Building Capacity:
Applying EU Experience to the Western Balkans

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There is an old joke told about economists. It is often said that they are people who worry about whether things that are known to work in practice will also work in theory!

But there is a sting in the tail of this joke. Namely, that new policy initiatives – such as extending a type of EU Structural Fund investment aid to the Western Balkans - often need compelling intellectual support in addition to demonstrable practical need. Where ideology and logical arguments reinforce a case based on obvious need, vigorous and effective action often results. But when need and ideology clash, ideology often wins the day.

Let me illustrate this by referring to and earlier presentation in our conference. Three rather striking points were made concerning the development of the Western Balkans region:

(1) Any outside financial support to the region should be transitional;
(2) The region does not consist of "developing" countries; and
(3) The region was wealthy before, and should be capable of regaining the prosperity that it once enjoyed.

Behind this cautious attitude presumably lies a reluctance to be seen to promote what was earlier referred to as "aid addicted societies", and what we economists refer to as a *Mezzogiorno* problem, after the regions of Southern Italy which have been in receipt of large-scale aid since the early 1950s, and which has stubbornly refused to develop and catch up with the more prosperous Northern Italian regions.

The term "cohesion" first came into use in the late 1980s at the time major reforms and expansions of EU regional aid were being carried out. As set out in Article 130a of the Treaty on European Union, there is an explicit aim to promote "harmonious development" with a specific geographical dimension: "reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions". Thus, there is an explicit recognition that wide disparities are intolerable in any community, if that term has any real meaning.

Orthodox (or neo-classical) theory takes the view that all one has to do to promote cohesion between the regions of any state or between grouping of states is to put in place policies that facilitate the free movement of goods and the factors of production (i.e., labour and capital).

Newer theories of growth and development have served to focus attention on the importance of such factors as the initial level of regional physical infrastructure, local levels of human

capital, the fact that regions that start off at a structural disadvantage may never converge in any reasonable time period.

The political problem is that the benefits of EU Structural Fund-type investment aid are by no means accepted universally, particularly by the major donor states: Germany, the UK and the Netherlands. In the empirical policy literature, the debate rages, and both sides point to studies that show that such policies in the past have had a wide spectrum of effects ranging from negative to positive. For example, recent evaluations by the Dutch Planning Bureau – the influential CPB – suggested that such aid was useless in promoting growth other than in a context of complete economic openness to the forces of globalization.

So, even if there were a political willingness to do so, the empirical economic case for extending EU investment aid to the Western Balkan region is by no means self evident. A compelling case needs to be built.

In an earlier revealing interchange at our conference, we learned how the European Commission reacted to a Romanian request for an easement of visa restrictions. It appears that the Romanians were told to go away and make the case! The same applies to the extension of Structural Fund-type assistance to the West Balkan region. The West Balkan states will have to make a compelling case, particularly in an internal political context that is by no means favourable to success.

In my short presentation I want to share with you some insights from the EU experience with Structural Fund aid since 1989, and how this is being extended to the acceding states from 2004, after an extended prior period of transitional aid during the 1990s. The European Stability Initiative (ESI) and Gerald Knaus in particular - has made an eloquent practical case for this kind of investment aid system to be extended to the Western Balkans. Their policy prescription – as laid out in the paper entitled *The Road to Thessaloniki* in March this year (which was stated earlier in November, 2002 in *Assistance, cohesion and the new boundaries of Europe*), is as follows;

(1) A pledge to make cohesion an explicit EU objective in the Western Balkans;
(2) A commitment to applying lessons from cohesion policy in the EU and the acceding countries to the Western Balkans;
(3) A commitment to sustaining assistance levels so that the gap between the present candidate countries, such as Bulgaria and Romania, and the countries of the Western Balkans does not wider further.

The ESI case is a compelling on the grounds of trans-European equity. My contribution will be to write a footnote to bolster that with additional arguments on the basis of efficiency, and I hope that the overall case will be persuasive in the corridors of Brussels!

First, I will briefly describe the type of planning, monitoring and evaluation systems that lie behind large-scale Structural Fund programmes, and this will beg the question as to whether the economies of the Western Balkan region are currently in a position to replicate such systems. For those interested in more detail, I have a separate detailed paper that I can make available.

Then I will comment on some features of the West Balkan economies that appear to stand in the way of successful Structural Fund-type programmes. These problems need to addressed directly and honestly.

Finally, I will make some suggestions on what form an EU aid package might take and how the region itself might create conditions that might call forth a favourable response from Brussels.

Living with Structural Funds:

EU regional investment aid was expanded greatly in the late 1980s for two main reasons;

(1) Successive enlargements had brought in a group of poorer countries (Ireland, Greece, Portugal, to a lesser extent Spain), and there was a risk of a two-tier Europe: rich and poor;

(2) In the Single European Market initiative of 1992, there was a serious risk that the rich would become richer, and the poor would become poorer;

Given the very small size of the overall EU budget (under 1.5% of EU GDP compared with 40-50% for national budgets), the regional investment aid was focused on the poorest states (Greece, Ireland, Portugal) and the poor regions of states (southern Italy, southern Spain, and after German unification, the East German Lander). A special category of under development was defined: Objective 1 states are those whose general economic performance lagged behind the EU norm. Other sub-categories have also been defined: regions suffering from de-industrialization, regions suffering from serious youth unemployment, etc.

What is special about the Structural Fund-type policies is their goals, i.e., to design and implement policies with the explicit aim of transforming the underlying structure of the beneficiary economies in order to prepare them for exposure to the competitive forces being unleashed by the Single Market. This was, in effect, "economy-building", the economic equivalent of political "nation building".

These policies moved far beyond a conventional stabilization role, being directed at the promotion of structural change, faster long-term growth, and real convergence through mainly supply-side processes. They are intended to leave enduring impacts in terms of enhanced economic performance, even after the funding is wound down and terminated.

There are three main channels through which the development-enhancing effects of EU Structural Fund aid operate. These investment programmes:

1. Improve the physical infrastructure of the economy (roads, rail, air, sea, and electronic access, etc);
2. Raise the level of human capital (through enhancing the skills and education of the labour force); and
3. Directly assist private sector performance by subsidizing productivity-enhancing investment.

How relevant are these policies to the West Balkan states?

The first phase of the transition of the former command economies of Central and South-Eastern Europe involved considerable disorganization and a very basic overhauling of industrial and institutional capacity. Socio-economic mechanisms operating during this phase entailed the creation of market-based institutional structures accompanied by substantial reallocation of labour between the public and private sectors, as well as between manufacturing and market services.

The initial impacts of restructuring generated the well-known U-shaped pattern for income and employment: a sharp decline in activity, a bottoming out, followed by recovery. Most CEE economies have clawed their way back to a level of performance that at least equals that experienced prior to the liberalization of the late 1980s. Many have moved far beyond that baseline level. One country – Slovenia – has performed so well that it is about to move beyond the level of relative GDP per head that serves to define Objective 1 status: namely, 75% of the EU average.

This first phase of transition is by no means complete in the Western Balkan region. Gerald Knaus's presentation earlier at our conference, in combination with a series of detailed ESI papers – mainly from the *Lessons Learned and Analysis Unit* – illustrate just how far from completion this first phase is.

However, the processes that characterize the early years of transition in the Western Balkans should not be taken as the pattern of behaviour for the future. The second phase of transition is more likely to resemble the path followed in recent decades by EU countries like Greece, Ireland and Portugal, where the driving forces behind cohesion (or catch-up) include:

1. Progressive trade integration with the EU;
2. Foreign direct investment inflows;
3. Technology transfer; and
4. EU-aided investment programmes, mainly for the support of infrastructural and human-capital development.

What does the EU look for from any Structural Fund-driven development strategy? Briefly, it should provide a coherent and comprehensive set of policies for economic and social development for the foreseeable future, and it must be consistent with the availability of resources and its various parts must be well integrated.

More formally, it must have four crucial elements.

<u>First, it must set explicit targets</u>. **Prosperous developed countries can enjoy the luxury of setting a diverse range of socio-economic targets, since they tend to have adequate resources. Developing countries, on the other hand, need to focus on the over-riding target of accelerating growth of income per head.** Given appropriate care in influencing income distribution within the country, other desirable socio-economic objectives tend to come into line as a direct consequence of income growth (e.g., facilitating improvements in social conditions in the health and education areas, improved environmental care, etc.).

<u>Second, development strategy must clearly identify constraints</u>. For any poorer country, constraints are only too plentiful. The country may be located in a peripheral or otherwise

unfavourable geographic-economic area, close to zones of conflict and of deteriorating economic performance. **In almost all such economies, there is a inadequate set of institutional structures. The initial level of development is usually low, putting constraints on the availability of resources (i.e., policy makers face financial constraints from the balance of payments and in funding public sector borrowing requirements). It will probably have an unfavourable initial economic structure, with a very large agriculture sector, an unsuitable configuration of industrial sectors, and a very under-developed market services sector. The level of human capital as well as the level of technology tends to be low, placing constraints on feasible development strategies.** The need to reduce exploitation of non-renewable resources may place further constraints on growth.

Third, it must identify suitable policy instruments. The availability of suitable social and economic policy tools is as important for the success of any development plan as the clear statement of objectives. These usually include increased investment, fiscal incentives aimed at stimulating the private sector, and appropriate wage-setting institutions. In particular, public investment will focus on infrastructure and human capital, with increased investment in health, education and research, while stressing the need to improve telecom and transport infrastructures as well as building information technology competences. Both foreign and indigenous firms require incentives, designed to make the region more attractive to local as well as inward investment, since this latter will be the main facilitator of technology transfer and the re-orientation of manufacturing towards fast growing export markets. The main threat to restructuring will be unrest in labour markets. An evolution of wage rates that disregards the need to maintain international cost competitiveness will choke off growth. Consequently, any strategy can benefit from forms of Social Partnership among the three main institutional players – government, trades unions and employers - aimed at producing an orderly evolution of wage costs that preserves cost competitiveness.

Finally, it must include a rigorous system of monitoring, evaluation and renewal: Perhaps definitions of these two terms – monitoring and evaluation - may be useful at this stage:

Monitoring: This term is usually used to describe the verification of adequate compliance with policies agreed and codified in the SF treaties and their supporting documents, including financial aspects (was funding spent according to the plan?), as well as the collection and analysis of relevant activity and performance indicators (length of roads built, numbers of people trained, etc.).

Evaluation: This term refers to the examination of whether the Structural Fund programmes implemented actually brought about the achievement of the desired goals. This involves the tracing out and quantification of the chain of causality between structural measures being applied and the securing of intended objectives. At the most aggregate level, the basic question is whether or not the Structural Fund programmes taken as a whole promoted convergence (or cohesion). At a more detailed level, one might seek to evaluate how an individual project (such as the construction of a specific section of new road, the execution of a specific training scheme, or the provision of a specific aid to company export marketing) increased economic efficiency or addressed market failure.

How has this process of Structural Fund aid worked in the EU? Since the late 1980s, there have been three waves of EU investment aid: 1989-93 (Delors I); 1994-99 (Delors II); and 2000-2006. The acceding states will come into the last programme for the period 2004-2006.

The first stage in the SF process involves the preparation of a comprehensive National Development Plan, setting out:

a) A detailed statement of the socio-economic *status quo*,
b) A clear diagnosis of the major barriers to faster growth and development,
c) An identification of a range of policies that will address these problems,
d) A formal costing of these policies,
e) The execution of an *ex ante* evaluation of the extent to which the NDP will promote cohesion.

When the details of the NDP have been fully negotiated and agreed with the EC, a formal CSF (or Community Support Framework) Treaty is drawn up, codifying the arrangements in a quasi legal way. There are quite complex institutional and organisational requirements to this process, with important horizontal and vertical elements.

Concerning *horizontal* aspects, an active system of Social Partnership has always operated in Ireland. The Social Partnership consists of the main Trade Union organisation (The Irish Congress of Trades Unions, ICTU), the main employers organisation (the Irish Business and Employers Confederation, IBEC), the main Farmers organisations, representatives of the unemployed and socially excluded, and Government (both central and local). This Social Partnership operates at the very heart of strategic policy-making, and in particular is a vehicle used to negotiate a social pact every three years that covers issues such as wage determination, the level of social support and many other aspects of government policy.

The Social Partners tend to become involved in the monitoring of EU funds mainly through participation in Steering Committees for the individual Operational Programmes of the Structural Funds. Social Partners also make important inputs into the formulation and priorities of the National Development Plans that precede the agreement of the Community Support Frameworks with the European Commission. But they are not normally directly involved in actual policy decisions. Perhaps this situation can be best explained by the fact that the Irish political system is very "centrist" in structure, with the main parties who enter governing coalitions grouped around the centre and not strongly divided along a left-right axis, as in many other EU countries.

Concerning *vertical* aspects, it must be stressed that regional government in Ireland is very weak, with little or no policy-making discretion and no fund-raising powers. The small size of the country (population 3.7 million) also tended to encourage continued centralisation in policy-making, particularly in aspects such as planning the physical infrastructure of the country in an integrated way, and in ensuring that systems of education and training, as well as investment incentives, were designed with national interests and standards in mind.

The first two EU Structural Funds (or Community Support Frameworks) covered the periods 1989-93 and 1994-99, and were designed and implemented with a purely national focus. For the purposes of these CSFs, the whole country was designated as Objective 1, i.e., a lagging region in need of development and structural adjustment. These CSFs were designed and administered centrally, by various Government Departments. The nature of monitoring was determined at the implementation stage. For example, the actual construction of roads were administered at the level of Local Government, and Local Government had a role in monitoring progress. Education and training schemes were designed by the responsible

Central Government department and administered through a mix of central institutions (such as a national training agency, FAS) as well as through vocational schools, which came under the control of Local Government.

In summary, it could be said that the first two Irish CSFs were designed, monitored and evaluated within a system that had strong *horizontal* elements, but only limited *vertical* elements. Only at the implementation stage did *vertical* organisational elements come to the fore. The latest CSF – with its greater emphasis on regional issues - has had stronger vertical elements.

Who administers the monitoring system?

The Managing Authority for each Operational Programme of the CSF is vested in a range of different bodies. Taking the latest CSF for the period 2000-2006, the Managing Authority for the overall CSF is the Department of Finance. There are seven Operational Programmes, as set out below:

1) Economic and Social Infrastructure (Dept of Environment and Local Government)
2) Employment and Human Resources Development (Dept of Enterprise, Trade and Employment)
3) Productive Investment (Dept of Enterprise, Trade and Employment)
4) Border, Midlands and West Regional Programme (BMW Regional Assembly)[1]
5) Southern and Eastern Regional Programme (S&E Regional Assembly)
6) Peace Programme (Special EU Programmes Body)[2]
7) Cohesion Fund, devoted to physical infrastructure (Department of Finance)

The principal responsibilities of the Managing Authority for each Operational Programme is as follows:

(a) Chairing and providing the secretariat for the Monitoring Committee.
(b) Assembling statistical and financial information required for monitoring and supplying this information to the CSF Evaluation Unit in the Department of Finance.
(c) Drawing up an annual implementation report for approval by the Monitoring Committee and for submission to the European Commission.
(d) Submitting payment claims to the paying authorities for Structural Funds.
(e) Ensuring that EU funded expenditure is properly accounted for and managed.
(f) Ensuring compliance with EU policies on public procurement, publicity, the environment and equality.

Each Operational Programme and the CSF as a whole, is supervised by Monitoring Committees, whose membership has remained fairly stable over all previous CSFs. Typically, there are representatives from the Managing Authority, the Department of Finance (which exercises a general supervisory role), other Government Departments and public bodies involved in implementation of programme measures, representatives from the regional assemblies and from the Social Partners (all pillars). In addition, there are representatives of

[1] For the purposes of CSF 2000-2006, Ireland has been divided into two regions: the Border, Midlands, West (BMW!) region, designated as Objective 1, and the Southern and Eastern (S&E) region, designated for transitional aid.
[2] The Peace funding is a special issue related to the civil conflict in Northern Ireland, which has affected the border areas of the Republic of Ireland adversely.

equal opportunity and environmental interests drawn from relevant Government Departments or other statutory bodies.

The Monitoring Committee is responsible for decisions regarding EU co-funded measures in the Operational Programmes, including decisions on the reallocation of co-funded expenditure between measures within the Operational Programmes or between Operational Programme in the case of the overall CSF Monitoring Committee. They are also responsible for the mid-term review of the Operational Programmes in conjunction with the CSF Evaluation Unit in the Department of Finance. As regards operating procedures, each Monitoring Committee is responsible for drawing up its own rules of procedure and agreeing them with the Managing Authority and the Department of Finance. The Monitoring Committee is chaired by a representative of the Managing Authority.

Success?

How successful have the CSFs been in promoting faster growth in the EU Objective 1 regions? This is by no means a simple question. To answer it requires one to formulate a hypothetical or counter-factual outcome where Structural Fund aid is absent, and to compare this with a situation where aid is available. It also requires one to explore the effects of other changes in the external and policy environment that might also have serves to boost growth (e.g., the Single European Market, EMU, CAP reform, the global business cycle, etc.).

To answer these questions requires the assistance of much economic research and the use of computer models. **Cutting through the tedious technical details, research suggests that the Structural Funds were crucial to the enhanced performance of Greece, Ireland and Portugal. Ireland started at 64% of the EU average living standards in 1988 and by the end of the 1990s was above 110%. Those figures flatter the Irish performance to some extent, but it represented a massive improvement. We summarize briefly a logical sequence of interconnected effects that brought about that impressive Irish result.**

1. First, the Irish economy in the late 1970s and for the first half of the 1980s was seriously and massively destabilized – high unemployment, relatively high inflation, and the public finances almost out of control. Fiscal stabilization measures were implemented rigorously from the mid-1980s.

2. Second, there were the effects of the Structural Funds. These had demand and supply effects. As you actually build a road, it injects income and expenditure into your economy. But the long-lasting benefits of building a road come when it is available to connect your cities and to transport goods more efficiently into and out of your economy. So, there was an immediate stimulus to demand, and the longer term benefits came towards the middle of the 1990s.

3. The third event was the beneficial effect of Ireland joining the European Monetary System (or EMS). This was the exchange rate mechanism that was instituted in 1979 and served as a precursor of the 1999 Economic and Monetary Union (or EMU). But the credibility benefits of Ireland's membership of the EMS were delayed by about a decade. The lower Deutsche Mark interest rates did not become available to the Irish economy until the late 1980s when eventually credibility was established.

4. The fourth event was the massive inflow of mainly US foreign direct investment, most of it in high technology areas. This was in part a spin-off benefit of the Structural Funds, making use of the improved infrastructure and human capital. It was also due in part to Ireland's access to EU markets for exports produced by multi-national companies located and producing in Ireland. Additionally, of course, one of the long-term elements of Irish policy was a low rate of corporate taxation, designed to attract inward investment.

5. The fifth event, producing a reinforcement of the fiscal stabilization benefits, came as a result of the Irish government strongly signaling its firm intention to join the EMU from the start-up in January this year, even in the absence of our largest trading partner, the United Kingdom, from EMU membership.

6. Finally, in Ireland there was an evolving social partnership (involving employers organizations, trades unions and government) that eased the distribution conflicts and disputes that come with recovery and rapid growth.

Could these results, and the good performance of Portugal and Greece, be replicated for the West Balkans?

The West Balkan economic restructuring

You will appreciate that the CSF-type aid programmes are complex, and impose serious "compliance" costs. In the case of the existing EU member states, they served to dynamise economies that were already fully compatible with the demands of full integration into the Single Market. In the case of the acceding states of Central and Eastern Europe, they come on stream at a time when the first phase of "transition" from the formed Communist planning regimes is complete, and the second – cohesion – phase is well under way.

Are such programmes suitable for the Western Balkan region? The answer to this question depends on institutional capacity of the states in the West Balkan region. Let us reflect for a moment on this issue.

Douglass North has suggested that:

> "the present and the future are connected to the past by the continuity of a society's institutions".

A common feature of most of the Balkan states is that conflict was accompanied by a complete breakdown of the societal institutions, which further exacerbated violence. It is impossible to assign causality here, but the breakdown of institutions is usually the most important element of any self-determination dispute insofar as the collateral damage to the economy is concerned.

North makes a distinction between what he refers to as the "rules" and the "players". The rules (or institutions) define the way the economic game is played. But the players (or organizations) operating within a given set of rules determine the economic opportunities in a society. As organizations evolve, they alter the institutions. If the underlying institutional

framework reinforces incentives for organizations to engage in productive activity, then this usually produces economic growth and development.

But if the institutional framework (or, indeed, an inability to provide any such framework in a situation of conflict) favors activities that promote redistributive rather than productive activity, and creates monopolies rather than competitive conditions, then this restricts growth rather than expands it.

North's work augments conventional economics and constructs a theory of institutions by combining a theory human behaviour with a theory of the costs of transactions, and led him to delineate three types of archetypical exchange mechanisms that underpin all economic activity:

i. Personalized exchange involving small-scale production and local trade;
ii. Impersonal exchange, in which the parties are constrained by kinship ties, bonding, exchanging hostages, or merchant codes of conduct;
iii. Impersonal exchange with third-party enforcement, of a type that is a critical underpinning of successful modern economies involved in complex contracting necessary for modern economic growth.

History demonstrates the tendency to evolve sequentially from the first to the third exchange mechanism over time, but the Balkan experience is one of situations of conflict where economies have imploded and exchange mechanisms have reverted to earlier, more primitive, and often illegal forms. North concludes that:

> "One cannot have the productivity of a modern high income society with political anarchy".

and suggests that:

> "Political rules in place lead to economic rules, though the causality runs both ways. That is, property rights and hence individual contracts are specified and enforced by political decision-making, but the structure of economic interests will also influence the political structure".

Mancur Olson has used a related classification of markets into "self-enforcing" and "socially contrived". Absent an appropriate institutional environment, a country will be restricted to trades that are self-enforcing. But with appropriate institutions (legal system, political order, etc.), all possible gains from trade can be realized. Olson suggests two general conditions that are required to sustain a market economy that is likely to generate economic success:

1. secure and well-defined property rights, as well as
2. the absence of predation of any kind.

He concludes:

> "Given the extraordinary gains available from adopting the advanced technologies available in the postwar world and the possibility of interacting with a reasonably successful world economy, these two conditions, if fully met, are nonetheless sufficient to bring prosperity to a society".

An essential part of any aid programme often involves the establishment of a devolved administration to oversee the operation of public policy and administration. A central issue concerns the degree of autonomy in policy making that is granted to the regional authority, and the implications for regional and national financing.

A devolved system of governance tends to be valued for a variety of reasons.

1. It encourages an efficient allocation of national resources;
2. It fosters political participation and a sense of the democratic community; and
3. It helps to protect basic liberties and freedoms.

Central government is assigned responsibility for services that are pure public goods (e.g. national defense, basic research) or when there are inefficiencies arising from externalities across jurisdictions (e.g. transport, communications and energy infrastructure). Lower-tier government is assigned responsibility for provision of "congestible" services, i.e. ones that become congested as more households use the service (health, education, police, sanitation), and may also fulfill a role in conflict resolution.

Regions of centralized states face a further dilemma as they participate in the global economy because the nation-state has tended to become a somewhat unnatural, even dysfunctional, unit for organizing human activity and managing economic endeavor in what is becoming a borderless world. A nation-state sometimes represents no shared community of economic interests and may not define meaningful flows of economic activity. The nation-state tends to overlook many of the true linkages and synergies that exist among often disparate populations by combining important measures of human activity at the wrong level of analysis.

In what has become an extensive debate, others have argued that the much discussed phenomenon of "globalization" does not mean the hollowing-out or death of the nation-state, nor indeed a withering away of the economic strength and policy autonomy of national governments. The important point is that increased regional autonomy and the continuing importance of the nation-state are not contradictory, but should be mutually-beneficial and mutually-reinforcing phenomena. For example, it has often been argued that strong regional economies tend to be associated with strong national economies and that an important factor is the degree of regional policy autonomy.

The European Stability Initiative (ESI) has pointed out that, as the period of initial reconstruction and stabilization draws to a close in the Western Balkans region, there is a looming crisis of social and economic dislocation. The crisis is emerging just as existing EU assistance is being scaled down, and in a context where the countries of the region find themselves excluded from the EU enlargement process. The ESI suggest that the existing EU policy instruments – designed with post-conflict reconstruction in mind – need to evolve into a genuine and long-term commitment to address the region's chronic economic and social problems. A possible suggestion would be that the EU undertake to include the Western Balkans in its commitment to economic and social cohesion across Europe prior to opening negotiations with states in the region.

An investment aid package for the West Balkans?

In the post-communist era the homogenizing forces of globalization place severe restrictions on the menu of economic policy options that are realistically available to small countries and regions. When conflict moves towards resolution, the first dawning reality of devolved or self-government is usually the grim realization of just how powerless countries and regions can be in designing and implementing well-meaning strategies to improve their economic welfare!

Much attention has been paid to the role of international involvement or intervention. But foreign direct investment, by far the dominant form of international involvement in any modern economy, usually manifests itself only when any conflict is fully resolved, or when it is partially resolved and violence has reduced to an "acceptable" or "tolerable" level. Host country experiences of inward investment can take different forms: many such experiences are development-enhancing while some are exploitative. But openness to the global economy, and in particular to foreign private capital, is a crucial lever of growth, and post-conflict economic policies are often directed at enhancing the ability to attract such investment, in a context of fierce competition from other countries and regions, in order to augment their own domestic successes.

But there are severe limitations on the scope of small economies in this area. An important reason why groups of nations tend to adopt similar strategies arises from basic similarities in their size and their stages of development. For example, Ireland would appear to fall neatly into a category that one might term an "industrial nicher". This group includes smaller industrialized nations, in particular the smaller EU member states, whose main characteristic is that their domestic markets are too small to permit a competitive strategy based on scale economies and cost reductions other than in highly selective niche sectors.

One can characterize their strategic dilemma as "the small-country squeeze".

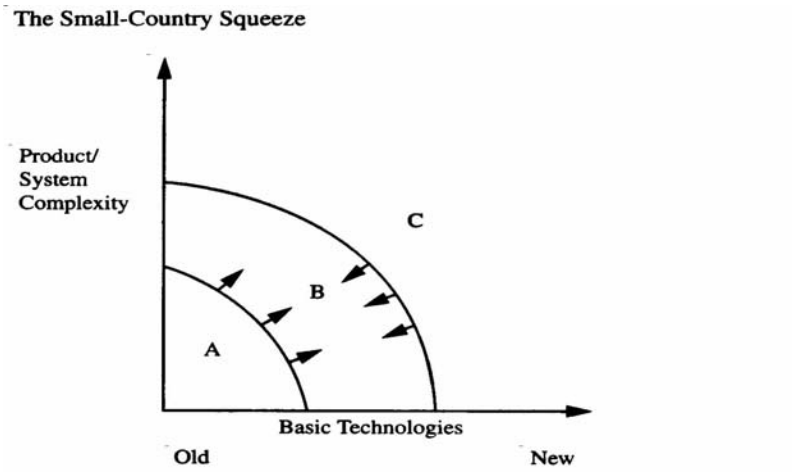
i. They are subject to fierce competition in simple products based on mature technologies from the newly industrialized countries (NICS) of Asia:

ii. Their indigenous manufacturing is effectively excluded from markets for complex products, based on new technologies, where the economic "superpowers" are dominant: This area is itself increasing as traditional sectors (such as Benetton in clothing) themselves adopt new technologies.

iii. The natural domain of "nichers" is therefore being squeezed in both directions. Only when the niches are dominated by foreign multi-national enterprises are they likely to be capable of sustaining global competition. The niche sectors in Ireland – computers, software and pharmaceuticals – are almost all foreign owned.

A crucial choice for small nations is whether to encourage specialization in areas where they already have a comparative advantage (obtained either through low cost production capability arising from scale economies or through experience curve benefits), or to develop a niche in a new area where the potential benefits may be greater.

Figure 1: The small-country squeeze



Source: Christopher Freeman and Bengt-Ake Lundvall, eds., *Small Countries Facing the Technological Revolution* (New York: Pinter Publishers, 1988), Figure 2.1, p. 49 (based on Stankiewicz, 1982).

Policy strategists in Ireland, in view of its very late industrial development, choose to build a capability based on new technologies. This strategic thrust is appropriate for nations that have a relatively low level of wealth but possess, or can develop, strong international competitiveness. The strategic goal is to move up the ladder of relative income per head. For a small nation like the Ireland, with wage levels that were initially low relative to the USA and the wealthier European nations, but high relative to those of the less developed regions in Asia, South America and North Africa, the strategy needed the following features:

i. Competitiveness based on high productivity and quality rather than just on low wage costs;
ii. Creation of a niche in the global total value chain, assisted by trade liberalization, improvements in human capital and physical infrastructure, and direct incentives to encourage inward investment;
iii. A strategy of continual improvement in quality and towards ever higher value-added activities.

The trends in growth of world trade and investment are well known. The driving forces include the emergence of a "borderless" world due to trade liberalization and the emergence of the triad of supranational trading blocs (EU, NAFTA, ASEAN). Global industries have also emerged, which operate in all parts of the world and create a new international division of labour. With falling transportation and telecommunication costs, national economies were destined to become increasingly interdependent, and in the words of Robert Reich, President Clinton's Labour Secretary:

> "the real economic challenge ... [of the nation] ... is to increase the potential value of what its citizens can add to the global economy, by enhancing their skills and capacities and by improving their means of linking those skills and capacities to the world market."

This process of global competition is organized today mainly by multinational firms and not by governments. Production tends to be modularized, with individual modules spread across the globe so as to exploit the comparative advantages of different regions. Hence, individual small nations and regions have less power to influence their destinies than in previous periods

of industrialization, other than by refocusing their economic policies on location factors, especially those which are relatively immobile between regions: the quality of labour, infrastructure and economic governance, and the efficient functioning of labour markets.

In Ireland, governments of all parties pursued a vigorous policy of attracting suitable export-oriented industries to invest and produce in the country. In the early stages of the foreign direct investment (FDI) strategy, efforts were made to attract a wide range of industries, often in the mature stage of the product life cycle, but as the competitive position of the country improved, a more selective approach came to be adopted. Today, the support strategies are designed to attract industries that are in the growth stages of their product life cycle, when profitability is high.

At the level of the individual firm or corporation, strategy is usually formulated in a context where government policies are largely taken as given, and firms address the challenges of assessing the business portfolio and identifying strategic goals. The crucial role of management is to formulate a corporate strategy that aligns with the nation's wealth-building strategy. So, this issue is usually examined largely from the point of view of domestic corporations adjusting to national strategy.

In Ireland, or indeed in many other small economies, including the Balkans, causality as often as not runs in the opposite direction. In other words, the Irish industrial development agency – the IDA – was constantly scanning the world for inward investment in high technology sectors. Quite often the domestic environment initially was not sufficiently attractive to persuade leading-edge firms to locate in Ireland. But information on firms' needs were fed back to the Irish government authorities by the IDA, and major policy changes could be executed rapidly.[3] So, the national wealth creating strategy in Ireland often needs to adapt to the requirements of firms in the global corporate environment, and not the other way around. Thus, the strategic challenges facing small open economies are very different from those facing large developed nations like the US, Japan, Germany, France, the UK.

Poor countries often have inadequate financial resources to address their developmental problems. If left to their own devices, such countries run the risk of drifting further away into poverty, and thus threatening internal socio-economic cohesiveness. Thus, poverty and conflicts of self-determination tend to form a vicious circle that can easily spiral out of control.

When preparing national and regional strategies for investment in post-conflict regions, it is useful to reflect on the pattern that emerged in EU structural aid programmes. We have seen that these are usually classified into three broad economic categories: support for basic infrastructure (i.e., roads, telecommunications, etc.); support for human resources (training, re-training, etc.); and support for productive structures (investment and marketing subsidies, etc.). Such programmes provide examples of how economic policy within the EU is shifting from one appropriate to independent and individualistic states to that of region-states fully integrated into an encompassing European economy. The willingness to go down this road was perhaps conditioned by domestic policy failures of the past. Few people believe any longer that impacts emanating from national discretionary demand management and "fine tuning" policies provide durable support for success in the long run.

[3] A case of information feed-back was the transformation of the Irish university system, where massive resources were put into the education of electronic engineering and chemistry to create a skilled labour force for potential inward investors.

Paul Krugman has described the issues that will be central over the next decade to the management of many of Europes small open economies. For example, he suggests that industrial revitalization will be led by an initial clustering of similar industries supported by local suppliers of specialized inputs subject to economies of scale. These clusters are likely to generate a local labour market for skilled workers which further facilitates the growth of the cluster. Appropriate human resource policies are crucial at this stage. Spillovers of information will further encourage growth in the initial sectoral cluster and provide the basis for additional clustering effects, often in traditional areas that benefit from new technologies (e.g., food processing, textiles, clothing). To facilitate this stage, the improvements in physical infrastructure and in the productive environment are crucial. Finally, a consensual process of social partnership needs to be put in place to ensure that there are as few losers as possible in the economic restructuring that accompanies such a virtuous circle, with the result that growth was less likely to be choked off by industrial unrest if the social partners fight over their respective shares of added value.

These types of policies worked in the poorer peripheral economies of the present EU. They are about to be implemented in the economies of the acceding states, and there is every reason to believe that they will further enhance the already impressive performance of these economies. There is also every reason to believe that the economies of the Western Balkans would benefit massively from strategic planning and Structural Fund-type aid. Even in advance of such aid, there is no excuse for delaying preparation for that day. This is an area of strategic policy planning where initiatives by the West Balkan states – either individually or collectively – are very desirable, will not be very costly, and are likely to bring massive dividends in terms of stimulating the EU to act.

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