activities and support which the higher levels, the *Länder* and the federation would be duty-bound to provide anyway. Rather, they primarily involve the co-operation, initiated at the regional and local level, of very different actors and their temporary institutionalisation and positioning alongside traditional arrangements. The catalyst for this was and continues to be two factors. One is the new conception of economic promotion: the kinds of growth milieus that are characteristic of the economically successful regions should be recreated at the local or regional level. The second is growing pressure for the communes. With the withdrawal of the federation from certain areas, such as housing, welfare and labour market policy, the communes find themselves confronted with a heightened compensatory function without any real structural change in their position or financial resources.

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Local economy and employment development in Germany as an alternative to corporatist administrative federalism: a new model of structural policy based on localised co-operation

Before the accession of the GDR to the *Bundesrepublik,* the regional development policy debate in West Germany was characterised above all by the North-South divide. It was stated that – apart from brief exceptions – economic growth in the northern German *Bundesländer,* including North Rhine Westphalia, was clearly below the federal gross domestic product average and would have to struggle with an unemployment level above 10%. Structural policy discussion in North Rhine Westphalia quickly established that that *Bundesland* is not a uniform entity with consistent development trends. Within the *Land* there have always existed regional disparities in development, which have tended to be amplified as a result of structural change. Against this background, the policy of reindustrialisation as a uniform development strategy, which dominated in North Rhine Westphalia up to the late 1970s, proved insufficient. For too long the political and economic decision makers were convinced that the structural problems of the *Land*, above all of the Ruhr area, could be overcome through technology-oriented promotion of mining – a perfectly understandable conviction, given the continuing economic policy significance of the mining, steel, and energy sectors.

The Ruhr area in North Rhine Westphalia, also known in the vernacular as the country's "coal pot", had almost 6 million inhabitants in the 1950s. Following the end of reconstruction in Germany, a process of de-industrialisation began to take place, one that continues today: of 128 mining locations, only six remained in 2000; of 400 000 employed in mining, less than 40 000 remained. Since the 1980s it has been evident that the major challenge here is no longer growth, but "contraction". The population prognosis for the year 2015 is for only 4.5 million inhabitants. Apart from people, the Ruhr's problem lies above all in its having too many things: too many industrial areas and buildings, too much industrial infrastructure, too many housing units, too many kindergartens, schools, hospitals, streets. "Regenerating" today means that a city landscape that for more than 100 years has been optimally arranged for industrial production needs to be reconstructed.

It was only from the middle of the 1970s that North Rhine Westphalia structural policy began to change: now, the emphasis is increasingly placed on a more broadly constructed promotional policy. Accordingly, the individual regions can – proceeding from their respective specific development constraints and potential – search for their own answers to the upheaval in regional development and, with the support of the *Land* government, find their own specific path. In the 1980s it became clear that countering the withdrawal of industry with social welfare state action would not suffice. Derelict lands, slag heaps, empty industrial buildings, a dense and high-capacity street network – in short, a city landscape with a negative image for lifestyle and leisure – at the same time "of course" attracts like a magnet all that is unpopular elsewhere in Germany: logistical centres, rubbish dumps, warehouses – *i.e.* basic, capital-poor and knowledge-poor jobs in the traditional industry structure milieu.

Since then the state government in North Rhine Westphalia has focused on individual responsibility, dedication and the power of self-organisation in the sub-regions. At its core, this focus involved drawing support from specialist knowledge and the potential of the local actors, who were to find new forms of co-ordination and co-operation in self-responsibility. With this localisation policy the *Bundesland* on the one hand intended a procedural control for the greatest possible regional use of the resources provided by the *Land*. The *Land* government for its part makes financial resources available, and allocations are clarified in a dialogue with the actors. Thus resources of the "Improvement of Regional Infrastructure" Joint Task (*Gemeinschaftsaufgabe*) and city development promotion are incorporated into a local activation policy. This is not without self-interest on the part of the *Bundesland* level; the contribution of the *local* level to the structural development of the *whole Bundesland* is to be increased. On the local level the decision-making actors are given the chance to take their future into their own hands. This is to be achieved though a mutual assessment of strengths and weaknesses, ascertainment of basic ideas and intensified collaboration in structurally relevant policy fields. On the other hand, with this policy the *Bundesland* was also confessing that for its individual sub-regions, a particular given *Land*-based programme is insufficient. A bundle of diverse concepts, measures, instruments and so on is needed in addition, and achieving this seems to be possible only at the local level.

The result of localising North Rhine Westphalia structural policy was the creation of local and regional institutionalised development partnerships. These positioned themselves outside the established traditional institutions but included them in their work. With this, co-operation between the traditional institutions – normally a tense affair much criticised for its deficiencies – was greatly improved, and significant leverage for local development successfully attained.

The IBA Emscher Park project in the Ruhr

In 1990 the international building exhibition Emscher Park was founded as a limited company for a period of ten years by the *Land* North Rhine Westphalia. The IBA (*Internationale Bauaustellung*) project, encompassing measures in a series of communes within the Ruhr, established a new and temporary institutional context for actors, within which the conditions for co-ordination and (economically, socially, and politically rewarding) co-operation were to be created. The goal of the IBA was and is to make the Ruhr – *i.e.* its industrial core area along the Emscher River – "fit" for the 21st century. Using public resources amounting to about EUR 1.5 billion, the IBA has generated private investments of EUR 1 billion.

As the agent of the paradigm shift, the IBA succeeded in turning the negative image of the industrial landscape into a positive one. Industrial culture acquired a good name; the region has begun to be proud of its industrial heritage. The landscape of mining slag heaps, blast furnaces, canals, colliery buildings, gasometers and pithead frames has become a fascinating "world" for a new generation of children and adults who work and play in front of computers. From the beginning it was clear that renewal of the old industrial landscape could only succeed through integrative concepts. The individual projects were therefore planned to be co-ordinated and mutually strengthening. The results, which can now be seen, are impressive – and were certainly of decisive importance in the very recent choice of the city of Essen to be the European City of Culture in 2010.

With the concept "working in the park" the IBA Emscher project has brought a new generation of commercial, service and technology parks into being. Taking into account ecological design features, modern commercial and landscape architecture and "intelligent" reclamation, supply, and waste disposal systems, the aim is to create attractive locations for small and medium businesses that provide as high a number of jobs as possible. With this overall concept the IBA has brought some 20 projects into being. Examples include the Gelsenkirchen Science Park, the Holland colliery in Bochum-Wattenscheid, the service park on the Krupps site in Bochum, the Arenberg start-up centre in Bottrop, the Erin commerce park in Castrop, the Duisberg inland port, the Zollverein colliery in Essen-Katernberg and the Environment Technology Centre in Oberhausen.

The *Landesentwicklungsgesellschaft*/LEG (*Land* development company) supervised the overall concept from the beginning and developed it beyond the IBA project. The LEG has realised similar projects to this day. Essen is the site of one very ambitious project – the New University Quarter in the vicinity of Weststadt. This connects the inner city with the university quarter in the northern freight depot area. Here too, the basic idea is to have a multifarious, as-"colourful"-as-possible mix and use of living, entertainment, sport, culture, retail, and offices.

In 1999 North Rhine Westphalia was introduced to the innovative instrument of "community planning", which has since become known in Germany as the "prospects workshop". Here, the basic ideas of "participatory planning" are being put into action: all affected and interested citizens are brought into the planning process and share a high degree of involvement.

The project aims at a fusion of professional and citizen-oriented planning and looks set to secure widespread acceptance from its participants.

The "RheinPark Hochfeld" project for economic promotion in Duisberg is also based on this concept of high-level acceptance. Planning has been themed in line with the slogan "Duisberg on the Rhine", and anticipates the development and connection of four inner city (industrial) areas along the Hochfeld Rhine bank. In addition, the main railway station and the "Multi Casa" project (retail, gastronomy, recreation, culture) are to be joined to the Rhine through the freeing-up of railway lines, a chain of extensive green and open areas, and generous Rhine promenades. The Duisberg inner port will be incorporated as a third anchor point. The aim of this inner city development project is the securing in Duisberg of a modern mix ratio of work, living and recreation. Four thousand new jobs are anticipated.

The collaborations among various actors from different institutions and co-ordination of the activities in the different communes made possible by the IBA in the Ruhr were of central significance to the course of local development within each individual commune. They allowed the resulting incentive instruments to bring communal *local* developments into a causal and wealth creation chain of *regional* developments. By promoting investments with great development potential in a commune, sustainable jobs are created and secured (*i.e.* qualified lasting jobs with high incomes). In this way the employment market, the income situations of the region, and the sectoral economic structure as a whole are improved. This leads in turn to lessened migration and heightened economic efficiency, as well as a harmonisation of living conditions between the economically problematic and successful regions. In summary, the following can be said: it is precisely the IBA's newly institutionalised association of actors that is realising the goal of countrywide regional economic promotion in Germany. This is not about harmonising living conditions in the federal area through relocation of existing areas, but rather about creating new sources of income in disadvantaged areas. It is all the more remarkable for the IBA's unusual, complementary status with regard to the traditional institutions, and the fact that it operates outside the compromise-oriented bargaining processes between the federation, the *Bundesländer*, and the communes.

The IBA Fürst-Pückler-*Land* in Lausitz, eastern Germany

Following the accession of the GDR to the *Bundesrepublik* there began a rapid structural transformation that demanded swift structural policy measures for the renewal of the eastern German *Bundesländer*. Experiences in the western German *Bundesländer,* particularly in those with major structural problems, were drawn upon to a great degree in designing specific policy models. For example, through a sponsorship by the *Bundesland* North Rhine Westphalia, officials were sent to

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the eastern *Bundesland* Brandenburg to help deliver administrative aid for the reconstruction of institutions, in the form of knowledge-transfers and consulting services. North Rhine Westphalian structural policy – that is, the experience of the IBA Emscher Park – was taken as a model for the renewal of industrial and mining regions with structural problems.

The IBA Fürst-Pückler-*Land* is the largest mining-landscape rehabilitation project in Europe. An area almost twice the size of the Saarland *Bundesland* is to be rehabilitated within a period of ten years (2000-10), and targeted for local economic development. At one time the largest energy centre of the GDR mined lignite from an open pit here; now once again, millions of cubic metres of earth are to be moved – but this time in the opposite direction. The broken, uninhabitable landscape and its industrial buildings, mining machines, workers' housing estates and extensive industrial areas are to be transformed into one of the largest lake-land areas in Europe, with industrial monuments, cultural centres and an efficient modern service sector. A combination of artistic and technical innovations will be put to use to enhance the 2 000 km^2, with the aim of attracting international attention to the area. In this connection there are international collaborations, such as the Polish-German Europainsel Gubin – Guben. Specialists from the Ural area in Russia have been here to see the now-transformed Plessa factory, as the project has many similarities to the planned steelworks museum in their region.

Twenty-two individual projects constitute the core of the activities initiated, co-ordinated and supervised by the IBA. These involve renewal of the vestiges of the industrial era, landscape art projects and landscape architecture. Examples include the reconstruction of housing estates (Gartenstadt Marga in Senftenberg, Großsiedlung Sachsendorf/Madlow) and the building of residential and holiday homes (*inter alia* a number of floating houses), as well as the initiation of new economic activities. Integrated into these activities are employment creation measures *Arbeitsbeschaffungsmaßnahmen* (ABM) of the federal employment agency, as well as further education and qualification measures. Attempts are being made to attract production resettlement; one involves negotiations with a biodiesel producer concerning the aforementioned Plessa factory, the largest lignite factory in Europe. Simultaneously there are efforts to develop fruit juice extraction here, and thus develop a connection with the surrounding mixed fruit orchard region, one of the largest in Germany. In these projects the promotion of economic development, city development, and measures of the federal employment agency work hand in hand.

A number of characteristics distinguish Lausitz from the Ruhr area. What took decades in the Ruhr is being completed here within a few years. The Lausitz is the object of swift economic structural transformation that affects the whole of eastern Germany. The particularity of the region lies in the fact that it was so dominated by a large-scale coal and energy industry that became redundant at a stroke. Approximately 80% of production was declared no longer cost-effective. This transition was more rapid and more serious than in the Ruhr, which – for example with the Ruhr University, major cultural events and company start-ups – had long been ready for the new developments. In contrast to the Ruhr, the Lausitz is a very thinly populated region, with half a million inhabitants.

This points to another difference. The IBA in the Ruhr had strong partners in communes like Essen, Gelsenkirchen, and Dortmund. In the Lausitz the inhabitants had to do as much as they could on their own. New operating and financing models are needed that run independently of communal support and financing. The IBA in North Rhine Westphalia was set up by the state government – thus initially "from above" – conceptualised at the federal level, financed by the communes, then granted its autonomy and given a series of co-operation tasks that it implemented inter-communally. In the Lausitz this was done exactly the other way round. There the administrative districts (*Landkreise*) and the cities were the driving forces. The Lausitz IBA arose at the communal level – that is, "from below". Before the IBA started here, the Lausitz was simply to be recultivated, and the region's typical landscapes reconstructed. Doubts grew among the actors in the local communes as to whether previous conditions were merely being reproduced, and whether the project could in any way offer real prospects for development. Because of these doubts alternative ideas were developed and, from 1994, adopted and prepared by a regional planning association. They were eventually accepted by the state government in 1998.

Comparisons between the IBA in North Rhine Westphalia and in Brandenburg show that for the model of localised collaboration at the regional level already tested in west Germany to transfer successfully, the political-institutional infrastructure must be present. Above all there needs to be a co-operation-facilitating "foundation" consisting of the communes on the one hand, and on the other societal organisations such as chambers of industry and commerce, unions and other associations (*e.g.* the regional planners). The agency established temporarily at IBA headquarters in Brandenburg secures a series of collaborations beyond the functional department limits and the respective communes. It also guarantees elasticity in the co-ordination of various programmes of the *Bundesland* and the federation. These things can only be achieved with great difficulty by the established institutions.

Admittedly, at the end of the 1990s when the IBA Fürst-Pückler-*Land* was agreed and established, almost ten years had passed since the GDR's accession to the *Bundesrepublik*. The political-administrative institutions and actors on the local level continued, however, to be in high demand. Their eased burden with respect to local development through the co-operative efforts of the IBA actors has been of great importance to them. The traditional institutions at the local level were still preoccupied with adjusting to the new rule and bargaining processes without running idle. They represented the only institutional continuity in the transfer of the GDR to the new *Bundesrepublik*: the central government apparatus of the GDR had ceased to exist on reunification, the former regional administration of the GDR (the districts) was dismantled, and the governments of the *Länder* were newly reconstructed. In addition, the adopted West German communal model did establish tasks and responsibilities for the local institutions that they had to perform on behalf of the state – that is, the federation and the *Bundesländer*. These institutions have thus been confronted with enormous problems. Not least among them is a socio-economic situation characterised by the collapse of the old economic structures, runaway unemployment, and the fact that the economic and social consequences of this development become manifest in individual lives and difficulties – above all at the local level, where effective remedial measures have become necessary. In order to guarantee a trouble-free cycle and to secure adaptation to the new administrative principles, the special tasks and arrangements that lay outside the norms of institutionalised cycles taken over from the west must be avoided. They certainly would not have furthered the careers of individual actors. Besides, given the burden of problems and economic dislocations, the communes have been forced to go beyond the activities formally assigned to them with respect to the economy and the employment market. In other words, merely creating framework conditions (planning-related area classification, infrastructure, etc.) for private economic activity is not sufficient. In light of the moderate successes here in economic development, the communes were given the freedom to pursue their own proactive procedure. For financial reasons as well as formal reasons (*i.e.* the fixed procedures of the administration), they were not able to do so on their own with sufficient flexibility. An additional structure like the IBA, which made more flexible arrangements possible, was thus welcome as catalyst and compensating factor.

Conclusion

Both the western and eastern German examples of IBA demonstrate that complementary regional forms of co-operation do not stand in competition with the traditional political-administrative institutions and actors. In the case of the IBA Emscher Park they will even be assigned a compensatory function (*i.e.* due to their more flexible functioning compared to the traditional forms of administration) as they will be used "from above", that is by the government of North Rhine Westphalia. Both IBA cases involve a new form of inter-municipal co-operation, with inter-communal organisation regulations. The compensatory functions of both IBAs must clearly be of sufficient additional value to the various actors involved – especially the various communes – to allow the establishment of an additional institution, despite the actors' loss of autonomy and decision-making competence, *i.e.* a shift in the division of influence. This situation could be formulated in the following way: there is an agreement to less influence for each individual in exchange for greater economic development for all. What initially appears to be a narrowed scope for action for each individual commune is actually extended influence over a larger number of variables of local economic development.

Both cases involve additional institutions whose specific functions are not simply complementary in nature. In the respective regional institutional landscapes they are unique, as their co-operative way of working overcomes the incompatibility (and even competition) that usually arises among institutions and programmes. The prerequisite for this is the procedural free space that tends to be alien to the traditional political-administrative institutions and methods. Meanwhile the added value consists in the fact that localised co-operation on the regional level – within limits – itself produces free space for the traditional institutions for purposes of local development. Formulated differently: the free spaces are both a precondition for, and the result of, the working methods of these new institutions.

This especially applies to the German context, with its constant overlapping, consensus-oriented bargaining processes between levels in co-operative federalism. In both cases, despite the lack of financial or legal autonomy at the local levels, existing leeway was exploited and new agencies created and proactively institutionalised. Localised regional co-operation is set below the level of procedurally formalised co-ordination between the federation, *Bundesländer* and communes. It becomes active where formally assumed compatibilities between economic promotion and economic policy fail to generate co-operation or synergies towards the development of specific regions or localities. This involves more than organisational added value for communal self-administration, which is powerless when it comes to active economic development and labour market policy. It is not merely that decentralised decisions are as a rule more adequate to the problems, more flexible, or more efficient than those made centrally. Rather, what is essential is attaining co-operation between actors, or a co-ordination between questions of labour market policy. That co-operation and co-ordination are impossible – or possible only with difficulty – in the existing sectorally fixed and federally vertical bargaining processes. What matters, then, is channelling the results generated in the existing sectoral bargaining process to local economic development.

The two cases make another thing clear: it is at the local level that compensation and co-operation can be put into practice as a supplement – only here does it make any sense to establish such additional institutions. As the examples show, establishment of these additional institutions is possible both "from above" and "from below" according to the institutional, socio-

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cultural and socio-economic arrangements. A centre of gravity for both regional/local economic development policy and regional/local labour market policy – as well as for co-operation between the two – has been created through a focus on development at the local level. Economic development measures (financial and other investment aids, tax relief, infrastructure improvements, technology transfer, innovation centres, and so on) should and will create general opportunities for the settlement, restructuring and development of companies. The labour market measures are aimed at improving employment chances and creating employment opportunities. These can include job-related qualifications, job creation measures, further education and reschooling, and limited wage cost subsidies.

Both IBA examples also demonstrate that their transferability is possible given adaptation to the respective initial conditions. The structures of the two IBAs are similar, as are their working methods. Where they differ, according to the environment, is in their areas of speciality, procedural arrangements and actor relationships. Furthermore, the experience of localised regional co-operation such as the IBA is relevant for transformed societies. Admittedly the process of change of the GDR has proved a special case, insofar as the transition to and integration in the political, economic and social model of the *Bundesrepublik* took place almost overnight – at any rate incredibly rapidly – and those formal, legal, and political-administrative conditions that made an IBA possible in the west suddenly held in the eastern *Bundesländer*. However, the available field reports and results of comparative research suggest that co-operation between levels, functional departments and programmes represents a considerable challenge. This would appear to be true even in the case of rifts in the political-administrative fabric less radical than those seen in the case of East Germany: the economic problems associated with transformed societies are asserted primarily at the local level – and thus urgently require *local* solutions.

Notes

1. The commune is the smallest local political subdivision/smallest administrative district of the German state.
2. The promotion of regions is part of the regional policy of the BMWA (Federal Ministry of Economics and Labour). Initiatives supported by the ministry aim to help less favoured regions, by reducing location disadvantages and maintaining open access to overall economic development. According to Art. 30 GG, the federal states are primarily responsible for the economic development of their regions. "Improvement of Regional Economic Structure", a federal government programme, is funded in equal shares by the federal states and the *Länder*, and based on additional funding from European Union Structural Funds (mainly ERDF).
3. In the 1970s the concept of uniformity was replaced by the formulation "the parity of living conditions" in the federal regional planning programme, in order to make it clear that the policy aim was not the standardisation of living conditions. With the

change of Article 72 of the basic law in November 1994 – that is, after the fall of the Berlin Wall and the accession of the GDR to the *Bundesrepublik Deutschland* – the aim of uniformity was replaced with that of the "creation of equivalent living conditions".

4. Following reforms the long-term unemployed receive the so-called "*Arbeitslosengeld II*" (unemployment benefits II), which have replaced the "social assistance" (*Sozialhilfe*). Social assistance is now restricted to those who have been categorised as no longer capable of working (*e.g.* due to illness).
5. The *Arbeitslosengeld II* scheme is covered by the federal level and the remaining "social assistance" (*Sozialhilfe*) by the communes.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 8

Cross-border Co-operation and Local Governance – The Case of Kaliningrad

by

Alexey Ignatiev

A Russian enclave in Europe, the Kaliningrad region is in a unique position to co-operate more intensively with territories of foreign states than any other region of the Russian Federation. Indeed improvement of local governance and elaboration of development strategies in the framework of EU regional policy directly benefit Kaliningrad. Therefore, adjacent EU regions should be considered not just as its economic rivals or partners, but as role models as well. The case of Kaliningrad well illustrates the benefits of cross-border co-operation and the advantages of exchanging experience and best practice with foreign partners on specific issues of common interest. It can be seen as a pilot region for designing and testing new mechanisms of bilateral partnerships and for experiencing new forms of governance for economic development in the Russian Federation.

Introduction

The Kaliningrad region is a unique federal entity of Russia and a special area for EU-Russian co-operation.

Because it is detached from the country's mainland and located within the enlarged European Union, Kaliningrad[1] is in a position to co-operate more intensively with territories of foreign states than any other region of the Russian Federation. Moreover, provided Russia and the European Union move forward on their way to integration, the role of that co-operation can only increase.

Although reforms and the transformation to a market economy have been under way in Russia for the past 15 years, the Kaliningrad region in particular (and the country on the whole) is lagging badly behind its immediate neighbours Poland and Lithuania in terms of modernising the economy and social sphere, attracting investments, developing effective public policies and planning regional development.

How can policy avoid converting the opportunities and benefits of the region's specific geopolitical location into new strains and conflicts due to numerous problems of transition? How can it create a modern economy, society and governance in Kaliningrad within the shortest time frame possible, avoiding mistakes and misconceptions?

The answers may lie in the relevant best practice accumulated by neighbours (which find themselves to a large extent in similar conditions). However, it might not be enough to examine the lessons learned. Very likely, it would be even more important to acquire necessary practical experience through elaboration and implementation of joint development strategies, programmes, projects, etc. And that is how cross-border co-operation might become the cornerstone of Kaliningrad regional policies, and greatly facilitate the achievement of the region's socio-economic development objectives.

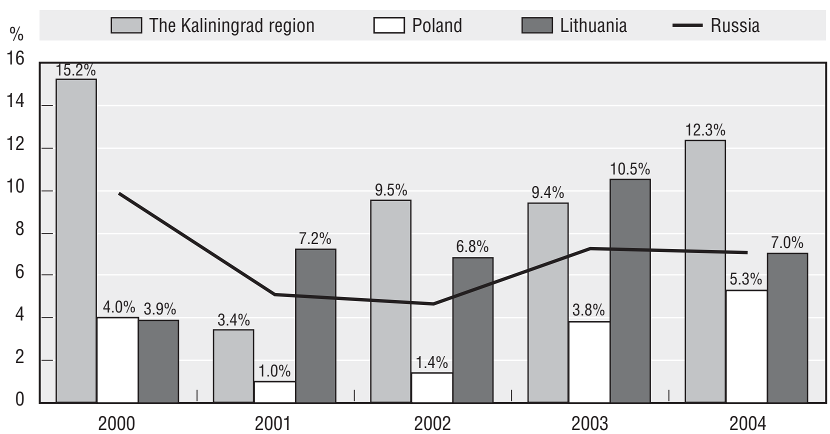
The context of EU-Russia relations

Current socio-economic situation

The Kaliningrad region is one of the smallest Federal entities of Russia, with a total area of 15.1 km^2 and population of 945 000 people. The only exclave of Russia, it is separated from the country's mainland by territories of the EU member states. In the 1990s it suffered a major economic decline, but is currently demonstrating one of the highest rates of economic growth in the country. This is mainly due to large-scale assembly and processing production that benefits from the advantages of the Special Economic Zone (SEZ) regime established in 1992 and modified in 2006.

In particular, the growth rate of gross regional product (GRP) in 2004 was 12.3% (compared to a 7.0% growth rate of GDP in Russia), and estimated to be 10.9% in 2005.

Figure 8.1. **GDP (GRP) growth rate in Kaliningrad, Poland, Lithuania and Russia, 2000-04**



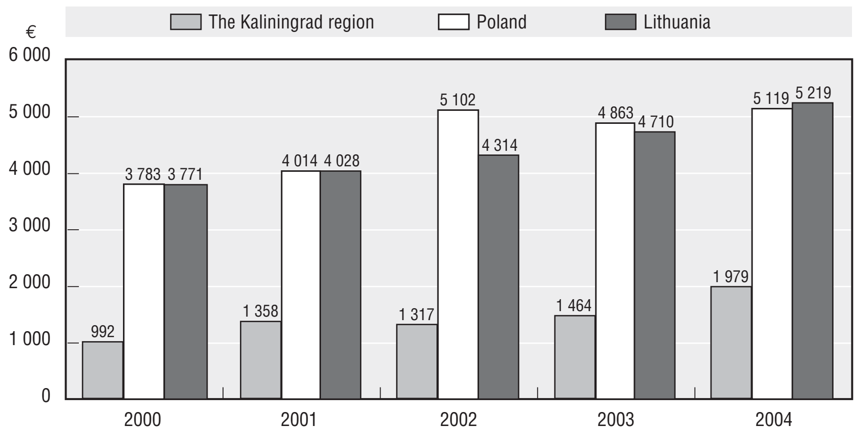
Source: Official website of the government of the Kaliningrad region: *www.gov.kaliningrad.ru*.

However, when compared by indicators of GRP/GDP per capita, the Kaliningrad region is still far behind its neighbours – Lithuania and Poland. This testifies to the low productivity level of the region's economy.

The recent economic growth has positively affected the real incomes of the population (they increased for 30.3% over 2005 alone), and contributed to improving the standard of living. The level of unemployment (calculated according to ILO methodology) has dropped from 7.1% in 2002 to 6.7% in 2005.

Despite this favourable economic background, the demographic situation in the Kaliningrad region remains difficult. Life expectancy in 2005 was below 62 years, while in Russia on the whole this indicator is above 65. The death rate has been twice as high as the birth rate for a number of years, and the population loss has been only partly compensated by migration (the inflow of migrants has in fact diminished in recent years).

Figure 8.2. **GDP (GRP) per capita (calculated according to Purchasing Power Parity) in Kaliningrad, Poland and Lithuania, 2000-04**



Source: Official website of the government of the Kaliningrad region: *www.gov.kaliningrad.ru*.

The place and role of Kaliningrad in the context of EU-Russia relations

Kaliningrad has a special role and place in EU-Russia relations and co-operation. Owing to its unique geopolitical location – Russia's "island" in the midst of the EU – the region finds itself in a double dependency: on the one hand on decisions made by the Russian federal authorities and on the other by the European Union. In other words, conditions determining the region's socio-economic development are regulated by Russian and EU legal acts. This primarily affects such vital areas as passenger and freight transit, trade, ecology, fishery and power supplies. Kaliningrad economic players have found themselves in a less favourable competitive position compared to companies from other Russian regions (due to increased transit costs) and from the adjacent border areas of EU (where there is a direct access to EU markets and substantial development aid from the EU funds). Were this to evolve into a widened socio-economic divide, or economic stagnation if the SEZ regime lost its appeal to key investors – with major productions shutting down due to unprofitability – potentially dangerous conflicts could develop.

In Russia's mid-term strategy towards the EU (2000-10) adopted in 1999, Kaliningrad is designated as a pilot region for bilateral co-operation and dialogue. At the Hague summit held in November 2004, the parties agreed to establish a standing working group on Kaliningrad that would serve as a negotiation mechanism; that group has not, however, been set up so far. Currently, high-level discussions are being held on a regular basis between Sergey Yastrzhembsky, RF President Special Envoy for Issues of Development of Relations with the EU (who also chairs the interdepartmental working

Figure 8.3. **The Kaliningrad region within Europe**

group on regional development issues) and Benita Ferrero-Waldner, EU Commissioner for External Relations and European Neighbourhood Policy. However, the dialogue so far has mostly referred to policy issues, rather than specific joint actions and programmes.

Overall, progress in solving Kaliningrad-related problems depends heavily on the state and dynamics of EU-Russia relations and co-operation. Due to its special geopolitical location and problems the region has faced in the aftermath of EU enlargement, Kaliningrad reflects the essence of EU-Russia co-operation: both its potential for further development and all of its current difficulties.

The role Kaliningrad plays is that of pilot and contact area with respect to the cross-border co-operation between regions of Russia and EU member states. The region has already actively participated in a number of EU initiatives designed to promote co-operation on the common EU-Russia border, such as the Northern Dimension, Euroregions, Interreg and others. It is the only Russian region which in 2003 received a grant of EUR 25 million from the EU in the framework of a special funding scheme to support regional development.

At the same time it should be noted that the Russian federal centre and the European Union pursue different interests as far as Kaliningrad is concerned. While Russia puts forward the issues of hard security (alienation of and loss of sovereignty over Kaliningrad in light of recent EU and NATO enlargements), the EU is more concerned with matters of soft security (illegal migration, cross-border crime, smuggling, pollution of the environment, the spread of diseases and trafficking in people). Different priorities are reflected in how the parties treat Kaliningrad, and in their approaches to problem solving. However, both parties acknowledge the importance of the socio-economic development of the region. And this is where their efforts may and should be joined, as the prosperous region may then more easily become an integral part of the Baltic Sea region, which will undoubtedly bring benefit to the overall partnership-building process.

The "Kaliningrad factor" of EU-Russia relations acquired a new dimension in 2005 with the adoption of the EU-Russia road maps for the common policy spaces: the Common Economic Space; the Common Space of Freedom, Security and Justice; the Common Space of Research, Education and Culture; and the Common Space of Co-operation in the Field of External Security. The Kaliningrad region can and should play a key role in establishing these spaces, although it may on the other hand hamper these processes in case its own problems get politicised.

Challenges and opportunities for Kaliningrad in the aftermath of EU enlargement

According to some expert estimates, the model of economic growth currently created in the region is rather artificial and may well prove unsustainable in the long run. One factor that may undermine the attractiveness of its local economy in the eyes of investors is Russia's upcoming accession to the World Trade Organisation, which will erode the core of customs benefits currently provided in Kaliningrad. The risks related to possible complication of transit procedures *via* the EU territory (Lithuania) should not be ignored either, considering the strong dependence of the local economy on freight communication with mainland Russia – a major market for local goods and the main source of raw materials supply. The consequent shutdown of many of local import substituting productions will inevitably result in higher unemployment and entail new economic problems.

Another issue is the new Law on the SEZ in the Kaliningrad region introduced in April 2006 and designed to attract large-scale companies at the expense of small and medium-sized businesses, as it stipulates provision of benefits to companies investing not less than RUB 150 million (about USD 5.5 million).

Thus the major challenge for Kaliningrad now is to build a *sustainable economy* (*i.e.* one based on SMEs and export-oriented companies) and to reduce the *socio-economic divide* between the region and adjacent border areas of EU member states (Poland and Lithuania), which may be further widened in case Kaliningrad's fragile economic model fails.

For the region to find its specialisation in the division of labour in the Baltic Sea region and accelerate its development, it should take advantage of its favourable geographic location and become a large international hub servicing cargo flows on the East-West and North-South routes between Southeast Asia and Europe – and in particular, mainland Russia and the EU member states.

In order to solve the problems mentioned above and attain development objectives, a number of specific issues that are closely interdependent should be addressed, such as: improvement of local governance through dedicated reforms and de-bureaucratisation of administrative procedures; efficient support developing SMEs; employment through better organisation of vocational training; internationalisation of local businesses; improved access to EU markets for local companies; development of engineering infrastructure; attracting foreign investment; development of tourism capacities, in particular through restoring medieval monuments, creation of new tourist facilities and services (agricultural tourism, water tourism, etc.); environment protection and rehabilitation; concessions, energy-saving and improvement of quality of public utilities.

As the experience of Lithuania and Poland (including their adjacent border territories) has shown, many of these problems can be successfully dealt with, provided the appropriate approach and expertise are applied. It would be prudent for Kaliningrad – which finds itself in similar conditions (transitional economy, similar geography and climate, a border coastal region, etc.) – to closely examine the lessons learned from the development of neighbouring territories.

One such lesson is to promote further cross-border co-operation at the regional and local levels.

Local governance in Russia: Kaliningrad's case

Local governance in the Kaliningrad region is implemented by the public regional and local authorities, which work jointly on developing respective territories and participate in cross-border co-operation with foreign states, in line with guidelines of the federal authorities.

Regional government

The regional authorities in charge of socio-economic development of Kaliningrad include the legislative (representative) branch – the Kaliningrad Regional Duma – and the executive branch – the governor and government of the Kaliningrad region.

The Regional Duma is responsible for approval of the regional budget and development programmes, which are submitted by the regional government. The Duma also exercises control over their implementation, and prepares progress reports and budget performance reports. The regional government meanwhile elaborates and implements public policy in the fields of finance, science, education, healthcare, social security and environment protection.

The following departments play the key role in preparing and implementing socio-economic development programmes: the Ministry of Economy, Ministry for Infrastructure Development, Ministry for Industry, Finance Ministry, Ministry for Social Policy and Labour, and Ministry for Agriculture and Fishery. The new government structure established in November 2005 is better suited to tackling regional development tasks than the previous regional administration. Especially welcome is the creation of the Ministry of Development of Territories and Liaison with Local Self-Government Authorities, which is to play a co-ordinating role in cross-border co-operation with regions of EU member states. Also worth mentioning is the Kaliningrad Governor's recent initiative (April 2006) to establish an Inter-Departmental Council for Development of Municipal Entities, which will be created within this Ministry and will be responsible for strategic planning for socio-economic development of the Kaliningrad region's municipalities. The Council will be formed from key stakeholders – officials, NGOs and representatives of business community.

Local self-government

Local self-government of the territory is organised in accordance with the statute of the region and in compliance with a legal framework based on the common principles and norms of international law, international agreements of the Russian Federation, the Constitution of Russia, and other legal and normative acts.

Currently, in Russia as a whole and in the Kaliningrad region in particular, reform of local self-government is under way with a view to making it more efficient and open (*i.e.* accessible *and* transparent) to people. This is done in line with the fundamental principles of the European Charter of Local Self-Government adopted by the member states of the Council of Europe in Strasbourg on 15 October 1985, joined by Russia on 28 February 1996.

A specific and essential feature of the current system of territorial organisation of public authority (local self-government and the territorial system of state authority at the local level) is the fact that it has been organised on the basis and within the boundaries of the administrative and territorial division that existed in the Russian Federation until 1993.

In accordance with the Article 12 of the Constitution of the Russian Federation, the authorities of local self-government are excluded from the system of state authorities. However, the lack of proper regulation of relationships between the state and local self-governing authorities is now considered one of the urgent issues in the public organisation of the Russian Federation.

In this connection, the President of Russia has stepped up an initiative to carry out a reform of local self-government within the Federation. To this end, the federal law "On the Common Principles of Organisation of Local Self-Government in the Russian Federation" was adopted 6 October 2003.

The main directions of reform in accordance with this law are:

- Creation of a conceptually new legal framework for local self-government on the federal, regional and municipal levels.
- Change of territorial organisation of local self-government through the introduction of a two-tier system, "municipal district-settlement", that will increase the number of municipal entities and alter the boundaries and legal status of existing municipal entities.
- Change of the structure of local self-government authorities (membership, competencies, ways of establishment).
- Modifying co-operation between settlements within a municipal entity, at the municipal level, and with the state authorities.
- Sharing of property between the Russian Federation, federal entities, and municipal entities.
- Creation of a new concessionary model of municipal economies.

The initial stage of the reform (*i.e.* determination of boundaries and status of municipal entities) has been completed in the Kaliningrad region: 36 municipal entities have been established (19 urban districts, 3 municipal districts, 4 urban settlements, 10 rural settlements) – 14 more than existed previously – of which 14 are attributed to municipal entities of the first tier and 22 to municipal entities of the second tier.

Experts note a particular feature of public activity in the region: Kaliningrad is the only federal entity of Russia where the level of voter participation in federal elections is, as a rule, lower than the country's average while the turnout for local elections is, on the contrary, higher.[2]

Figure 8.4. **The Kaliningrad region of the Russian Federation**

Thus the current reforms may contribute to the further progress of civil society in the region, by involving citizens in policy making through co-operation with the local self-government authorities, creation of effective Thus the current reforms may contribute to the further progress of civil society in the region, by involving citizens in policy making through co-operation with the local self-government authorities, creation of effective mechanisms of public control over local self-government authorities, and paving the way for citizens' organisations that can deal with local issues.

Russian and European experts mention two major trends in the existing practice of local governance. Some of them note the problem of a mechanical replication of outdated European legal norms and principles of local self-government in the Russian legislation: the issue of "verticality" of the Russian system of local self-government (*i.e.* incorporation of a territory of one legal entity into another), as well as differences in status of various municipal entities posing problems in establishing a hierarchy. At the same time they point to the positive dynamics of developing interregional (including cross-border and trans-border) co-operation among Russian regions.

However, a number of experts doubt if the commonly applied term "European model of local self-government" is appropriate at all, since they believe that there is and will be no unified system of local self-government in Europe.[3]

EU practice of local governance and regional development – The case of the Polish and Lithuanian border areas

Poland and Lithuania in the context of EU regional policy

Regional policy is now one of the most dynamically developing components of socio-economic policy in Poland and Lithuania. At the initial stages of market reforms in these countries, regional policies were virtually ignored, because governments had more pressing priorities. However, in recent years the significance of such policies has sharply increased, partly reflecting the new stage of transition to a market economy. While major macroeconomic reforms had been completed, a new spatial configuration of economic and social disparity emerged, which required the state's interference. Introduction of the basic principles of a well-reasoned regional policy had become especially important in light of the accession of these countries to the EU in May 2004.

In Poland and Lithuania, EU membership was considered not just as a chance for accelerated socio-economic development ensuring stability of democratic systems and the progress of civil society, but also as an opportunity to enhance their capacities for implementation of efficient regional policy. Of course, EU membership puts certain restrictions on an independent realisation of such policies and on the selection of corresponding tools. However, governments of these states are well aware that there is no alternative: without assistance from the European Union (EU structural funds and extensive experience in the implementation of regional policies), whole countries or their specific regions may find themselves at the periphery of the Union's development. In Poland, such a threat is real with respect to the eastern part of the country. In fact, only a few of the largest urban agglomerations and tourist and recreational areas are capable of sustainable development. The situation in Lithuania is quite similar.

The socio-economic policy of local authorities in border areas of Poland

In 1999 Poland carried out administrative and territorial reform that radically changed the institutional, legal and other frameworks for implementation of regional policy. Among the motives behind this were the requirements of the European Union with respect to sizes of administrative entities and their competencies. Poland has returned to a three-tier administrative and territorial division. After a quarter of a century of existence, the former 49 voivodeships have been consolidated. The country is now divided into 16 new voivodeships, 373 *powjats* and 2 489 *gminas* (communities). It is worth mentioning that in the course of the reform the rights of territorial self-governance have been substantially extended. Basically, the voivodeship has become an independent regional policy actor, determining its own objectives and priorities. While remaining a unitary state, Poland has perhaps made the greatest progress among the countries of Central and Eastern Europe on its way to power decentralisation.

In practice, the "balance of powers" in implementation of regional policy between the centre and voivodeships is determined by the ratio of self-government's[4] own financial resources to funds allocated from the central budget and other sources. So far however, those ratios have not favoured territorial self-governments, despite the ongoing process of decentralisation of public finances.

Among the basic tools to address that contradiction are the so-called voivodeship (agreement) contracts implemented in the legal framework of the "Law on Principles of Support to Regional Development" adopted in 2000. The first agreements with voivodeship's self-governing authorities were concluded in July 2001.

The agreements allow these authorities to receive subsidies from the state budget to implement tasks set in their development strategies and programmes in accordance with objectives and priorities of the government. Funds of the Phare Programme and similar budgetary sources also contribute. Practically speaking, the voivodeship agreements have been the first attempt at financial planning of mid-term development programmes. They cover virtually the whole country, while until now most of the funding has been received by area, which can lead to socio-economic marginalisation. The border areas include those adjacent to the Kaliningrad region – the Podlaski and Warmia-Mazury voivodeships.

New forms of implementation of regional policies by voivodeship authorities have emerged with Poland's accession to the EU. The Warmia-Mazury voivodeship neighbouring the Kaliningrad region can serve as an illustration.

In this region, the Strategy of Socio-economic Development for the period to 2015 was adopted in 2000 and set the framework for implementation of regional policy. It is based on the use of the voivodeship's main advantage: its favourable environmental situation (clean atmosphere, nature, etc.) and support to three associated sectors of economy – agriculture, tourism and environmentally friendly industrial production.

In addition to the Strategy, a Voivodeship Plan for Regional Development for 2004-06 was approved in 2004. Its priorities have been linked with the main directions of national regional policy. In fact, three out of four objectives of this Plan elaborate the priorities of the Integral Programme for Regional Development in more detail, while the fourth is determined by "improvement of conditions for the region's socio-economic development in border areas".

This convergence with national regional policy has been further reflected in voivodeship's plan for regional development, containing activities eligible for funding from the EU initiative for interregional co-operation – Interreg III A. The priorities for this part of the plan are:

- Increased competitiveness and labour productivity in the area of interregional economic, scientific and technical co-operation.
- Support for co-operation among peoples, social and cultural integration, and integration of the labour market.

The main proportions of sectoral distribution of funding from the EU Structural Funds in the Warmia-Mazury voivodeship are as follows: development and upgrade of infrastructure with a view to ensuring growth of competitiveness (priority 1) – 55.8% (of which 25.4% is allocated for upgrade and development of the transport network; development of the economic framework and human resources (priority 2) – 20.8%; local development activities (priority 3) – 22.4%.

Socio-economic policy of local authorities in border areas of Lithuania

In Lithuania, as in Poland, there is a well-tuned system of regional planning at all levels. One of principles ensuring its uniformity is translation of all-national priorities to the lowest decision-making level. The Plan for Regional Development (PRD) of the Klaipeda County for 2001-06 may be considered as an example. It is worth mentioning that along with it, a comprehensive plan for regional development has been prepared for a longer-term perspective; its title is “Western Lithuania: 2020”.

In accordance with the National Development Plan, the following priorities have been set in the Klaipeda’s PRD: SME development; development of agriculture and restructuring of basic sectors of economy; employment and vocational training; development of science and education; development of paid services, tourism and leisure; development of the social support system; development of transport infrastructure; environment protection.

One of key targets for Klaipeda County’s PRD is to ensure sustainable development by means of accomplishing the following tasks:

- To decentralise economic and urban development, *i.e.* to restrict concentration of the population and economic activity in the county’s main centres – the towns of Klaipeda and Palanga.
- To mobilise capacities of self-governance for economic development.
- To protect the environment in non-urbanised areas.
- To harmonise the international co-operation plans, objectives and projects of the self-governments of Klaipeda county with the development of the Baltic Sea region.

In 2001 a strategic development plan was adopted also at the lower level of self-government, *i.e.* In the town of Klaipeda. It sets the following priorities:

- Creation of jobs through attracting investments and promoting entrepreneurial activity.
- Development of infrastructure with a view to improving conditions for entrepreneurship, work and life.
- Enhancement of integration between the town and the port.
- Development of housing facilities and improvement of their quality.
- Development of education, science and culture.

One should take account of the fact that successful realisation of some of priorities of the strategic plan aimed at enhancing competitiveness of Klaipeda – as an intermodal transport junction and a large cargo and passenger port – may directly affect the competitiveness of Kaliningrad as Russia's hub on the Baltic seaside. Thus, it is important to consider them in more detail, especially the "enhancement of integration between the town and the port". This priority has been subdivided into two objectives: balanced development of the town and the port, as well as efficient use of port capacities, and ensuring development of Klaipeda as an intermodal transport junction. The first objective includes the following tasks:

- Elaboration of integrated (coherent) plans for developing the town and the port.
- Strengthening urban integration of the port (*i.e.* its integration into the urban environment).
- Strengthening impact of the municipal self-government of Klaipeda on the port's administrative processes by establishing the appropriate institutional and legal framework.

With a view to solving the above-listed tasks, the Strategic Plan foresees implementation of a number of activities: supporting growth of transit freight flow via Klaipeda; rehabilitating municipal areas around passenger and cruise terminals in an effort to improve services for tourists and seamen; and improving architectural appearance of Klaipeda from the sea.

Attainment of the second objective – ensuring development of Klaipeda as an intermodal transport junction – includes, in particular, implementation of the following activities: construction of frontage and bypass roads, support to establishment of logistics centres, construction of terminals for passenger ferries, as well as corresponding roads and parking lots; and development of river transport lines, connecting Klaipeda with other Lithuanian towns and recreation centres.

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A tool for transforming best EU practice of local governance into the region of Kaliningrad

Cross-border co-operation (CBC), a unique tool for solving local problems of border territories plays an important role in implementing foreign economic and foreign political strategies of states. At present, it may accelerate development of economically weak regions. National borders and legal frameworks obstruct the of free movement of goods and services between countries with a view to meeting national interests of states, while the activity of international and regional institutions designed to promote cross-border co-operation, on the contrary, supports integration processes.

Cross-border co-operation in regions is affected by the following relationships:

- Relations at the state level, regulated by central governments pursuing national interests.
- Relations of a border region with its national capital, depending on the former's role and place in the national political and economic frameworks.
- Interstate "direct" links between the adjacent border territories, determined by local administrations pursuing their local interests and by their respective capacities.
- Relationships between border areas within each country, including their solidarity and capacity to defend their specific interests to the central government.

The situation in the area of cross-border co-operation is also defined by economic and social factors, ranging from economic specialisation, public perceptions, and political cultures and actors to educational, healthcare and social protection frameworks.

Regional cross-border co-operation is widely supported in the European Union as a strategy promoting political and economic independence. From the 1950s the EU began to establish *Euroregions* in Western Europe, formed from border areas of two or more states. The nature of co-operation within Euroregions, its objectives and tasks, priorities and conditions of functioning is determined in each particular case by provisions of respective agreements concluded between the participating parties.

Co-operation does not threaten territorial integrity of states, but organises and regulates neighbour relationships at local and regional levels. The experience acquired by EU member states has demonstrated that Euroregions may substantially enhance the efficiency of economies. Co-operation in practice may also be considered as an additional backing for integration of neighbouring states.

The legal framework in the Russian Federation

According to the Constitution of the Russian Federation, foreign affairs are under the exclusive mandate of federal authorities. Therefore, cross-border co-operation in Russia is regulated by a number of federal legal acts in addition to the RF Constitution. These are listed below.

Concept of Cross-Border Co-operation in the Russian Federation (adopted in February 2001) spells out goals, principles and priorities for authorities at the federal, regional and local levels. CBC is seen as the co-ordinated activities of all three levels of power aimed at strengthening co-operation of the Russian Federation with the neighbouring states in order to achieve sustainable development of the border areas. According to the Concept, the federal/regional authorities, local administrations, legal entities and all actors have a role to play in CBC. Thus, the main mandate (to adopt international agreements, to implement federal programmes for CBC, etc.) is assigned to the federal authorities while regional authorities may co-operate within their competence with the regional authorities of the adjacent border regions and, on a case-by-case basis (upon RF Government approval), with the governments of foreign countries.

In July 2002 the European Outline Convention on Transfrontier Co-operation between Territorial Communities or Authorities was ratified by the Federal Law of Russian Federation. It provides for a definite set of policy tools to fill in the legal vacuum in Russian legislation in this field. However, the key principle of the European convention is that of local self-government, while in Russia cross-border co-operation is carried out at all levels of power: federal, regional and local self-government authorities.

The Federal Laws of the Russian Federation on Co-ordination of the Foreign and Foreign Economic Co-operation of the Regions of the Russian Federation and the Agreement on Cross-Border Co-operation in the Field of Research, Extraction and Procurement of Natural Resources were adopted in May 2001.

All these documents and legal acts have laid down the legal foundation for CBC at the regional level. They are in line with the main CBC principles elaborated by the EU and international organisations.

Analysis of the current state of cross-border co-operation in the Kaliningrad region

According to some experts, the current state of CBC between the Kaliningrad region and the adjacent areas of Poland and Lithuania corresponds to a *gradient model*,[5] characterised by such forms of co-operation as implementation of joint projects and establishment of standing working groups, and cross-border trade as one of fields of co-operation. However, some more advanced types of cross-border co-operation, already applied elsewhere, may be appropriate for the Kaliningrad region as well. One example is the *contact model*, when parties from the both sides of the border establish joint institutions and implement joint programmes, co-operating in the field of culture, social contacts, and economy (cross flow of factors of production, joint investment projects, etc.).

Owning to its special geopolitical location, Kaliningrad has become one of the key targets and *beneficiaries* of EU policies aimed at supporting cross-border co-operation based on strategic goals: opportunities to open up new markets; interests of European security, political stability and economic cohesion; opportunities to avoid negative consequences of competition between the regions; development of national/regional economies in post-socialist countries.

A significant outcome of CBC programmes funded by the European Union is the establishment of Euroregions on the border with Russia. Companies, educational institutions, scientific and research centres, authorities and NGOs have gained new ways for co-operation, acquired know-how and established networks in border areas of Russia. This serves as a good basis for developing business relations, as well as for support and promotion of existing forms of co-operation.

The municipal entities of the Kaliningrad region have become members of such Euroregions as the Baltic, Neman, Saule, Shishupe and Lyna-Lava, designed to smooth the differences and gaps in levels of socio-economic development of participating territories; to jointly solve environmental problems; to eliminate imbalances in employment and production; and to remove cultural and language barriers.

The Euroregion "Baltic", where the Russian side assumed presidency in March 2006, may be considered as an example of *good practice* of such co-operation. In 2005 the Euroregion elaborated its own Development Strategy and Joint Development Programme in the framework of the project Seagull DevERB.[6] These documents define specific priorities of co-operation for the six parties involved (local and regional authorities from Russia, Sweden, Denmark, Lithuania, Latvia and Poland). In accordance with the Programme, co-operation objectives shall be achieved through implementation of a project (Seagull II) designed to strengthen institutional framework and capacities for spatial development of the Euroregion. Particularly, it aims to transform the Euroregion Baltic into a prosperous area with good living conditions by 2015. By that time the Euroregion should be internationally recognised as a leading region in terms of sustainable development and integration of old and emerging market economies in the Baltic Sea region, demonstrating real socio-economic cohesion.

Creation of Euroregions within the Kaliningrad region is justified by a number of factors. Firstly, Euroregions enhance the capacity of local authorities to solve problems quickly and efficiently, using local potential coupled with material and technical assistance rendered by Euroregion partners. Secondly, Euroregions represent a new framework in the field of regional development management that is more efficient than existing models. They provide favourable ground for creation and development of innovative structures (incubators, technoparks, venture firms, etc.). Euroregions have a positive influence on regional economies through demonstration and teaching effects. Thirdly, a Euroregion as a structure differs from a state, and so is more effective in attracting investments. This is especially the case with Kaliningrad, where raising investments may be one of the key ways of ensuring accelerated regional development. Fourthly, Euroregions may help to transform Kaliningrad into a growth pole (a region with a particular capacity to attract and efficiently utilise investments) of the Russian economy, since they allow a coupling of local organisational and financial capacities with resources from the neighbouring states and funds from the European Union.

However, some researchers indicate that Euroregions on the EU-Russia border are as yet far from attaining their ambitious objectives.[7] Despite generous project subsidies, real co-operation has only been established in a limited number of fields. The experience of most Euroregions has shown that the private sector is weakly represented in cross-border co-operation, and difficulties remain in involving it further.

From the year 2004 a special programme for developing co-operation has been in operation, titled the Lithuania, Poland and Kaliningrad Region of Russian Federation Neighbourhood Programme.[8] This initiative is designated for collaboration of NUTS III administration-level border territories in 2004-06. It is co-funded by the European Regional Development Fund and TACIS.

The Programme territory covers Klaipėda, Tauragė, Alytus and Marijampolė counties (21 local governments) in Lithuania, the Pomorskie (Słupski, Gdański and Gdańsk-Gdynia-Sopot subregions), Warmia-Mazury (Elbląski, Olsztyński and Ełcki subregions) and Podlaski (Białostocko-Suwalski and Lomżyński subregions) voivodeships in Poland, and the entire Kaliningrad region. The overall area of the regions taking part in the programme is 97 284 km^2 with the population of 6 730 000.

Co-operation in the Kaliningrad region is also promoted through international and network organisations: at the inter-governmental level – the Council of Europe; the Council of the Baltic Sea States;[9] the Lithuanian-Russian Council for Long-term Co-operation between Regional and Local Authorities of the Republic of Lithuania and the Kaliningrad Region; the

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Polish-Russian Council for Long-term Co-operation between the Regions of Poland and the Kaliningrad Region; the Council of the Baltic Cities, the Baltic Sea States Subregional Co-operation; the Baltic Development Forum; the Northern Dimension; and others. A number of international donor and research institutions have also been quite active in Kaliningrad, including the Bosch Foundation, the Batory Foundation, the EastWest Institute, SIDA, C.S. Mott Foundation and others.

Despite all the efforts and initiatives to promote cross-border co-operation in the Kaliningrad region, one should acknowledge that so far only a limited number of actors have been involved (authorities and NGOs) and for the most part have remained at the macro (regional) level, while participation of particular citizens or other entities at micro level has been extremely low. This may partly be due to insufficient promotion of CBC opportunities (coverage in the local mass media, etc.). However, the main reason is likely related to a lack of experience in project management among the majority of the organisations and individuals that could be involved.

Policy and action recommendations to regional and local authorities

Studying the cross-border co-operation best practice and policies and monitoring the regional development of adjacent border areas Poland and Lithuania are vitally important for the success of socio-economic development of the Kaliningrad region, for two reasons.

Firstly, many problems of the Kaliningrad region and its Polish and Lithuanian neighbours are quite similar. Thus approaches to their solution may also have much in common. Of course, capacities to carry out regional policies in Russia and in new EU member states differ. This is not just about funding capacities, but also about the fact that Polish and Lithuanian regions have become the targets and actors of regional policy in the European Union, and have accumulated significant positive experience in this field. The new EU members have received what Russia is badly lacking: an up-to-date and integrated (in the proper sense of the word) approach to regional policy, with well-tuned mechanisms for stage-by-stage cohering of regional and sectoral development programmes and programmes for local development of territorial units of different tiers.

Nevertheless, the experience of problem solving of Polish and Lithuanian border areas should be examined and, to a considerable degree, be applied in the Kaliningrad region.

Secondly, the development of adjacent regions of Poland and Lithuania will both inevitably and greatly affect (both positively and negatively) development of the Kaliningrad region. On the one hand, neighbours may achieve higher levels of competitiveness in sectors that are or may become the fields of specialisation for Kaliningrad's economy. On the other hand, development of Polish and Lithuanian border areas may stimulate development of the Kaliningrad region itself.

Issues for consideration

Considering the above, it would be prudent for the Kaliningrad regional and local authorities:

1. To carry out *monitoring of socio-economic and political development* of border areas of Poland and Lithuania with a view to:
   - Ensuring timely *response to changes* in Polish and Lithuanian border areas that represent new opportunities or pose new threats to the development of the Kaliningrad region.
   - Identifying *positive and negative experiences of implementation of regional policies* in border areas of Poland and Lithuania in order to use or take account of them in the Kaliningrad region.
   - Analysing *strategies of regional development* elaborated in the *framework of EU regional policies*; the *attractiveness of special economic zones* in Lithuania (Klaipeda county) and in Poland (Warmia-Mazury voivodeship); and the experience of establishing and supporting *technoparks*.[10]
2. To elaborate a system of adequate *measures* to *compensate the existence of new border barriers* that isolate the Kaliningrad region from its foreign neighbours. The system's overall objective should be to strengthen contact functions of the Russian-Polish and Russian-Lithuanian adjacent border areas, as well as those of the Kaliningrad region as a whole.
3. To examine the experience of and new trends in relationships between state authorities and local self-governments at the level of large regions – Polish voivodeships (there are no similar regions in Lithuania), as well as self-government authorities of different tiers. In this context special attention should be paid to the division of functions between a representative of a government (a voivode) and self-government authorities.
4. To study the *role and place of cross-border co-operation* in local development (how it corresponds to development plans, etc.) and to learn how CBC had been organised at the EU border before its enlargement in 2004. In this respect, the lessons learned from co-operation between adjacent border communities on the Polish-German border may be of special benefit to the Kaliningrad region (Lithuania is not involved here, as it had no common border with the EU). Special emphasis may be placed on analysing *promotion of citizens' participation in the CBC* (the so-call *bottom-up approach*) and organisation of *communities* as CBC actors at a *micro level*. (The bottom-up approach also existed in Russia until 1917, but has been lost over the past decades.) Relevant Polish-German

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good practice may be transferred by implementing a specific project aimed at development of joint strategies for co-operation between Russian and Polish adjacent border communities (in the fields of socio-economic development, security and environment protection).

5. To study EU *good practice of integrated border management* (for instance, on the Polish-German border) as a key factor facilitating cross-border co-operation (the movement of people and goods).

Action recommendations

1. *Reform of the local self-government.* Lessons may be learned from the Polish and Lithuanian experience with respect to solving issues of territorial division of municipal entities, mechanisms for involving citizens in issues of public significance, encouragement of public reactions to vital issues, coverage of reform of local self-government in the mass media, etc.
2. *Reform of municipal finances.* The important issue for successful participation of municipal entities in CBC is the organisation of their finances, *i.e.* the degree of transparency and efficiency in spending. In this regard, it would be prudent to take account of budgetary techniques applied by municipalities in Lithuania and Poland, with a view to learning their best practice.
3. *Enhancement of the efficiency of municipal economies* through concessions, energy-saving and improving the quality of public utilities and improving the state and functioning of water treatment plants. One of the urgent issues in the towns of the Kaliningrad region, as well as in Russia as a whole, is to improve the efficiency and quality of services of the public utilities sector. Substantial relevant experience has already been accumulated in the neighbouring countries, for instance in Lithuania. Authorities in the city of Vilnius have already successfully implemented a reform resulting in concession of public utilities to a French concern that won the tender, and in ultimate improvement of quality of services and a drop in tariff rates of 8%.[11] It would be prudent to learn how potential private investors may be attracted into the public utilities sector with a view to making it cost-effective. To this end, local authorities in the Kaliningrad region should co-operate with their colleagues from adjacent regions and learn the mechanisms of conducting international tenders (including samples of the documents required), building relationships with investors, etc.
4. *Public-private partnerships.* It is obvious that upgrading infrastructure in the Kaliningrad region to European standards requires considerable investments; public funds alone may not be enough. That is where private funds may have a role to play, as companies are the first to benefit from improved infrastructure. It may be of a special interest to learn the mechanisms of

public-private partnerships developed in Poland and Lithuania, to see how infrastructural issues may be jointly solved in Kaliningrad.

5. The *establishment of representations* of the Warmia-Masury voivodeship in Kaliningrad currently being discussed should be supported. It would be prudent to consider establishing representations of other adjacent Polish and Lithuanian regions in the Kaliningrad region and, correspondingly, representations of the Kaliningrad regions in the respective adjacent border areas. Such representation offices may ensure direct liaison, ultimately resulting in closer cross-border contacts and co-operation.
6. Establishment of a *Tri-national Border Contact Centre*. Such a structure has been advised by an expert on integrated border management as a tactical operational unit for cross-border co-operation and co-ordination of all border-related issues. It should include representatives from Russian (Kaliningrad), Polish and Lithuanian authorities (Burkhart, 2005). It could serve as a platform for transfer of integrated border management concepts, and for monitoring of the actual practice of border management.
7. *Active involvement in the common information flows and exchanges* in the Baltic Sea region through establishment of the Common Information Space of the BSR. The concept of the space developed by the Council of Baltic Sea States involves promoting the removal of information barriers. The Kaliningrad region, surrounded by borders, may benefit most significantly from such a space. It would be prudent to consider establishing a pilot common information space between the Kaliningrad region, Poland and Lithuania.
8. *Trade and investment promotion*. Information support and dissemination as well as technical assistance are the tools actively employed by the EU in its policy towards Russia. This has also been the case for Kaliningrad. Initiatives such as establishment within the Kaliningrad Regional Economic Development Agency of a Virtual One-stop Shop for Investors – designed to support enterprise startups and provide consulting and assistance on legal issues, including registration and functioning of joint ventures, licensing, financial reporting, etc. – and a Business Information Center (on EU legislation) – the result of a TACIS project for the region – should be supported and further promoted. These would help attract foreign investors and promote exports from the Kaliningrad region by easing access for local companies to EU markets. It would be prudent to establish a network of such agencies from the Kaliningrad region and the Polish and Lithuanian adjacent border regions.
9. *Joint development of tourism*. Tourism has been acknowledged as one of the key viable sectors for sustainable development in the Kaliningrad region and adjacent Lithuanian and Polish border areas, a fact reflected in their

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respective regional development strategies. Taking account of similar and common features of these regions (Baltic Sea coast, common historic heritage, etc.), it would be prudent to initiate elaboration of a joint concept and strategy for tourism development. This would include an exchange of know-how, development of joint tourist routes, joint promotion campaigns abroad, etc. One of the specific proposals in this field stems from the fact that all these regions are renowned for amber: in the Kaliningrad region there is the largest deposit of amber in the world, in Palanga (Klaipeda county of Lithuania) there is a well-known amber museum, and Gdansk in Poland is renowned for amber trades. The proposal is to establish amber tourist routes and joint festivals on a regular basis; that would strongly unite all the adjacent regions and promote co-operation among them.

10. *EU-Russia Kaliningrad Pilot Partnership Programme.* It is recommended to initiate a proposal to Russian Federal and EU authorities elaborating a new mechanism of joint socio-economic development of the Kaliningrad region similar in design to the Northern Dimension Environmental Partnership. Such a framework may not just improve the co-ordination of funding currently allocated to Kaliningrad by the Federal authorities and European Union, but also attract resources from international finance institutions and the public sector, thus substantially enhancing financial capacities and increasing the number and scale of investment projects.

Conclusion

This chapter provides an overview of policies implemented in the border areas of Poland and Lithuania adjacent to the Kaliningrad region. In general, those policies refer to improvement of local governance and elaboration of development strategies in the framework of the EU regional policy, and might be useful for the Kaliningrad region.

Ignoring this existing experience is hardly justified, especially when the socio-economic development objectives of the Kaliningrad region are similar to those of the Polish and Lithuanian neighbouring areas, while the living standard in those areas is taken as a reference point for planning the regional development of Kaliningrad.

Therefore, adjacent EU regions should be considered not just as economic rivals or partners for Kaliningrad, but as role models as well. It would therefore be prudent to establish monitoring of their development on a regular basis, which will allow more useful lessons and practices to be learned and help Kaliningrad become more competitive and better prepared for co-operation.

An effective framework and tool for transfer of relevant best practice is interregional co-operation with foreign partners on specific issues of common interest. The role of cross-border co-operation for Kaliningrad can only grow, alongside evolving EU-Russian relations. The importance of Kaliningrad will also grow, as a pilot region for designing and testing the new mechanisms of bilateral partnerships – first and foremost in the field of interregional co-operation and dissemination of lessons learned to other areas of the EU-Russia common border.

Notes

1. In this paper "Kaliningrad" refers to the whole territory of the Kaliningrad region.
2. Foundation for Information Policy Development: *www.frip.ru*.
3. Conference Report "Federalism and Local Self-Government in the Context of European Integration", Pskov, 29 April 2005.
4. "Self-government" includes both branches of power on the local level, while "government" is solely the executive branch.
5. International Youth Summer School: *http://summerbaltika.hse.ru*.
6. Government of the Kaliningrad Region official website: *www.gov.kaliningrad.ru*.
7. *www.auditorium.ru,* Euroregions with Participation of the Kaliningrad Region as a Pilot Model for the Use of European Experience of Cross-Border Co-operation in Russia.
8. Official website of the Interreg Joint Technical Secretariat (JTS): *www.interreg3a.org*.
9. It is worth mentioning CBSS recent initiative to establish the Common Information Space of the Baltic Sea Region, where Kaliningrad might play a pilot role.
10. The creation of a technopark has been declared as one of priorities by the Kaliningrad Governor G. Boos (*www.kaliningrad.ru*).
11. Kaliningrad City Administration official website: *www.klgd.ru*.

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Baltic Partnerships
Integration, Growth and Local Governance in the Baltic Sea Region

Chapter 9

The Possibility of Creating Regional Governments in the Baltic States: the Case of Latvia

by
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Contrary to other EU member states, Latvia has not yet addressed the issue of whether it should establish a regional tier of government. If strong and directly elected, such governments could become a driving force of regional development in Latvia. The regionalisation process is a complex one however, as politicians often hope to balance the interests of important groups – entrepreneurs, political parties, self-governments of big cities, local governments, ministries and the inhabitants of rural municipalities and small towns. The existence of large-scale regions would help decrease economic and social regional disparities.

A prolonged period of decision making in Latvia has not yet led to a conclusion as to whether that country will establish large-scale regional governments. The aim of this chapter is to evaluate why previous efforts to establish that type of self-government were not successful, as well as to offer a solution of the problem. It describes the main interest groups connected with the regional reform, examines the influence of economic, social and political factors and compares tendencies with those in the countries of the European Union.

Need for the regional reform was already recognised in "The Concept of Self-Government Reforms" elaborated in 1993 (The Cabinet of Ministers, 1993). The law "On Administrative Territorial Reform" adopted in 1998 [the Saeima (Parliament), 1998] provided for the establishment of this kind of local government, and the Declaration of the Cabinet of Ministers of 2004 envisaged the creation of large-scale regional governments. Yet to date, the political decision has not been adopted.

Why? The simple answer is that in the majority of Latvian society it is not thought that such a regional reform is necessary. Opponents of the reform are easily gaining support while reform supporters face difficulties.

This is related to the fact that the Latvian nation has been its own country for a very short period. Many consider it necessary to consolidate the state as *the* governing entity, which would mean not allowing other forms of territorial power to develop, but rather limiting and subordinating them as much as possible to state control. The idea that developed and democratic local governments are sustaining and not weakening the state is not very popular in Latvian society for the time being.

On the other hand, were the political and intellectual *élite* to argue cogently in favour of establishing large-scale regional governments, reform would indeed be possible.

Some lessons from regionalisation in the EU

After the Second World War, Germany and Austria were reorganised as federative states. Still, the hopes of the victor countries to weaken these states politically and preclude their economic development by decentralising their power were not realised. On the contrary, regional variety in Germany greatly contributed to that country's development; its position of economic leadership in Europe was further secured with each passing year. What took

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place clearly ran contrary to the established belief that political centralisation facilitates development.

In the 1970s and 80s, reforms in the local government framework were planned in several European countries. These were meant both to establish directly elected regional governments and to unify local governments so as to establish larger administrative territories. The motivation was mainly connected with economy of scale – the belief that a bigger scale held clear advantages both for the production of goods and services and for public administration. But the reformers frequently faced resistance from society at large – the implemented reforms were either unpopular (as happened in Denmark) or the proposals for the regionalisation did not get support in referendums (as happened in the United Kingdom).

At the beginning of the 90s, when the EU was implementing its policy of four basic freedoms – the free movement of goods, services, persons and capital – the threat of massive immigration to territories more advantageous economically and socially became apparent. EU countries increasingly saw the need for common effective regional policy. Underdeveloped territories needed to covey the message to people that immigration is not the sole solution to their problems.

What was eventually chosen to "equalise" the various levels of development was an administrative-territorial scale second in size only to the state territory. It was thought that at that level, territorial particularities can be taken more fully into consideration and development is more easily planned and managed. Both the financial resources from the Objective 1 programme of the EU Structural Funds and the resources from the EU Cohesion fund were directed to the regions on this scale (facilitating the process that became known as "regionalisation"). Regionalisation came into effect via two lines of action: the consolidation of existing local governments, and the establishment of new regional governments.

It follows that several forms of regional administration have been established in the EU. Member states can thus be categorised as follows (see Table 9.1):

1. Federal states.
2. Five unitary states with local governments of three levels.
3. Nine unitary states with local governments of two levels.
4. Eight unitary states with local governments of one level.

Regional governments have been established in the last decade in five countries: Ireland (1994), the United Kingdom (1998 and 1999), Poland (1999), the Czech Republic (2000) and the Slovak Republic (2002). In the United Kingdom regional assemblies were established in Northern Ireland, Scotland

Table 9.1. **Countries classified by form of regional administration**

Group	States	Form of regional administration	Description
1.	Germany Austria Belgium	16 states 9 states 1 region and 2 communes	There are regional parliaments, whose competence separate from the competence of state
2.	France Ireland Italy Poland Spain	22 regions 8 regions[1] 20 regions 16 regions 17 regions	Different degrees of autonomy. Responsibility for the planning of development and management
3.	Czech Republic Denmark Greece Hungary Latvia Netherlands Slovak Republic Sweden United Kingdom	14 regions 13 regions[2] 50 departments 19 regions 26 districts and 7 major cities 12 provinces 8 regions 21 regions[2] 36 local governments of "larger scale"[2]	Regions implement the administration of state laws, and they have independent budget. Different degrees of autonomy
4.	Cyprus Estonia Finland[4] Lithuania Luxembourg[3] Malta Portugal[1] Slovenia	There are no local governments in the regional scale	The de-concentrated administration of the state is functioning at the regional level

1. Indirectly (by local politicians) elected decision making institutions of local governments; this only partly applies in the case of Portugal.
2. Because of political considerations they are referred to as larger-scale local governments, not regional governments.
3. The regional administration level does not exist.
4. Effective co-operation of local government in the regional level.

Source: Falzon, 2004.

and Wales. In Hungary it is planned to establish larger-scale regional governments to replace the existing seven planning regions. In Lithuania discussions are under way about establishing five regional governments. In many cases regionalisation was connected with the aim of implementing regional development more effectively. This was especially true of the Objective 1 regions of the EU (Committee of the Regions, 2003).

As Latvia is experiencing growing regional disparities, it should take into consideration the regionalisation experience of other member states.

Regional reform and interests groups

While rational planning is the notion popularly associated with Latvia's public administration (Cabinet of Ministers, 2001), a more appropriate framework for analysing regional reform is the theory of groups – *i.e.*, that the basis of political decisions is not a "common benefit" for society, but the balancing of interests of different groups.

While it is not possible here to analyse all groups and their connection with regional reform in more detail, it is nevertheless useful to note several of the important interests.

The interests of entrepreneurs cannot be estimated with any exactitude. The small and medium-sized entrepreneurs could expect that decentralisation of state power to regions would increase their opportunities to receive government support. The large entrepreneurs might, on the other hand, prefer the centralised development model. Currently the possibilities for gaining profit in the territories, where capital circulates more rapidly because of better infrastructure, are not being explored. This means that vast majority of entrepreneurs, whose influence on political parties can be decisive, do not yet feel the need to equalise the development of Latvia's regions. It also signals a negative attitude toward regional reform.

The interests of political parties are mainly tied in with the Saeima elections. There are first and foremost questions about more or less advantageous electoral constituencies and about the possible influence of regional governments on election results. If regional reform were to become an issue on the political agenda, the parties could at least argue for or against it in relation to strengthening the support of interested regional development voters. As it stands, the long-term political indecisiveness about placing it on the agenda indicates vast uncertainty on the part of the governing political parties about their success in the elections of regional governments.

The interests of major cities are connected with both historical tradition and the major influence they currently wield over political and economic processes. Ever since the Middle Ages, cities have tried to gain more autonomy. At the moment they are fulfilling the functions of both district and local government. Establishment of regional governments on a large scale could mean that these cities would be absorbed into regions and so lose some of their functions to regional powers. That prospect can place the governments of major cities in opposition to regional reform.

The interests of local governments result from their endeavours to gain support from the inhabitants of their respective territories. These endeavours involve carrying out tangible, visible development activities, the results of which the inhabitants can "use" daily.

On the one hand, the local governments of cities and rural municipalities have permanently been in competition with districts, disputing the latter's competence and trying to transfer that competence over to the local scale. This process, until now facilitated by the state, has not always led to rational results. Transformed competencies are not suitable to the smallest government scale, as evidenced by the high amount of mutual payments among local budgets. The solution is sought in the development of larger-scale local governments – amalgamated municipalities – and not in transfer of functions more appropriate to the regional level.

On the other hand, the present 26 district self-governments defend local governments from the excessive intervention and control of central government. As districts in Latvia do not represent a second level of local government but form larger-scale one-level local governments together with towns, rural municipalities and amalgamated municipalities, they do not have control, monitoring or co-ordination functions. Co-ordination of interests in the district is implemented on a voluntary basis among district councillors who are mayors of corresponding local governments, and the district cannot give any instructions to local governments. Thus the existence of districts is the factor enabling local autonomy.

Local governments look to possible establishment of larger-scale regional governments with both hopefulness and suspicion. The critical question is whether their creation will lead to the establishment of regional governments functioning at a superior level.

The interests of ministries in this context derive from efforts to develop and improve their performance. Every official estimates their own accomplishments and tries to increase their influence in the implementation of development plans for sectors coming under the responsibility of that ministry. Efforts to increase the accountability and responsibility of every ministry are facilitated by external factors:

- The practice of forming coalition governments reflecting the proportion of political forces; ministries are then used by political parties as the tool for increasing their influence.
- The "normativism" in Latvian legislation, *i.e.* the efforts to regulate public relations in the most detailed way, which gives rise to bureaucratisation and increased numbers of officials.

In Latvia the law states that the official or institution does not work in their own interests – they are working in the "interests of society" (Saeima, 2001, 2002). Nevertheless, that does not stop those working in public administration from considering that ever-growing centralisation serves these "interests of society". Ministries will therefore facilitate neither the decentralisation of competences, nor the decentralisation of finances from ministries to regional governments. Only the well-defined and unequivocal political will of the Cabinet of Ministers can neutralise such an attitude.

The interests of the inhabitants of rural areas and provincial towns are closely connected with regional development. The fact that all the regions of Latvia are lagging ever further behind the Rīga region does not engender efforts to connect one's activities with his or her place of residence; instead it encourages migration. A key problem here is perception. Although the inhabitants of these regions would appreciate better representation of their interests, the great majority do not link this better representation with decentralisation.

In order to turn the inhabitants of rural areas and provincial towns into associates of regional reform, it is necessary to furnish a better understanding of the local democracy and the opportunities that democracy creates.

The economic case

Statistical data naturally reveal a growing disproportion in the economy of regions, as measured by GDP per capita. During the centralised management of development, GDP per capita in the period 1997-2001 in the Rīga statistical region increased by 69.3%, while the highest indicator in the Latgale statistical region was only 41.4% (Vanags *et al.*, 2004). If these figures are set against the EU average, then only one region – the Rīga region – helps Latvia approach EU levels; the other four statistical regions lag further and further behind. This means that regional development policy in Latvia in the period of centralised management is unsuccessful, with objectives falling behind year by year.

This situation already poses problems, and these can only increase in the future. It is clear that strengthening the autonomy of regions and creating directly elected regional governments could offset the dominance of Rīga.

The case for regional governments goes beyond a "fairer" division of resources. Democratic elections facilitate a fuller consideration of territorial particularities. If the structure of Latvia's economy were homogeneous, balanced development could be attained by unified centralised measures dividing public investments. However, the GDP structure shown in Table 9.2 suggests the opposite.

The table indicates that from the point of view of location marketing theory (Vanags, Locane and Vilka, 2003), these regions develop competition or co-operation relations that are different from other regions in the European economic area. Each region has its most important sector in the economy and that leads to different marketing strategies. Centralisation is not appropriate for such diversification.

Table 9.2. **Sectors with the biggest proportions of overall added value in Latvian regions**

Region	Sectors with biggest proportion	Proportion (%)
Rīga	Wholesale and retail; repair of cars, motorcycles, items of individual application, domestic devices and equipment	20.9
Vidzeme	Processing industry	21.6
Kurzeme	Transport, storage and communications	28.1
Zemgale	Agriculture, hunting and forestry	18.5
Latgale	Transports, storage and communications	18.5

Source: Vanags *et al.*, 2004.

Thus there are at least two fundamental economic arguments in favour of directly elected and strong regional governments:

- The fiasco so far of existing regional policy managed from the centre.
- Structural differences in the economy of regions, which call for different marketing policies for every region.

Social implications

Economic differences are strongly linked with social differences, because the latter result from the level of employment, the income of the employed, and the quality and quantity of public services rendered by local governments.

The integrated index of territorial development elaborated by the researchers at the Latvian Statistical Institute (LSI) and the University of Latvia characterises both economic and social indicators (Vanags *et al.*, 2004); included are the level of unemployment, the size of personal income tax, the demographic situation, the index of attractiveness of the territory, and dwellings built per 100 inhabitants.

The surveys prove that in Latvia as well there is a strong link between economic and social indicators. Thus in 2001, with regard to GDP per capita, the difference between the best and the weakest region was 2.7 times; with regard to the level of unemployment 3.1 times; and with regard to personal income tax per capita 2.5 times.

The potential impact of regionalisation on the efficiency of social policy has one more important aspect, because attempts to solve social assistance and medical treatment problems in a centralised way have not come up with expected results. The Ministry of Health cannot propose a hospital restructuring scheme that would be acceptable to the public, because without strong co-ordination with regional-scale development plans it is not possible. Also, attempts to decide regionally sensitive issues centrally are met with resistance. It would be much more natural if such decisions were taken by the deputies directly elected by the community of the region.

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Similarly, attempts to unify local government social assistance according to common standards applied throughout the country renders such assistance inefficient and lessens consideration of local initiatives and local priorities.

There are thus at least two fundamental social arguments in favour of regional reform:

- Decreasing economic differences clearly improves the social situation.
- Decentralisation of social policy better corresponds to the subsidiarity principle and could increase the efficiency of social services.

The politics of regionalisation

Public surveys and topical discussions in the mass media reveal increasing estrangement between the state authority and society. If in the beginning of nineties being a politician at the national level was a honourable profession, then this viewpoint has changed year by year. The mass media increasingly link politicians with corruption and deliver negative information about the Saeima and the government.

Estrangement is also manifest with regard to elections – every time, the great majority of voters look for some "new power" that will "bring the nation into the sunshine". This does not facilitate stability or the development of democratic institutions. Further estrangement can lead to a crisis in the constitutional machinery.

Strengthening of local governments can therefore have only positive effects on the public's perception of power and co-participation. Directly elected large-scale regional governments would promote involvement of citizens in public administration in all state territories.

At the same time, increasing the role of regional politicians can come into conflict with the interests of the current political *élite*. However, it would have a positive impact on the development of political parties: they would have to reform and activate their activities in all regions and local governments. That would ensure (very necessary) feedback; increasing the impact of local sections of the parties would bring national policy closer to the interests of the inhabitants.

On the whole, regionalisation does not endanger the state of Latvia or its structure; on the contrary, in the long term it can become a stimulating and developing tool for democracy. The main political problem lies in balancing short-term interests with a long-term perspective.

Regionalisation would open additional possibilities for Latvia to have a greater impact on the European Union. The impact of regions and local governments within the EU increases slowly but systematically. It is also expressed in new powers, which according to the EU Constitution (Ministry of Foreign Affairs, Republic of Latvia, 2004) will be exercised by the Committee of the Regions. Strong, directly elected regions would be able to ensure more effective representation of Latvia's interests in this institution as well, thus – making for a greater impact on EU regional policy as well.

An algorithm of possible reform

In order to establish directly elected regional governments in Latvia, political decisions on several key issues are necessary. Otherwise conditions are not clear, and that ambiguity will influence sector ministries, social partners and local governments in terms of how they proceed during the future course of the reform. Solving these key issues would build a framework for the continuation of consultations and lead to a co-ordinated model of regional reform.

The key issues are:

- How many regional governments have to be formed?
- In which administrative territory shall Rīga be included?
- Will there be a hierarchical relationship between the regional governments and local governments?
- What will be the link between the current district self-governments and regional governments?
- When will the regional government elections take place?
- Will the Saeima deputies be able to stand as candidates in the elections of regional governments?
- When should the administrative territories of regions be established and how should they be administered until elections?

In developing policy that will enable regional governments to be established, several problems need solving, and here the functions of regional governments and their finance sources should be especially stressed. These problems are more professional than political in nature. Their solution will therefore mainly involve a co-ordination process with the ministries and local governments. However, the issues put forward above are more connected to political choice. When the political choice is made, the prerequisites for a constructive co-ordination process to deal with organisational, institutional and finance problems shall be established.

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Chapter 10

Regional Co-operation on Innovation and Cluster Development

by

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The countries of the Baltic Sea region have all accorded innovation policy a high priority, viewing it as key in tackling the structural challenges facing their economies. They aim to bring together innovation policy makers, implementing agencies and analysts in order to take advantage of geographical proximity and policy learning synergies; to develop a joint conceptual framework; and to create a critical mass for joint innovation frameworks and programme implementation. The Baltic Sea region can thus serve as an example to other regions in Europe and the OECD area that seek to create environments for policy makers and practitioners to establish joint activities, build strong industrial clusters, and develop methods for measuring and evaluating innovation performance and policy success.

The importance of innovation

In recent decades the world has seen innovation become increasingly important for economic development and competitiveness. Medium- and high-tech products represent an increasing proportion of international trade. Advances in information and communication technologies have led to the increasingly rapid transfer of knowledge. On the micro level, companies strive to increase the value-added of their products and services. On the macro level, countries strive to promote entrepreneurship, company growth and productivity in order to secure a strong economic base, and thus the longer-term welfare of their citizens.

Governments in countries at many levels of economic development around the globe have recognised this increasing importance, and have intensified efforts to support and catalyse innovation in their economies. As more focus is placed on understanding innovation – how it can be measured or compared, how innovation processes differ between sectors and between countries, and how policy can more effectively catalyse or facilitate further innovation – newer perspectives and frameworks emerge.

The relationship between key components of innovation

It is broadly understood that innovation is a result of many factors – national framework conditions, levels of education, the business environment, etc. These interdependent factors make up what is commonly referred to as the innovation system. Innovation capacity and performance is generally measured as a compilation of various indicators: macroeconomic stability and rule of law, human resources and education, the ability to share knowledge through ICT, and the ability to co-operate and conduct work in an integrated innovation system. Different organisations have developed various innovation indices and scoreboards.[1]

Recently, further efforts are being placed on understanding and explaining the relationship between these components. The European Innovation Scoreboard (EIS) has, for the first time, developed an input/output approach in order to better understand how innovation assets are transformed into innovation return (European Commission, 2005a, pp. 5-6). The EIS has established three categories of innovation inputs and two categories of innovation outputs (see Table 10.1). It must be stressed, however, that there is no formula for innovation, or (more importantly) for transforming

Table 10.1. **European Innovation Scoreboard 2005 Indicators**

Innovation inputs	
Innovation drivers measure the structural conditions required for innovation potential	Science and engineering graduates Population with tertiary education Broadband penetration rate Participation in lifelong learning Youth education attainment level
Knowledge creation measures the investments in R&D activities	Public R&D expenditures Business R&D expenditures Share of medium-high-tech and high-tech R&D Share of enterprises receiving public funding for innovation Share of university R&D expenditures financed by business sector
Innovation and entrepreneurship measures the efforts towards innovation at the firm level	SMEs innovating in-house Innovative SMEs co-operating with others Innovation expenditures Early-stage venture capital ICT expenditures SMEs using non-technological change
Innovation outputs	
Application measures the performance expressed in terms of labour and business activities and their value-added in innovative sectors	Employment in high-tech services Exports of high-technology products as a share of total exports Sales of new-to-market products Sales of new-to-firm but not new-to-market products Employment in medium-high-tech and high-tech manufacturing
Intellectual property measures the results achieved in terms of successful know-how	EPO patents USPTO patents Triadic patent families New community trademarks New community designs

Source: European Commission, 2005a.

innovation into economic prosperity. Although there is a correlation between innovation input (such as R&D investment) and output (such as publications and patents), there is currently no satisfactory method for determining which input levels will yield which output results – nor for judging how efficient or inefficient national innovation policy choices have been.[2] One can only compare with other countries, and keep in mind that each policy or investment decision has an impact on a range of indicators. There are no independent variables in innovation systems.

The different types of innovation

The EU's definition of innovation encompasses products, processes and organisational forms in all types of sectors.[3] It is often stressed that innovation includes incremental changes in addition to radical ones, and occurs in low-tech as well as high-tech sectors. Yet different capabilities are required for the different types of innovation. Just as consumers are categorised (*e.g.* first-movers, early-adopters, etc.) for marketing strategy purposes, types of innovation can be categorised for policy strategy and comparative purposes. In order to provide a more detailed evaluation of the innovative capabilities of firms, the latest Community Innovation Survey data were analysed to assign innovative firms different categories.[4] In their reports for the European Commission, Arundel and Hollanders (2005) introduce four modes of innovative firms: strategic innovators, intermittent innovators, technology modifiers and technology adapters (see Table 10.2).

Table 10.2. **Innovation modes**

Innovation mode	% of innovative firms	Description
Strategic innovators	21.9	For these firms, innovation is a core component of competitive strategy. They perform R&D on a continuous basis to develop novel product or process innovations. They are the main source of innovations that diffuse to other firms.
Intermittent innovators	30.7	These firms perform R&D and develop innovations in-house when necessary or favourable, but innovation is not a core strategic activity. For some, R&D efforts focus on adapting new technology developed by other firms to their own needs.
Technology modifiers	26.3	These firms modify their existing products or processes through non-R&D-based activities. Many firms in this group are essentially process innovators that innovate through production engineering.
Technology adopters	21.0	These firms primarily innovate by adopting innovations developed by other firms or organisations.

Source: European Commission, 2005b and 2005c.

Innovation performance by sector

Whereas it has been difficult to establish the correlation between innovation and economic performance (GDP) on a national level, there is a significant positive correlation at the sector level (European Commission, 2005a, p. 22). There is therefore increasing focus not only on measuring and understanding the drivers of innovation by sector, but more importantly on developing policy measures specifically targeted to these sectors.

The "left-brained side" of innovation

There is a growing emphasis on the "creative competencies" involved in innovation. It is commonly understood that innovation is not solely the realm of scientists and engineers, and that increasing investment in R&D will not secure a comparable increase in innovation output. National governments around the world are therefore facing new challenges in adjusting their

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innovation strategies and policy mechanisms to address the "left-brained side" of innovation – and to take advantage of their countries' creative assets as much as they have their technical assets. To help guide governments' understanding of the situation so that they know better what to do, new indicators of non-technical innovation[5] and creativity have been developed.

The economist Richard Florida is one of the main proponents of the impact of creativity on economic development, arguing that the creative class of workers produce a disproportionately high share of wealth globally. The leading countries of the world will secure their future competitive advantage by attracting talented individuals (the creative class). Florida measures this through the creativity index, comprised of the "3 Ts": technology, talent and tolerance.

The impact of consumer demand

One of the main drivers of innovation has been the increasing sophistication of consumer demand. As the markets have become more global and information has become more readily accessible (through ICT), consumers have become more demanding. Companies have reacted to this by developing their ability to understand consumer needs; in some instances they involve the consumer more actively in the innovation process. Results are extremely positive for the companies that have responded to this trend: faster time to market, lower development costs, and higher hit rates for the innovations introduced to the market. This trend toward user-driven innovation[6] has led to increasing interest from the public sector. What can governments do to facilitate more of this (apparently successful) type of innovation?

Innovation governance and policy learning

Each country has its own national priorities. These are both reflected in and a reflection of innovation policies and the governance structure. They also have an impact on the resulting strengths and improvement areas for each country. The latest EIS included detailed analysis of the strengths and weaknesses, and patterns of innovation performance. The purpose of this analysis is to help the policy community identify peers (those that share both similar patterns of strengths and weaknesses, and have similar national systems of innovation) from whom they can best learn (European Commission, 2005c, pp. 9-15).

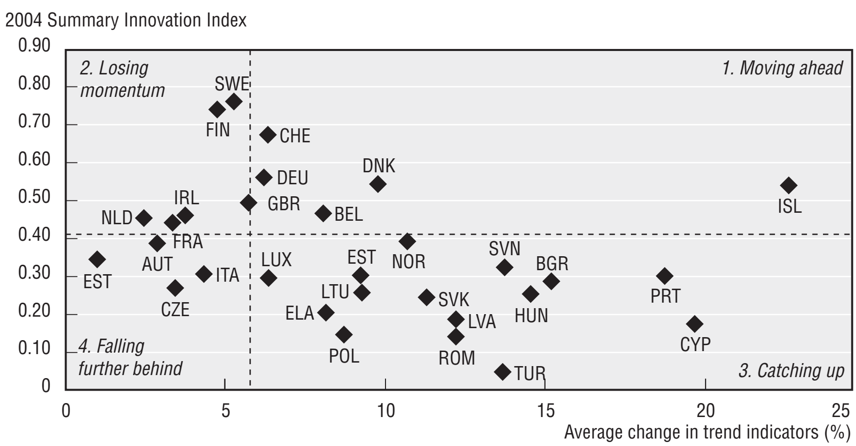
This analysis highlighted what has already been generally known among the countries of the Baltic Sea region: these countries share many similarities and also have complementary strengths, providing an optimal platform for fruitful policy learning.

Innovation in the Baltic Sea region

It is difficult to get an accurate picture of innovation in an economy comparable to that in others. Currently available innovation indicators are still far from satisfactory in assessing countries' innovative capacity and potential. One way to understand relative performance, strengths and improvement areas is to benchmark.

According to the 2004 Scoreboard (Figure 10.1), Sweden and Finland confirm their sustained leadership in terms of innovation performance, but are tapering-off in their performance improvement. Germany, Denmark and Iceland, however, are maintaining both above-average performance and above-average improvement trends. Iceland's improvements have been driven most by a strong rise in business and public R&D spending, growth in employment in high-tech sectors, and increases in tertiary education and lifelong learning. Denmark has made notable improvements in the percentage of science and engineering graduates and the number of EPO patents.

Figure 10.1. **EIS 2004 Summary Innovation Index and trends**



Source: European Commission, 2004.

Norway, Lithuania, Latvia and Poland all show stronger-than-average improvements in their performance trend, but they all remain below the European average performance. Lithuania has experienced the largest performance jump in ICT expenditures, ranking 6th among the EU25 in this area. Latvia's performance improvements have been driven by large jumps in EPO patents and business R&D expenditures. Poland's position is explained by a combination of increases in the number of EPO patents, the level of ICT expenditures and the level of public R&D expenditures. Estonia was the only

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country "falling behind", with negative trends in the percentage of science and engineering graduates, percentages of high-tech employment, business R&D and the number of patents. One must remember, however, that all new member countries have started from very low levels of performance, which means that even minor increases or decreases in absolute terms may show up as major swings in trends.

Higher education, in particular tertiary enrolment, is a strength for this region as a whole. The prevalence of science and engineering graduates and researchers in R&D is also generally high. The Nordic countries and Germany invest more than their eastern rim counterparts in R&D – particularly R&D from the private sector. ICT proliferation is highest in Sweden and Iceland, but impressive performance improvements in the Baltic countries in mobile proliferation and Internet usage are pointing towards convergence in this area. Government effectiveness is markedly stronger in the Nordic countries and Germany (as one might expect with countries that have a longer tradition of market economics).[7] Patent applications and employment in high-tech sectors are lower in the Baltic countries, Poland and Russia than in the Nordic countries and Germany. The availability of early stage venture capital (seed financing) is an issue for many countries in the region.

International indicators rank the Baltic countries, Poland and Russia much lower in competitiveness and political and economic stability than their western rim neighbours. These countries are still completing the transition from planned to market economies – having to completely restructure financial systems, revamp educational structures, build-up infrastructure and ICT systems, and privatise a large majority of companies. Despite the major changes and strains of the last decade, the countries are showing impressive performance – with annual GDP growth rates in excess of 6-7% in the past decade, major improvements in ICT usage, and scientific and research assets that remain strong. There is, however, still a long way to go before these countries reach prosperity levels equivalent to those of their European neighbours.

Policy makers are concerned over the ability of their countries to maintain the dynamism and momentum of the past decade – *i.e.* the growth and structural changes – as they approach "convergence", or "catch-up", with the older EU member states. As illustrated in the table above, none of the eastern countries seems to be on a smooth path to convergence with their western rim neighbours. Estonia and Lithuania are exhibiting the highest growth in R&D investments, but even if current growth rates are maintained until 2010 they will both fall far short of the 3% Lisbon objective (with 1.66% and 1.28% GERD rates, respectively). Lithuania also leads growth in scientific publications and EPO patent applications, but even if this strong growth continues Lithuania will not come close to catching up to current European or

Table 10.3. **Indicators of convergence in innovation performance, selected countries**

	GERD (% of GDP, Eurostat)			Scientific publications (total, Thomson ISI)			EPO patent applications (total by application date, Eurostat)			Mobile subscriptions (thousands, ITU)		
	1998	2003	AAGR	1998	2002	AAGR	1998	2001	AAGR	2000	2004	CAGR
Denmark	2.06	2.60	6.6	8 833	9 563	2.0	646.34	831.65	8.8	3 364	5 166	11.3
Estonia	0.58	0.77	11.6	583	660	3.1	6.25	6.08	–0.9	557	1 256	22.5
Finland	2.88	3.51	6.9	7 990	8 820	2.5	1 038.17	1 305.93	7.9	3 729	4 988	7.5
Germany	2.31	2.50	2.7	78 398	82 891	1.4	17 908.14	21 598.17	6.4	48 202	71 316	10.3
Iceland	2.07	3.09[1]	14.5	392	465	4.4	18.73	34.53	22.6	215	291	7.9
Latvia	0.41	0.39	4.9	384	386	0.1	4.70	7.72	18.0	401	1 537	39.9
Lithuania	0.55	0.68	9.4	481	715	10.4	1.33	2.92	30.0	524	3 422	59.9
Norway	1.65[2]	1.89	2.9	5 605	6 150	2.3	310.71	359.60	5.0	3 368	4 163	7.3
Poland	0.68	0.59	–1.1	9 515	12 729	7.5	34.91	35.83	0.9	6 747	23 096	36.0
Russia	n.a.	1.24	n.a.	28 788	27 525	–1.1	172.27	162.47	–1.9	3 263	74 420	118.5
Sweden	3.62	3.98	5.0	16 942	18 374	2.0	2 032.12	2 156.52	2.0	6 372	9 302	9.9
EU25[3]	1.82	1.93[1]	4.0	n.a.	n.a.	n.a.	41 575.90	49 203.21	5.8	291 425	571 806	18.4

1. 2002.
2. 1999.
3. Europe for ITU mobile subscriptions.

Source: Schwaag Serger and Wise Hansson, 2005.

Nordic levels by 2010. ICT (including indicators such as mobile penetration and Internet usage) is the only area where convergence appears possible. Both Estonia and Lithuania already have mobile penetration levels comparable to the Nordic countries. Estonia and Latvia currently outperform the broader European average in regard to Internet usage.

One of the most widely used proxies for innovative capacity (or input) is investment in R&D as a percentage of GDP (GERD). Other indicators include education levels and numbers of researchers. The Baltic Sea region[8] outperforms both Central Europe and the European average in all of these indicators. Figure 10.2 provides a comparative illustration of performance in terms of GERD. The region shows particularly strong performance in national R&D investments and numbers of researchers (with average rates of 2.5% GERD), with a nearly 40% higher share of R&D expenditure, and almost twice as many researchers per inhabitants. This is largely due to the fact that the Baltic Sea region is home to the global leaders in these indicators. Sweden, Finland, Iceland, Denmark and Germany all have GERD levels above the EU25 average of 1.9% and above the OECD average of 2.2 per cent. In addition, R&D expenditures in many BSR countries are growing at a fairly rapid pace. Iceland (14.5%), Estonia (11.6%), Lithuania (9.4%), Finland (6.9%), Denmark (6.6%), Sweden (5%) and Latvia (4.9%) have all exceeded the EU's (4%) average annual growth rate for GERD during the five-year period 1998-2003.

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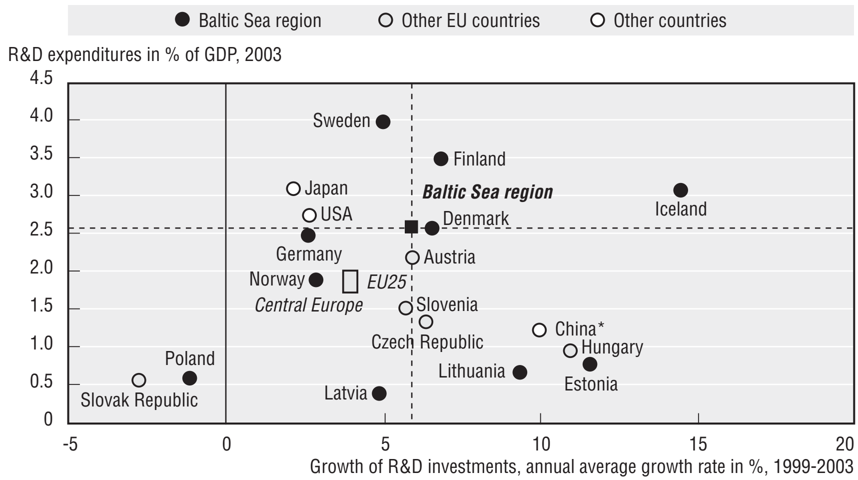
Figure 10.2. **R&D investment and growth**



* Annual growth rates in China have exceeded 10%; total R&D expenditure, in real terms, have grown by almost one-fifth each year.

Source: Ketels and Sölvell, 2005.

It is important to note, however, that some countries are not able to maintain high growth rates. Iceland has been illustrating strong R&D intensity and growth trends. But GERD growth rates have been tapering off in Finland, Germany, Denmark and Sweden. Of the countries with low R&D intensity, Estonia and Lithuania are exhibiting strong growth rates. However, the catching-up process has slowed in Latvia and ceased in Poland (where there are negative growth rates). Taking a broader global perspective, China has been experiencing GERD growth rates in excess of 10% since the late 1990s. The EU's DG Research recently reported that if R&D intensity growth continues at the same pace (+0.7% per year for Europe on average), China will have caught up with the EU by 2010: both will have reached a 2.2% R&D intensity. This level is far short of the 3% Lisbon objective, and highlights a significant competitive threat to the EU.

In terms of human capital, the Baltic Sea region has an average of 3 833 researchers in R&D per million inhabitants, compared to a Central European average of 2 100 per million inhabitants and a European average of 3 246 per million inhabitants. Iceland (8 592), Finland (7 431), Sweden (5 171), and Denmark (4 822) stand out with research assets exceeding both the European and US average (the latter has 4 048 researchers per million inhabitants). In addition, the science and engineering enrolment ratio in the region (39%) is above average levels in Europe (33%), as well as in the United States (19%) and Japan (21%). A concern, however, is how these human capital assets are used. Are these highly qualified researchers finding opportunities to make use of their skills, thus helping improve innovative performance and economic competitiveness – and, ultimately, turning knowledge into growth and prosperity?

Innovative performance (or output) is often measured by indicators such as scientific and technical journal articles and patents (per million population), proportions of professional and technical workers (as a percentage of the labour force), and levels of high-tech exports (as a percentage of manufacturing exports).[9] The Baltic Sea region consistently exhibits higher performance than Central Europe, but underperforms in relation to the wider European average on patents granted both in Europe and the United States.[10] These output indicators primarily reflect research results and do not capture broader economic impact. Although the Baltic Sea region has 33% more scientific articles published and 12% more EPO patent applications granted than Central Europe, the region's competitive advantage in terms of innovation output is smaller than its competitive advantage in terms of innovation input. From these indicators, it appears that the BSR is not making the most efficient use of its strong advantage in research investments and human capital.

It is not surprising to see that those countries with the highest R&D intensity are the same countries that have the highest number of publications and patents per million inhabitants, given the strong correlation. Sweden, Iceland, Denmark, Finland, and Norway all have a higher number of publications per million than the United States. Yet the regional average (754 publications per million) is below that of the United States (809 publications per million), as the larger countries (Germany, Poland and Russia) have lower publication rates.

It is unwise, however, to leave the subject of performance measurements without a caveat about taking these indicators at "face value".[11] It is always necessary to consider both the sources and time periods for the data, as well as the situational factors at the root of the measurements. In the case of the new member countries and Russia, percentage changes can appear noteworthy simply because absolute values are so low. Also, situational factors (such as large investment inflows from structural funds or foreign investment) can have a significant, if temporary, impact on indicators. In the Baltic Countries, for instance, the development of ICT (to support access to and the spread of information) had strategic priority and received considerable investment. These targeted investments had a direct impact on the improved performance for this specific indicator.

In addition, national industrial structures and strategic priorities may drive a different approach to improving innovation than is measured by the current indicators. Denmark and Norway are prime examples of countries where small businesses, rather than large multinationals, are the backbone of the economy and main source of innovation. Given that small companies seldom have the

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financial resources to invest in basic research, investments are instead targeted at applied research and *user-driven innovation* rather than *technology-driven innovation* measures. Current indicators are primarily focused on tracking technology-focused innovation (*e.g.* the percentage of employment in high-technology manufacturing and services), leading to a skewed measurement of innovation in countries where innovation activities and investments are focused on more traditional sectors or functional capabilities.

As innovation is spread over various functional and policy realms (education, ICT, business, science, etc.), success is determined by the ability of the various stakeholder groups to collaborate and complement each other in their innovation processes. On a national level, the increasing importance assigned to interaction and linkages for economic performance is captured in the notion of the innovation system, governed by innovation policy. In line with an increasing number of nations around the globe, countries of the Baltic Sea region are focusing on innovation policy and implementing so-called innovation strategies. They realise that in order to ensure long-term economic growth and competitiveness, they will need to establish the appropriate educational and technological foundations, ensure conducive framework conditions, and facilitate effective and productive interactions and linkages between actors within their borders as well as with other countries in the region.

National choices concerning governance of innovation policy play a key role in determining the effectiveness of policy in enabling and strengthening innovation in an economy. Lately, increasing attention has been paid to high-level co-ordination of innovation at regional, national and supranational level.

Regional co-operation on innovation policy

The eleven countries of the Baltic Sea region share a number of characteristics: they have close traditional cultural links; they are generally small, open economies; they have close commercial ties with each other; they tend to have a well-educated labour force; they share common weaknesses in the enterprise sector; and they have a desire for sustainable economic development around the Baltic and North Seas. In addition, these countries all accord a high priority to innovation policy as a key to tackling the structural challenges facing their economies. The BSR is home to global leaders in innovation capacity and performance, as well as the most dynamic new EU member countries. This combination allows for a fruitful exchange of good practice and experience, as well as a productive discussion of new policies and mechanisms to address common challenges.

Over the past couple of years, a number of regional initiatives have formed the basis for more ambitious and longer-term regional co-operation. These initiatives are discussed in Box 10.1.

Box 10.1. Baltic Sea region initiatives

Northern Cluster Alliance (NCA)

The NCA was established in 2004 as an informal network of national Cluster Information Points (CIPs) in each of the Nordic countries, the Baltic countries, Germany, Poland and Russia. Participating organisations include: FORA (Denmark), Enterprise Estonia and University of Tartu (Estonia), TEKES (Finland), Schleswig-Holstein (Germany), Ice-Tec (Iceland), Latvian Development and Investment Agency (Latvia), Sunrise Valley (Lithuania), Innovation Norway (Norway), Ministry of Economics and Labour and Gdansk Institute of Market Economics (Poland), Baumann Innovation (Russia), VINNOVA (Sweden), and the Nordic Innovation Centre.

The mission of the Northern Cluster Alliance (NCA) is to improve the competitiveness and productivity of industry within the Baltic Sea region through enhancement of co-operation among clusters, and in so doing to strengthen the basis for lasting prosperity and employment.

Through their meetings, a number of opportunities for cross-border collaboration in the area of clusters were identified: benchmarking policies and cluster support programmes; cluster mapping/analysis in order to link clusters and facilitators; facilitator training; common research; and jointly implemented cluster support programme.

Northern Dimension Working Group on Innovation (NDWGI)

In line with the Nordic Council of Ministers' priority areas of innovation, economic growth and cross-border co-operation, the NCM (in August 2004) decided to initiate a project focused on "Strengthening Cooperation on Innovation and Enterprise Development in the Northern Dimension". The primary objectives of this project were to: establish a network and forum for policy learning for innovation policy makers in the eleven countries of the region; raise awareness and competency levels on innovation policy; and strengthen regional co-operation and build the foundation for co-ordinated/joint action in the realm of innovation policy.

The working group was formed to complement and add value to existing forums focused on innovation policy by providing a different structure and a more interactive approach to policy learning, an informal and open atmosphere, and a focus on selected policy areas of particular importance to the Baltic Sea region. Working group members are national representatives who work with innovation policy on a daily basis and who are familiar with their country's broader network of stakeholder groups involved in innovation policy formation and execution (*e.g.* In innovation agencies and innovation councils, research institutes and universities, and in the private sector).

Box 10.1. **Baltic Sea region initiatives** *(cont.)*

Meeting throughout the year, working group members identified four priority areas of innovation policy which they deemed both appropriate and beneficial to undertake in a regional context: Supporting Cluster Development; Promoting User-Driven Innovation; Strengthening Entrepreneurship Skills; and Establishing a Baltic Sea Region Innovation System.

Baltic Sea Initiative 2010 (BSI)

The Initiative was jointly launched in 2004 by VINNOVA and the Baltic Development Forum as a process tool to prepare the BDF Annual Summit held in Stockholm, October 2005. The core aim of the initiative has been to inspire and support supranational regional development of innovation and competitiveness in the Baltic Sea region. The Baltic Sea Initiative 2010 operates as a joint platform for discussion and co-ordinated action, open to all institutions with a stake in the economic competitiveness of the 11 countries forming the Baltic Sea Region.

The key objectives of the BSI have been to improve co-ordination of existing initiatives, define joint ambitions for the region, and formulate a strategy and action agenda in order to strengthen the region's competitiveness and innovation.

The primary components of the initiative have been:

- A State of the Region Report, providing the critical data and analysis (including indicators) needed to make informed choices about the region's direction and its action agenda. The Report covers economic performance, regional economic integration and the business environment. It also includes action priorities for the region and its member countries reflecting the leverage regional co-operation can provide.
- A consultative process in 2004-05 involving over 100 key representatives from the region's stakeholders to establish a clear indication of demands, visions and commitments to action.
- The Baltic Development Forum Summit held in Stockholm in October 2005, where a structure and plan of action for longer-term regional co-operation was presented.

At that Stockholm Summit it was agreed that the BSI would continue to serve as a structure for regional co-operation – a network of networks, focusing efforts on the following five priorities for action:

- Cluster development.
- User-driven innovation.
- Research cooperation.
- Removal of border barriers in relation to the financial sector.
- Branding (marketing) the Baltic Sea region.

Box 10.1. **Baltic Sea region initiatives** *(cont.)*

A Core Group – made up of organisations representing policy makers, innovation agencies, investment agencies and the private sector – has been established to facilitate developments in the prioritised action areas. The members of the Core Group are the Nordic Council of Ministers (chair), TEKES, VINNOVA, Scanbalt, the Council of the Baltic Sea State's Business Advisory Council, the Baltic Development Forum and the Baltic Sea Investment and Promotion Agencies, BIPA.

Each of these initiatives has represented different constellations of stakeholder interests, yet has had a similar ultimate goal: strengthening productive linkages between countries in the region in order to improve innovative capacity and performance, leading to economic growth and international competitiveness. Each of these networks views cluster development as a priority for reaching that goal.

Cluster development

A common definition of clusters (in policy circles) is: a mode of organisation of the productive system, characterised by a geographical concentration of a critical mass of economic actors and other organisations, specialised in a common field of activity, developing interrelations of a market and non-market nature, and contributing to the innovation and competitiveness of its members and the territory. Although the concept of clusters has been around for quite some time, the role of policy in supporting cluster development is a newer phenomenon.

Clusters support the innovation process – and thus economic prosperity – in a range of ways: through informal contracts and network exchanges; through increased knowledge flows leading to efficiency improvements and the introduction of higher value-added products and services; through better access to seed-funding and opportunities for new firms to form; and through intensified competition. Policy makers are interested in finding ways to support cluster development – but what is the rationale for policy intervention? *The Cluster Policies Whitebook* (Andersson *et al.*, 2004) summarises a number of reasons for public sector intervention:

- *Market failure* to initiate or sustain inter-linkages that could be favourable from a societal perspective – for instance, by addressing co-ordination problems that lead to firms viewing co-operation as unreliable.

- *Government/policy failure* to deliver public goods in key areas such as science, basic education, or product regulation… or failure to target policy measures to appropriate actors or sectors.
- *Systemic failure* to match interrelated institutions, organisations or rules of play… a framework lacking appropriate incentives for public and private knowledge-producing institutes to co-ordinate.

There are different types of cluster policies: *broker policies* (to establish a dialogue of co-operation between different stakeholders), *demand-side policies* (to provide data, information and education on markets and technologies to foster demand), *training* (to upgrade skills and competencies – in particular for SMEs) and *promotion of international linkages* (to eliminate barriers and strengthen communication in order to improve resource flows and specialisation of value chains across national borders), as well as *broader framework policies*. In addition, there are a number of different types of clusters to foster (see Table 10.4).

Table 10.4. **A simple typology of clusters**

	"Mega cluster"	"Local network"	"Knowledge-based"
Level	Macro Meso	Micro	Micro Meso
Driving force	Competitiveness of the area (country, region)	Competitiveness of enterprises	Technological development, innovation
Origin	Mapping studies, Strategic analyses	Enterprises dynamics	Knowledge flows science-industry
Main components	Sectors, value-chain, "filière", firms and other organisations	SMEs (other firms)	Enterprises and research centres
Success factors	Critical mass, presence of complete "filières", factor conditions, demand, adapted labour market…	Geographic proximity, entrepreneurship, social capital, communication, vision, leadership, co-opetition, competence base…	Adequate regulatory and institutional framework, efficient intermediaries, match in specialisations, scale economies, knowledge flows…
Examples	Danish "resource areas" and Dutch "mega clusters", Finnish clusters, Scottish clusters, Austrian clusters, Basque country clusters…	Italian industrial districts, French SPL, Greek clusters, Danish networks of competence, Norway SME development policy, Welsh supply-chains…	Flemish "VIS", Walloon and Luxembourg technology clusters, Dutch R&D partnerships, German Bioregions, Finnish centres of expertise, Swedish and Austrian competence centres, Norwegian Reginn regions…

Source: Nauwelaers, 2003.

A general first step in developing and designing cluster policy is to analyse the region or national economy in order to determine "strongholds" and competitive strengths. Second, a more restricted number of those clusters are selected, introducing the possibility for policy to bring value to the cluster. Third, policies are implemented supporting cluster initiation or growth. Finally, the role of policy should cease as clusters become self-supporting.

Conclusion: Linking innovation systems for economic development

Within the Baltic Sea region, there are both sectors (*e.g.* forestry/wood, medical devices, fishing products, furniture, telecommunications) and skills (*e.g.* design, engineering, science) that could be better leveraged with a more co-ordinated approach to support and development.

Several of the networks and initiatives aimed at strengthening innovation and regional co-operation have a common desire to improve analytical capacity and knowledge, learning opportunities and regional linkages in the area of innovation policy broadly, and to improve cluster development more specifically. These groups have decided to "join forces" to pursue a common goal – linking their innovation systems across national borders.

The aim is to bring together innovation policy makers, implementing agencies and analysts in order to take advantage of geographical proximity and policy learning synergies; to develop a joint conceptual framework; and to create a critical mass for joint innovation frameworks and implemented programmes in the Baltic Sea region. In this way, the region aims to serve as an example to other regions in Europe by creating an environment for policy makers and practitioners to establish joint activities; to build strong industrial clusters and innovation poles to link national innovation systems and innovation programmes; and to develop methods for measuring and evaluating innovation performance and policy success.

The activities mentioned above – aimed at linking innovation systems trans-nationally – are structured on a national level. In addition, there are a number of other activities in the Baltic Sea region that work towards establishing cross-border linkages – in education, research, and in certain sectors or value chains.[12] In these areas, local or regional governments are key players. Regional governments have played a particularly important role in providing the legitimacy and strategic foundation necessary to catalyse cluster development. Just as national innovation policy makers benefit from policy learning forums, local and regional governments could also benefit from opportunities to compare approaches and exchange experiences.

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Notes

1. World Bank Knowledge Assessment Methodology (KAM), the OECD *Science, Technology and Industry Scoreboard*, the European Innovation Scoreboard, and the *Global Competitiveness Report.*
2. It is for this reason that policy learning and policy evaluation are becoming increasingly important. Countries are working to establish methodologies and measurements to determine the success of policy initiatives.
3. The European Commission officially defines innovation as the renewal and enlargement of the range of products and services and the associated markets; the establishment of new methods of production, supply and distribution; the introduction of changes in management, work organisation, and the working conditions and skills of the workforce [European Commission (COM 1995/688)].
4. More detailed information on the methodology and results can be found in the EXIS report on the TrendChart website: *http://trendchart.cordis.lu/scoreboards/scoreboard2004/pdf/EXIS.pdf.*
5. Measured in the EU as *a)* organisational, management or design innovation; *b)* marketing innovation (as measured by number of trademarks); and *c)* design innovation (as measured by number of industrial designs).
6. Also referred to as human-centred innovation, consumer-driven innovation and many other terms.
7. Government effectiveness is measured by an index which combines into one grouping perceptions of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, degree of freedom of the civil service from political pressures, and the credibility of the government's commitment to policies.
8. For purposes of this comparative analysis, the Baltic Sea region has been defined to include the Baltic countries (Estonia, Latvia and Lithuania), the Nordic countries (Denmark, Finland, Iceland, Norway and Sweden), northern Germany (Hansestadt Hamburg, Mecklenburg-Vorpommern and Schleswig-Holstein), northern Poland (Pomorskie, Warminsko-Mazurskie and Zachodnio-Pomorskie), and Russia's North Western region. The Central European region has been defined to include Austria, the Czech Republic, Hungary, the Slovak Republic, Slovenia, southeastern Germany (Bavaria, Saxony and Thuringia), and southern Poland (Dolnoslaskie, Malopolskie, Opolskie, Podkarpackie and Slaskie). These two cross-national regions are comparable in economic size and population, and combine both old and new EU members. They share similar challenges in terms of leveraging the level of the cross-national regions to improve competitiveness.
9. The Nordic Innovation Centre (among others) is interested in developing new ways of measuring innovation performance – indicators that capture not only research-driven innovation, but also innovation in design, processes, marketing, etc.
10. The patent data analysed in this report are based on patent applications granted at both the EPO and USPTO, by date of grant for 2003. This method was chosen in order to present the most recent data. It is recommended, however, that analysis of patent data should be based on triadic patent families (Europe, USA and Japan) in order to avoid a data bias (*e.g.* the US has a higher number of patents with the USPTO), and by priority date (date of the first filing worldwide) in order to represent the date closest to actual invention. Using this methodology, the latest available data is for 2000.

11. For further discussion of the problems with indicators, see Schwaag Serger and Wise Hansson (2004).

12. Scanbalt (*www.scanbalt.org*) is a good example of an international network of clusters in the biotech sector.

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Baltic Partnerships
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Baltic Partnerships

INTEGRATION, GROWTH AND LOCAL GOVERNANCE IN THE BALTIC SEA REGION

The Baltic Sea Region is rapidly becoming one of the world's more competitive regions. The region is capitalising on its strengths and making the most of its diversity to stimulate innovation, build a strong pool of skilled labour and foster entrepreneurship. A deep spirit of co-operation and integration has led the Baltic Sea countries to set up ambitious governance frameworks to pursue economic development objectives jointly from Oslo to St. Petersburg. Yet major challenges at the local level lie ahead for the Eastern shores of the Baltic, where economic transition still needs to be accompanied by more innovative strategic planning, new forms of governance and dynamic civic entrepreneurship. Policies will need to be made more adaptable and capacities will need to be strengthened if prosperity and living standards are to increase on the Baltic Rim.

Fortunately, the Baltic Sea Region includes some of the world's most innovative countries. From Denmark to Finland, the Region possesses a breadth of experience in facilitating policy co-ordination, adjusting policy to local conditions and involving business and civil society in shaping policy measures. There is a great deal that other countries can learn from this experience in setting up partnerships and other forms of governance. The learning process has already started, with the Baltic Rim becoming a unique laboratory for economic and employment development. This book analyses the new developments in the Baltic States and Northwest Russia and provides suggestions on how to speed up this progress. It is essential reading for all stakeholders in the Baltic Sea Region and for those elsewhere wishing to apply emerging lessons to their region of the world.

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