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1

The Local Dimension of Transformation: an Introduction

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Introduction

This book is about transformation in the framework of European integration. However uncertain the latter has become after the unexpected results of the French and Dutch referendums on the European constitution, the path for the Balkans to European integration is outlined, although the exact track is admittedly uncertain, with the exception of Romania and Bulgaria.

The double challenge for the Balkan countries is to pursue transformation and integration amid difficult circumstances. Compared to the countries of Central and Eastern Europe (CEE) who became EU members on 1 May 2004, the Balkan countries have to face greater difficulties for both external and internal reasons. External factors, such as economic and political support appear, if anything, more favourable. This is due to both the experience gained by the richer countries in supporting transformation, the smaller size of the Balkan economies and societies, and the greater danger from their political and military instability. However, it is the overall environment of the European Union (EU) that has made the integration process for the Balkan countries politically much more difficult than in the case of Central and East European Countries (CEECs).

As far as internal circumstances are concerned, a critical set of difficulties result from instability, which shortens time horizons of economic, political and social actors, and increases uncertainty and transaction costs. However, another set of difficulties results from the greater institutional immaturity of the Balkan countries compared to the requirements of a competitive market economy, a pluralistic society and a democratic polity. Institutional immaturity is due to uncertain reforms as much as to more unfavourable starting conditions.

Local development is usually defined as development in a territorially, administratively, economically, legally, and socially delimited space that concerns local government, the private sector, the non-profit sectors and the local community cooperating to achieve sustainable institutional settings

and pursuing social and economic growth that brings benefits and improvements in the quality of life for everyone in the locality. According to the European Charter of Local Self-Government it '... denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population' (<http://conventions.coe.int/Treaty/Commun/ListeTraites.asp?CM=8&CL=ENG>). A locality is any component that is at sub-country or sub-state level. Therefore, a locality may be a region, a province, a county, or a municipality when discussing administrative levels. It may be a group of locally based firms, a social network or a political constituency when dealing with economic, social, or political issues.

Due to its very nature, local development encompasses different disciplines, approaches and many local government and private-sector functions including planning, infrastructure provision, finance, entrepreneurship, governance, environmental management, and culture. Local development is, therefore, about communities continually upgrading their institutional setting, improving their internal coordination and the cooperation with the outside world, upgrading the investment climate to improve their competitiveness, creating jobs and improving incomes.

In short, it is development in a limited part of a country. But how limited? Is it the development of a region of a country, perhaps of a republic in a federal country, or is it the development of a municipality, a village or a group of people? Clearly, these cases differ in the nature of the problems involved and the policies that can be implemented.

Societies and economies at a sub-national level – whatever their actual level is – share at least two important features. First, in neither case are 'local' problems self-sufficient and local policies (implemented by local authorities) really sufficient. A multilevel hierarchy of problems, policies and governments exists and the different levels are intertwined so, to form a system of multi-level governance (Bache and Flinders, 2004). The concept of multi-level governance has been defined as 'a system of continuous negotiation among nested governments at several territorial tiers – supranational, national, regional, and local – as the result of a broad process of institutional creation and decisional re-allocation' (Marks, 1993: 392). It stresses that, although conflicts should not be disregarded, these different levels are complementary and each one produces spillovers that other levels can appropriate. This point is particularly important and clear in legal and administrative issues. Yet it is also important in economic and social issues, for example, under the heading of transportation costs, the costs and problems of transacting cross-border, and costs and complexities of the (local) organization of production.

Secondly, social and political capital and also the various forms of economic capital, that are so important for supporting local development, are locally based and even success in international trade and in globalization depend largely on local development. Economists have long shown that

'[a]ctivities concentrate close to their needed inputs, and this generates greater locational concentration and hence, specialization of regional economies' (Storper, 2000). The dramatic decrease in transportation costs² did not diminish the importance of localization of economic activities. As a result of the above reasons there is a rationale in dealing with local development in an unspecified, simply sub-national manner. Moreover, this local development has to be part of a broader national, international and supranational perspective: one adopted in this book.

The basic hypothesis of this book is that local development is a particularly useful device to overcome the difficult transformation in the Balkans, provided that it is in harmony with national and international processes. Why should it be so? Does local development show particularly useful features in any circumstances or is it so only in the Balkans? Or does local development in the Balkans require particular features, given the difficult circumstances among which it takes place?

I am going to propose a general framework for studying local development in the Balkans, and introduce the different contributions in this book by many distinguished authors. I shall first outline in the next section the issue of local development, listing its features and the reasons why it is considered generally to be a useful device for development and stability. This section will introduce Chapter 2 by Marer. The following section will describe the starting conditions in the Balkans, with particular reference to the state of transformational reforms. This section is intended to complement the chapters by Gozi (11) and Berloff and Segnana (4) and to provide a useful background for the remaining chapters. The penultimate section is intended to assess some important aspects of institutions in the perspective of local development. The final section provides some conclusions.

Local development

Central governments have important records of local policies as parts of the main policies in countries characterized with significant territorial differences. Other countries have used local approaches to solve problems linked with poverty. However, these approaches have been traditionally seen and managed as exceptions and prompted by particularly important, yet localized problems. Local development has been considered not as an important part of general development, but as a necessary detour.

Indeed, until recently, central policies were largely uniform and addressed to the whole country, without particular concern for its constituent parts, with some notable exceptions (e.g. central policies for the Italian South). This was typical especially of economic policies, but also of institutional and social policies, and political, legal and administrative implementation. The so-called neo-liberal wave that has been dominant in most countries and international agencies in the last two decades has remarkably strengthened

this undifferentiated approach relying as it does on the mobility and substitutability of resources, price flexibility, and the goal of unifying countries and markets in the frame of the nation-state. It is interesting to note that central planning that was prevalent in Eastern Europe until the late eighties had a similar attitude in this sense.

An important reason for this approach lies in the confidence that the factors that lead or push development are universal and independent of the peculiarities of individual localities – and perhaps even of individual countries. Local assets and processes have meaning only as components of general processes. The model of the free market approach extends to most fields of social life, such as political, social and legal issues (e.g. the case of minority rights treated as – individual – human rights), whereby the individual is the principal and original depository of rights and the best interpreter and arbiter of her or his own preferences and objectives and, therefore, the only sovereign actor.

However, this mechanism needs certain conditions to work, including self-interested, rational, and profit-maximizing actors, and full knowledge and information by means of free prices, perfect mobility and substitutability of resources. However, this book deals with countries where the ‘imperfections’ that prevent the smooth working of the mechanism are important, evident, and resilient. They have not been removed so far either by the working of a free market mechanism or the inability of authorities to remove the obstacles to its optimal working.

Under these circumstances various questions arise. First, why is it so? Is it because free markets require special conditions to develop and work smoothly, conditions that do not hold in the Balkans which are ‘abnormal’ countries (Rosefielde, 2005)? Was the (economic, political, and social) action against the ‘imperfections’ preventing the proper working of the virtuous mechanism insufficient? Are actors self-interested in a more complex and less virtuous way than the mechanism envisages or do they pursue different kinds of rationality? Should we look for an explanation in the role of institutions or in that of knowledge and information that actors use in strategic ways or that cannot be transmitted and circulated, for instance because much of it is tacit and non-transmittable? Or is it because of a mix of these and other reasons?

Secondly, what can be done under these circumstances? Should we analyse the reasons why in the Balkans, as in so many other countries the free market mechanism has not worked properly so far and look for different, more reliable and realistic general explanations? Although the authors in this book offer different opinions on this issue, they agree that idiosyncrasies in Balkan local processes are embedded in broader and general processes.

In reality, policies are often pragmatic and proceed by trial and error. In this pragmatic perspective, policies for fostering and supporting local development

and solving the problems derived from ethnic diversity have been implemented and have gone through an important process of evolution prompted by previous failures and limited successes.

In general, three waves of local development and related policies can be identified (<http://www.worldbank.org/html/fpd/urban/led/defining.html>). During the first wave, which lasted from the sixties until the early 1980s, the focus was on the attraction of crucial factors into the local area by means of direct intervention and direct finance by public, often central authorities. The second wave lasted from the 1980s until the mid-1990s: its focus moved towards broadening the area of public intervention, targeting specific sectors or certain geographic areas, and the means utilized to reach the objectives, including a broad set of real services. Also, local authorities took over a more active role in policy implementation.

The third wave started in the late nineties and is still continuing. The focus of analysis and policy intervention shifted to make the environment more conducive to business, with particular concern for soft infrastructure investments, public/private partnerships, networking and the leveraging of private sector investments for the public good, and targeting inward investment to add to the competitive advantages of local areas. The success of communities depends on their ability to adapt to the changing and increasingly competitive environment. The goal is to mobilize endogenous resources and processes for local development. Therefore, what matters is that the proper economic, social, political, legal and administrative conditions are created for improving the local supply of resources, including entrepreneurship and knowledge. In this framework, policies should be mostly bottom-up in the sense that they should start from local endowments, needs and opportunities, they should have a long-term perspective and strategy, and should foster and be based upon a plurality of (economic, political and social) actors.

Dealing with local development in countries in transformation means addressing the above basic questions by dividing the issue into its three constituent parts, which are the most problematic because of the negative legacy of the old system: these are the context, the actors, and policies suitable to foster and support the development of an efficiently working democratic polity, a competitive market, and an economy, pluralistic society. Although the present book also deals with policies, it concentrates particularly on the context and actors as the most resilient features of the transformation process. Since it is clear that the starting point was not favourable, why is local development a suitable device to overcome the legacy of the past and foster transformation? Does local development (re)build a situation in which the free market mechanism works smoothly? Or is local development a critical component of an alternative kind of mechanism and general development?

There are various reasons for concentrating the attention on local development. Some reasons are traditional and based on a static perspective; some

are more dynamic and often linked to remoulding the traditional policy intervention, including restructuring of the welfare state. Traditional economic reasons include economies of agglomeration and local incentives to the accumulation of capital. These, by creating economies of scale and scope, may decrease production costs and also transaction costs, thus supporting the competitiveness of local economies (Becattini, 1987). Other reasons include enforcing the preferences of local constituencies. This reasoning is behind much of the debate about the advantages of decentralization in terms of greater efficiency and public responsibility: in this view a local autonomous society or administration is pushed to greater efficiency because the free riding game is more difficult than in a centralized society or administration and because local inefficiencies are evident in local constituencies. To this should be added the pragmatic approach to local development as a device that compensates for local social and political idiosyncrasies and transforms them into production factors in the economic, political and social field.

In countries in transformation such a static motivation for local development, although important, is probably of secondary importance, except for social and political idiosyncrasies. Economies of scale and scope and economies of agglomeration were important in the old system, as the concentration of investments in industrial areas or the representation of regions or minorities in politics are witness. If static motivations failed, this was primarily due to the misalignment of incentives, not to the disregard of agglomeration economies or proportional representation.

The second group of reasons supporting local development include the restructuring of the welfare state and asset building, the attempt to foster innovation in any field of social life, and the consequences of decentralization of economic and administrative activity. Local development was 'discovered' as a possible solution for the spreading crisis of the welfare state and, more generally, the fiscal crisis of the state in most countries, which promoted a drastic reduction of the direct intervention of public authorities in the economy and society. This goal is fundamental in countries in transformation, where the old paternalistic approach 'from the cradle to the grave' had to be replaced amid the disruption of the old state machine and the need to rebuild the fiscal, contributive, and social security systems (Müller, 1999).

The reaction to these problems has followed two different lines of action. First, the attempt to foster and mobilize local resources has been largely based on the concept of subsidiarity and on the provision of incentives for and support to build locally based resources, particularly through the promotion of entrepreneurship and the establishment of new businesses. This new approach required primarily setting up structures and programmes for supporting firms, for example, by means of local development agencies (World Bank, 2004). Secondly, the restructuring of the welfare state by 'lowering' the level at which the supply of services is provided and by supporting the individuals' role in providing the resources by which they can finance their

own welfare. This solution is usually seen not as a substitute for the direct support to the income of poor people, but complementary to it. A good example is supporting of asset-building in poor communities, which offer a potentially important and locally based solution to the provision of social services (OECD/LEED, 2003).

In the dynamic perspective, local development may support the social stability and the economic and social utilization of locally based knowledge and information that differentiate local economies and societies and that may in turn foster locally based technical, social, institutional and economic learning and innovation, grassroots democracy and pluralistic society, and the development of new dynamic capabilities in line with the new system. It is the utilization of locally based knowledge incorporating and adapting factors external to the locality (general knowledge, techniques, information, resources) that supports the placement of local economic systems in the international division of labour (Brusco, 1994).

The creation of knowledge assumes particular importance. It is a process that results from the interaction of economic actors among themselves and within the context including the territory, a well-defined geographical entity that includes a set of agents and institutions sharing a particular culture, history and perceptions. It is the ability of people, firms, regions and countries to learn, modify, adapt and specialize that determines their long-term performance. Knowledge and information are cumulative and their growth changes progressively with the change of the accumulated stock. An important local consequence is that actors and communities who have accumulated a particular expertise have a growing advantage compared to their competitors. This is an important basis for local development, but also for inter-territorial disparities. The interaction of the actors living in a particular territory influences learning and the creation of knowledge, mainly by doing and by using – perhaps in new forms, as Grancelli and Chiesi argue in this book. Knowledge is subsequently socialized and diffused through social group interaction. Therefore, geographical proximity is important – along with decreasing transportation costs – in creating specialization and industrial concentration due to: climate of imitation/cooperation and leadership/competition, coordination of decision-making, growth and diffusion of knowledge, guarantee against risk, and uncertainty.

Although in developed areas knowledge is largely codified and is relatively easy to diffuse and acquire, in take-off circumstances productive activities are largely based on contextual knowledge, that is created, diffused and rooted in the territory. Such knowledge is usually tacit, changes through trial and error and is transferred mainly through the circulation of the knowledge holder(s) and direct experience, which prevent its diffusion outside the holding community. In a sense, transformation can be compared to a take-off process, with two important differences: first, these countries start from a complex set of codified knowledge that has lost great part of its value, since

the economic, legal, political, and social systems changed; and secondly, the influx of outside knowledge (e.g. by means of Foreign Direct Investments (FDIs) or other forms of knowledge transfer) is actively pursued.

In these circumstances, external (codified) knowledge must be re-contextualized, embedded in the territory and/or organization. This may produce a *milieu* favourable to development, that is a coherent and organic system of production, institutions, culture, and history that reduces market and technological uncertainty for firms and strengthens routines. Recombination and codification produce interaction between local and global cultures, make the formation of specialization more efficacious, and influences the rate of change of organizational and technological routines.

These processes, though, cannot take place spontaneously, as many maintained in the early stage of transformation. The label of 'transition' that was used was intended to stress the nearly mechanical nature of the process. However, the Balkan countries may make use of different external supports that play an important role both directly, by supplying resources and markets, and indirectly, by creating a supportive international atmosphere.

In particular, the EU offers many devices that may support the countries in transformation in implementing local activities and recontextualizing their knowledge through its regional policies. Marer (Chapter 2 in this book) chronicles the evolution of EU regional policies, also discussing the key actors involved in regional policy decisions and the interaction among them. During this period the main regional policy instruments were the Structural Fund, the Cohesion Fund, and pre-accession assistance to the countries of CEE through Poland and Hungary Assistance for the Restructuring of the Economy (PHARE), Instrument for Structural Policies for Pre-Accession (ISPA) and Special Accession Programme for Agriculture and Rural Development (SAPARD). In 2004 the EU decided to supplement earlier aid programmes for the Western Balkans by adding pre-accession assistance to these countries as well. This chapter shows that having a favourable external context and financial resources is not enough: indeed, the main conclusion of the chapter is that the net recipients of regional aid – especially the less developed CEE and Balkan countries – should concentrate their efforts on improving the administrative absorption capacity of their public sectors.

Piattoni's chapter (3) builds on the 15-year experience with regional development policy at the European level to draw insights for the future enlargement countries, the so-called Stabilization and Association Process (SAP) countries in the Balkans. While no immediately applicable 'lesson' can be drawn, given the special nature of the problems these countries are facing, some insights can nevertheless be gleaned from the experience of the Structural Funds in the current member-states, including the ten recent enlargement countries. Apart from the obvious problems concerning the stabilization of the polities (construction of democratic institutions, rule of law, refugee repatriation, money laundering and illegal trafficking), these countries suffer

from momentous structural deficits regarding insufficient infrastructure, faulty market institutions, and educational deficiencies. Even more than in the Europe of 15 and the Europe of 25, the structural problems of the SAP countries are compounded by weak and inept administrative structures. Therefore, economic catching-up is also a problem of institutional catching-up.

The relation between growth performance, income distribution and trade policies show an important problematic aspect of the external context. Berloff and Segnana (Chapter 4) explain that trade and trade related policies are not necessarily growth-supporting. They imply significant redistributive effects that can create diffuse fears about the social and private costs of adjustments. These results are critical because, even independently of trade, growth is generating increasing inequalities in the Balkans. If trade and growth worsen the income distribution, and the speed at which poverty may be reduced in the region will be much slower, and the prospects of future growth undermined. The spatial, regional, and ethnic dimensions of poverty and inequality suggest that, if economic growth bypasses the areas where the poor are concentrated, it will further increase inequality and exacerbate spatial and social gaps in standards of living. Therefore, the local development of the poorest areas or regions becomes a strategic goal not only for the reduction of poverty and inequality but also for the long-term sustainability of growth. However, trade policy reforms will not yield the desired benefits unless there are parallel efforts to institutional upgrading, addressing the redistribution of the gains from trade and the interaction between trade openness and domestic and local redistributive policies.

Starting conditions and reforms

Perhaps the most striking feature in SEE before transformation is that this area included the most centralized countries in Eastern Europe and also the least orthodox and most decentralized country (Table 1.1). No reform was ever attempted in Albania, except in the direction of further centralization, at least until the mid-eighties. The mild attempts at decentralizing economic management that took place in late eighties destabilized economic administration without replacing centralization with anything resembling a market mechanism. Romania and Bulgaria were also highly centralized and hardly any reform took place during the entire socialist period. In the other extreme, Yugoslavia was a self-managed economy and the state administration was substantially decentralized at a republican level.

Theoretically, the Yugoslav self-managed system resembled rather closely a market economy due to the fair autonomy of enterprises, the weak role of central planning, the wide range of free or quasi-free prices, and economic openness. However, returns to economic activity were mostly centralized, resources were allocated centrally through bargaining mechanisms with

Table 1.1 A comparative evaluation of reforms in SEE: EBRD indices

	<i>Price liberalization</i>		<i>Foreign exchange and trade liberalization</i>		<i>Small-scale privatization</i>		<i>Large-scale privatization</i>		<i>Legal extensiveness 1999</i>	<i>Legal effectiveness 1999</i>
	<i>1991</i>	<i>2003</i>	<i>1991</i>	<i>2003</i>	<i>1991</i>	<i>2003</i>	<i>1991</i>	<i>2003</i>		
Albania	1.0	4–	1.0	4+	2.0	4	1.0	2+	2.0	1.7
BiH	n.a.	4	n.a.	4–	n.a.	3	n.a.	2+	2.0	1.0
Bulgaria	3.0	4+	3.0	4+	1.0	4–	1.0	4–	4.0	3.7
Croatia	3.0	4	3.0	4+	3.0	4+	1.0	3+	4.0	2.7
Macedonia	3.0	4	3.0	4+	3.0	4	1.0	3	3.7	3.7
Romania	2.0	4+	1.0	4	1.0	4–	1.7	3+	3.3	3.7
Yu/S&M		4		3+		3		2+		
<i>Unweighted average</i>	<i>2.4</i>	<i>4</i>	<i>2.2</i>	<i>4</i>	<i>2.0</i>	<i>4–</i>	<i>1.1</i>	<i>3</i>	<i>3+</i>	<i>3–</i>

Source: *Transformation Report 2000*, London: EBRD. Transformation indicators go from 1 (little change compared to pre-transformation situation) to 4+ (standards and performance typical of advanced market economies).

republican governments, and wages were largely planned. Therefore, compared to a market economy institutions were distorted perhaps more than in a centrally planned economy. In fact, in the latter budget constraints were a reality, albeit mostly at political level (Kornai, 1992). Another feature of the Yugoslav system that made it unfit for an orderly and productive transformation was the distributive processes. Introduced to settle inter-ethnic and inter-republican tensions, they generated macroeconomic destabilization, which in turn exacerbated those tensions both directly and via the effect of stabilization policies (Dallago and Uvalic, 1998). However, in other fields of social life (society, polity, governments, law) the distance from a pluralistic society and democratic political regimes was actually lower in Yugoslavia than in other East European countries.

Also transformation followed different routes in different countries: '[t]he eight countries of South-East Europe (SEE8) trail their Western European neighbours in income and other measures of development, but the differences among the SEE8 are as striking as their similarities' (Broadman *et al.* 2004: xix). Looking at the European Bank for Reconstruction and Development (EBRD) evaluation, some interesting conclusions stand out (Table 1.1). First, transformation is over, or nearly so, in all countries as far as price liberalization, foreign exchange and trade liberalization and small scale privatization are concerned – with a partial exception for Serbia and Montenegro (S&M). Secondly, progress has been reached in large-scale privatization (particularly in Bulgaria, although not clearly so in Albania, Bosnia-Herzegovina (BiH), and S&M), in banking sector reform and interest rates liberalization (particularly in Croatia and also in Bulgaria, but less so in Albania, BiH, and S&M). The same holds for the coverage of legal reform, which remains mostly formal with weak legal effectiveness. Countries have roughly the same relative positions as for the previous indicator.

However, these accomplishments are only apparently positive. 'Successful' small-scale privatization means simply 'complete privatization of small companies with tradable ownership rights'. Only one country, Croatia, has reached 'standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land'.

Looking at the two remaining 'positive' indicators in all countries, prices are liberalized in the sense that there has been 'comprehensive price liberalization; utility pricing which reflects economic costs' or that these countries have adopted 'standards and performance typical of advanced industrial economies: comprehensive price liberalization; efficiency-enhancing regulation of utility pricing'. Again, this means that prices work as informational devices, rather than pushing enterprises to productive outcomes – with perhaps the exception of utilities, which are not a particularly important field for Small and Medium size Enterprises (SMEs) and local development. Also, all this means that there are few remaining obstacles preventing SMEs from engaging in international trade despite how few actually do so or if they do, they do it in

an economically productive way. For instance, SMEs may be involved in arbitraging activities, thus contributing to establish market equilibrium. However, market equilibrium is not necessarily a synonym for socially productive activity.

As to foreign exchange and trade liberalization, in some countries there was 'removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility'. Most countries, though, went further and adopted 'standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership'.

Other aspects of transformation – such as the spread of poverty, increasing inequalities of income and wealth distribution, SME development, the decentralization of public administration – are discussed in the different chapters of this book.

In this book three chapters deal with particularly important aspects of domestic reforms in different fields. The common goal is to assess whether these reforms have been useful in fostering democratic political regimes, efficient market economies and pluralistic societies. Woelk (Chapter 5) analyses the current process of territorial and administrative reorganization at local level in former Yugoslavia as an important aspect of reconstruction and precondition for gradual integration into the political, legal and economic space of the EU. Starting with a short exploration of the traditions of local self-government in former Yugoslavia, the European Charter of Local Self-Government (ECLSG) is introduced as the main international document of reference: the comparison concentrates on five essential issues used as parameters for a critical evaluation of the reform-process: (a) the territory (including size); (b) the position of local autonomy in the legal system; (c) the powers to be exercised by the authorities at local level and their relations with higher levels of government; (d) autonomy in financial terms; and (e) autonomy in terms of local democracy. Other issues discussed are the ethnic question, which conditions local autonomy as well as the institutional structures in a number of countries. The chapter closes with some reflections on the effects of the 'importation' of 'models' that add to the considerations of local autonomy as an important element in the process of transformation.

Entrepreneurship and its features are discussed in Dallago's chapter (6). Putting formal institutions right is fundamental if entrepreneurship is to play a productive role, i.e. producing goods and services that increase the overall economic value in the economy. Starting conditions in the Balkans were rather unfavourable in this sense and the reforms were not the most effective to streamline institutions in a productive sense. This conclusion concerns both general policies and SME specific policies. The capabilities of entrepreneurs, their origin and nature strengthen this problematic outcome. To provide a

full picture the irregular economy³ is considered: it has weakened the virtues of regular institutions and offered entrepreneurs alternative ways to survive and prosper without adhering to formal institutions. It is concluded that reforms and policies should deal carefully with the interrelationship existing between formal and informal institutions and the irregular economy.

According to Grancelli and Chiesi (Chapter 7), who concentrate on the interaction between institutions and entrepreneurial capabilities in the Balkans countries, and in the former USSR, the *Nomenklatura* is the past that largely reproduces itself in the present. But what is in need of more investigation are the reproduction and circulation mechanisms in different organizational contexts within the process of post-communist transformation. A possible analytical framework cannot but start from the fact that while the influence of experts, Western institutions, professional press and competition have changed the cognitive patterns of local key actors, this does not generally impinge much on their actual behaviour. A disparity is still apparent between the new institutions and the norms and the largely path-dependent behaviour of local elites. This chapter provides some evidence and preliminary comments on the actors who should straddle that divide, namely the elites-in-the-making that are rising in the ranks of the institutions of local development.

Institutions in local development

Institutions in the vein of the neo-institutional economics may be defined as 'any form of constraint that human beings devise to shape human interaction' (North, 1990: 4). Institutions also define incentives and consequently determine the outcome of human activities (Baumol, 1990, 1993). Institutions may be formal, that is codified, and informal, such as conventions and codes of behaviour (Pejovich, 1998). According to the 'old' institutional economics both formal and informal institutions shape the economy by providing stability in a context of uncertainty, and provide a pattern for future development (Hodgson, 1988, 1993).

Institutions recall the issue of embeddedness, which refers to the process by which networks of inter-personal relations shape economic action beyond the assumption of the above-mentioned free market model and in ways that differ from it (Granovetter, 1985; Crosby and Stephens, 1987). Therefore, the economy is 'both an instituted process and a socially embedded activity' (Amin, 1998: 77).

The outcome of institutions also depends upon behavioural and cognitive processes in the sense that different actor rationalities produce different forms of economic behaviour (Simon, 1976). In our case, more than substantive rationality, which favours rule-bound behaviour, procedural and recursive rationality are particularly interesting. The former favours behaviour based on the accommodation of actors to the constraints posed by their

environment, while recursive rationality favours strategic behaviour, because actors use their capabilities to manipulate their environment.

These perspectives are particularly useful to examine such an 'unconventional' case as that of the Balkan countries. The interplay between (changed) formal and (sticky) informal institutions is one of the key aspects of transformation. Formal institutional change at a particular moment in time may give rise to informal institutions, which may, in turn, affect the negotiation of future formal institutions (Farrell and Heritier, 2003). However, the first period of systemic change has to exist with traditional informal institutions and transformation shocks may even strengthen traditional informal institutions. The outcome of transformation is clearly determined only when formal and informal institutions change in the direction of a competitive market economy, pluralistic society and democratic political regimes, thus supporting the same kind of incentives. When this is not the case, the outcome may be path-dependence and an irregular economy, as Chiesi and Grancelli (7) and Dallago (6) show in this book respectively.

In areas in transformation, such as the Balkans, local development is particularly beneficial because it may attenuate transformational shocks, including unemployment, and because it may foster and support institutional adaptation and the mobilization of economic and social resources. In a world in which codified knowledge is becoming increasingly important, ubiquitous, tacit and uncoded knowledge, rooted in the relations of proximity of which local development is rich, may also provide advantages in the broader economic, political and social market.

Transformation, at least in CEE, has been a general process requiring a local dimension in order to support adaptation and learning and avoid excessive divergence among the constituent parts of countries. Along with this, there have been three other critical features of the process of transformation required for a strategic role of local development. The first feature relies on the centralized nature of the previous system, with the partial exception of former Yugoslavia, which required a far-reaching decentralization to support the development of a democratic political regime, a market economy and a pluralistic society. The second feature is the goal of these countries to integrate in the EU, where local development is one of the basic principles and a prominent policy goal. The third feature derives from the fragmentation in former Yugoslavia: in this case local development has been devised to support the build-up of new states and accommodate ethnic tensions.

However, local development must be of a particular type, in that it must foster and support the integration of economies, polities and societies that have lost the previous administrative glue typical of the Soviet-type system and the decentralized bargaining glue of the self-managed system. Although the required type of local development must overcome the negative effects of bureaucratization, it must also avoid the danger of secession and disintegration may follow from the disruption of a dominant system.

Recalling the three waves of local development mentioned in the second section, it will be noticed that in the Balkans:

- (a) the transition to the third stage is far from fully implemented and generalized, and perhaps is still in its infancy. Policies implemented in SEE countries include important first-wave elements. Massive grants, subsidies to loans, tax breaks, subsidized hard infrastructure investment, upgrading of local governments, support to minorities, etc. are extensively used in all Balkan countries;
- (b) many policies are better characterized as second-stage policies. The extensive provision with rights and protection granted to minorities, through setting up new offices or specialization of public administration sections for dealing with EU and other funds and functions, with real services, in particular, with business incubators, advice and training for SMEs, technical support, business start-up support, which are perhaps the most important components of local development policies;
- (c) there are differences among countries as far as the combination of policy stages is concerned. A rather direct relation apparently exists with the level of development and economic and political openness. The countries and regions/localities that are more developed and more open also make more extensive use of second- and third-wave policies;
- (d) the particular 'content' of each stage is different compared to the above summarized 'common wisdom', due particularly to differences in institutional maturity. This statement should be read in two ways: first, the relative underdevelopment of institutions and actors' capabilities in the sense of (administrative, economic, legal, political, and social) maturity requires transitorily a greater interventionist content of policies. But, secondly, those same features may allow for a wider and deeper use of an indirect approach making greater use of indirect incentives and concentrating more at each stage on creating a development friendly environment;
- (e) when more mature (third-stage) policies are implemented that do not take into account the existing system and the actors' capabilities, unwanted and unforeseen consequences are widespread. These usually include the irrelevance of policies and structures, and support to rent-seeking attitudes and strategies (e.g. business incubator).

Three chapters in this book illustrate important aspects of the problematic nature of local development and show that the interaction between the external context and internal processes has been unbalanced and perhaps unilateral. Bartlett (Chapter 8) stresses that over the last decade the international community has provided enormous amounts of financial assistance to the Western Balkans. Recent literature on the effectiveness of financial aid flows has debated the influence of domestic policies on the effectiveness of financial aid. This chapter disputes the relevance of this debate in so far as it

takes domestic policy as 'given'. Drawing on the recent literature on the phenomenon of policy transfer, it argues that domestic policies are likely to be endogenous factors embedded within the flow of aid, and that policies are transferred by donors to recipients alongside financial flows. This approach draws attention to the aims and purposes of the agents involved in the donor-recipient relationship, and suggests that aid effectiveness is influenced by subjective factors and incentive structures specific to each individual case. Consequently the chapter argues for a case-study approach to aid effectiveness, and to the identification of the causes of policy success and policy failure. The theme is illustrated by a detailed examination of donor interventions in the economic development of North Montenegro, the least developed region of one of the poorest countries in the Balkans. The findings point to the complexities of the relationships involved in local economic development in the region, and indicate that neither international aid nor policy transfer are likely to provide easy solutions to the problems of poverty and underdevelopment endemic to the region.

According to Bateman (Chapter 9), since the collapse of communism, the overwhelming focus of enterprise development policy in South-East Europe has been upon conventional investor-driven enterprises. Cooperative development has been largely ignored, often seen as no more than an unwelcome throwback to communism, thus pointing to institutional incompleteness. This policy choice ignores a mass of evidence from across the world that the cooperative sector can play a vital role in promoting sustainable local economic development, especially in post-conflict countries. However, the growing perception of failure surrounding the policy advice emanating from the international development agencies, such as the World Bank (WB) and International Monetary Fund (IMF), has opened up new possibilities for cooperative development in South-East Europe. As a result, many new cooperative development programmes have been started, especially in the agricultural sector. New and more pro-active policies for cooperative development are required in SEE, however, if the sector is to achieve realistic and sustainable progress against a backdrop of continued decline in most key economic and social variables.

Finally, Trevisan (Chapter 10) discusses the possibility of fostering institutional innovation in the form of SMEs networks by means of de-localization from Western market economies. The chapter analyses whether the Italian industrial districts and their most complete form, the *area sistema*, are 'reproducible' in SEE. It analyses Outward Processing Traffic (OPT) between Italy and CEECs, and presents the de-localization of Italian SMEs, using the Veronese footwear district as an example. The *area sistema* is presented as an important answer to the problems of socio-economic development in areas peripheral to the main industrial and economic centres of a country and, as such, a potential model for local development in transformation countries. Data on trade flows between CEEC and Romania, particularly OPT, are discussed and used to show the existence of an international production network

between Italy and Romania in a few, SME-dominated, industries. This example shows how the attitude of many Italian *area sistema* SMEs is changing from a footloose quest for lower labour costs to a longer-term strategy of collaboration and nurturing of local capacity aimed at creating the conditions for improved strategic competitiveness of the de-localizing firms with important consequences in Romania.

Conclusions

Local development in the Balkans shares much with local development in the most developed countries upon whose experiences the mainstream approach is based. Yet, local development in the Balkans also shows specificities that derive from the particular administrative, economic, international, legal, political, social, features of these countries and their historical and cultural experience. It is the intertwining of internal and external factors and the difficult geopolitical situation of the Balkans that create a complex situation that EU support has to take into consideration. According to Gozi, the end of the bipolar system has placed the Balkans in a new and indefensible position, showing the inability of the states of the region to realize, on their own, a new security system, and highlighting the weak territorial integrity of Yugoslavia. The Balkan conflicts started in a moment of European institutional, political and operational emptiness. With the Stabilization and Association process, the EU gave a long-term vision for integration to all the countries of the region, while the Stability Pact constitutes the greatest attempt by the international community to use economic assistance and European perspective to stabilize the entire region in a long-lasting way. Such a process represents a new political context in which the EU and the Balkan countries elaborate a real common agenda and mutually engage to complete all the necessary efforts to realize it. The Balkan region can play a multiple role: it could be the last to join the EU's enlargement process, and represent the first step within the strategy of a 'larger Europe' facilitating the implementation of a special EU relationship with all the neighbouring countries, from Russia to the Mediterranean.

The various chapters in this book offer a coherent view, that may be summarized as follows. First, the external context presents important positive elements, but also has problematic aspects. Among the former, the role and the resources of the EU stand out. Among the latter, inequality and poverty and some consequences of international trade stand out.

Secondly, reforms have been uneven and incomplete throughout the region. This refers to all fields of administrative, economic, legal, political, and social life. It refers to both institutional reform and their consequences for social actors. The general outcome is that, while on paper the most important general reforms are either completed or apparently quite close to those existing in developed market economies, pluralistic societies and democratic polities, in reality their effect is still largely formal and not particularly effective.

Thirdly, as a consequence of the contradictory external context and of reforms, the economic, legal, political, and social systems are either incomplete or their working is ineffective. This has important and often negative consequences for economic, political and social actors, who find contradictory and ineffective guides to their activity, weak and blurred constraints, and conflicting incentives. This, when added to the relatively undeveloped configuration of the actors' capabilities in terms of competitive market economy, pluralistic society and democratic polity, explains why the situation is still unstable and unsatisfactory in most fields. However, this conclusion does not apply in the same way and with the same force to each country. Intercountry differences are significant and important.

Although much has been done in difficult circumstances, much remains to be done. This is the duty of policies. Since many internal and external elements exist that may support a virtuous outcome, the duty should not be prohibitive. Unfortunately, the recent turn in the process of European integration may jeopardize this outcome just in those countries that need most in terms of perspectives and stability: the Balkans.

Based on the analysis and conclusions reached in this book, supportive policies should have the following features.

1. Policies should be designed to strengthen networks more than focusing exclusively on individual actors and encourage the formation of social capabilities along with individual capabilities.
2. Policies should involve a plurality of decentralized and autonomous organizations since effective economic governance extends beyond the reach of individual organizations and should internalize spillover effects. There is also a need to encourage intermediate and mixed forms of governance, building upon local capabilities and institutional spillovers and including both the public, private, social, political, and nonprofit sectors.
3. Since institutions are in the making and the relation between the new formal and informal institutions is still unsettled, policies should aim at encouraging voice and negotiation and the formation of market-, democracy-, and pluralism-friendly procedural and recursive rationalities of behaviour. In an unsettled institutional context substantive rationality, which favours rule-bound behaviour, may have just formal or even perverse effects. Under these conditions, procedural and recursive rationality – favouring behaviour based on the accommodation to environmental constraints and strategic behaviour – should have priority in order to secure strategic vision, learning and adaptation.
4. Policies and the solutions pursued should be context-specific (for example consider the weakness of SMEs or poverty, or build upon the existence of universities and research centres) and pay attention to local path-dependencies to pursue transformation and development goals. In this way, policies would build upon spontaneous processes which have lower transaction

costs, better utilize the actors' assets (particularly knowledge), and lead to better sustainable solutions. However, policies should not become hostage to context-specificity and path-dependence that, in the unfavourable Balkan circumstances, would easily result in unwanted consequences. To this end and as far as spontaneous developments are insufficient, there is a great need for the state to provide a fundamental and strong role not only in institutional enforcement but also in arbitrating between decentralized authorities, pursuing collective strategic goals, upgrading human and social capital, supporting knowledge recontextualization, and, if needed, reallocating resources to these ends.

The final aim of policies should be to build the conditions for the development and wealth of local economies, polities, and societies by upgrading the administrative, economic, political, social and human base as the prerequisite for the success of transformation. This is not an easy undertaking since policies have important trade-offs and local policies coexist necessarily with more general policies and are under the influence of international events and policies. Therefore, they should pursue local goals by properly interacting with the general context. This is an important guarantee that policies based on mobilizing local resources do not degenerate into localism and an crucial factor in supporting local capabilities in anticipating and responding to changing internal and external circumstances.

5. Foreign-assistance programmes should take into account more the specificities of locality within countries, and should try to adapt the policy framework, which they often implicitly transfer to the beneficiary countries, to the variety of local circumstances. This would require paying more attention to the ways in which local economies function, and to the variation in local institutions within which economic incentives and agents' motivations are embedded.

Further research is needed to support the above conclusions in the case of the Balkans and elsewhere. This will hopefully make local development at the centre of attention.

Notes

1. I thank various authors of this volume, and in particular Will Bartlett for helpful comments on a previous version of this introduction.
2. However, the intensity of transportation to individual goods is now greater than in earlier times due to a deeper infra-industrial labour division.
3. Please see note 3 on page 126 for an explanation of this term.

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