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WESTERN POLICY LESSONS IN THE
SECOND PHASE OF REGIONAL TRANSFORMATION



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SUMMARY

The backward regions of Hungary failed to catch up during the first decade of the Hungarian transition, despite spectacular progress with modernization, accelerating economic growth, deep-rooted changes in regional-development policy, institutions and practice, and substantial spending on regional development. On the contrary, the spatial concentration of the foreign direct investment (FDI) that was attracted exacerbated the regional differences. Some regions caught up very fast and became growth-poles. The situation in others kept deteriorating, while certain regions simply remained hopelessly underdeveloped.

Drawing on Western experience and international literature on regional development, this paper analyses the applicability to Hungary of the Western policy approach and of certain measures aimed at restructuring and revitalizing old (traditional) industrial regions.

The main assertions are these:

- * Declining regions exhibit regionally concentrated forms of sectoral problems.
- * While the first phase of regional transformation involved institutional transformation (EU-compatible institution building), the second necessitates institutional empowerment (enabling regulations that contribute to the effective functioning of the institutions).
- * Regional-development practice needs to become more sophisticated in the second phase, which also covers the preparations for becoming a fully-fledged applicant for EU regional-development funds.
- * A regional innovation system to promote these efforts should include strengthening the existing innovation nodes and promoting technology transfer, rather than creating new focuses of innovation.
- * Regional-development policy-makers should be aware of the specific features determining the pattern and prospects of the Hungarian regional structure, because these may jeopardize the effectiveness of development programmes. At the same time, they must also be aware of best Western practice in regional development and adopt the promising approaches found so far.
- * The specific Hungarian features (some applicable to other transforming economies as well) include, in emerging industrial districts, the bias of the specialization pattern against intra-district industrial linkages, and in old industrial districts, the general lack of growth prospects and problems of basic financing, which hinder programmes focused on network-building.
- * The main aspect of best Western practice that needs adopting is the dual approach in the programmes for revitalizing old industrial regions. This combines structural change (attracting new actors and introducing new industries) with measures aimed at the performance improvement of existing actors.

INTRODUCTION

The backward regions of Hungary failed to catch up during the first decade of the Hungarian transition, despite spectacular progress with modernization, accelerating economic growth, deep-rooted changes in regional-development policy, institutions and practice, and substantial spending on regional development.¹ On the contrary, the spatial concentration of the FDI attracted exacerbated the regional differences. Some regions caught up very fast and became growth-poles. The situation in others kept deteriorating, while certain regions simply remained hopelessly underdeveloped.

The process of spatial differentiation has not been confined to the transition economies. There has been a marked recent acceleration in spatial concentration all over the developed world. (Brülhart, 1998) This may partly explain the remarkable stability of regional inequalities throughout Europe.

Martin (1999), in an EIB Prize-winning essay, was struck by the weak results that the huge regional transfers by the European Union (EU) were achieving. (Sums devoted to regional policies account for one third of the Community budget, making them the second largest item of expenditure after the Common Agricultural Policy.) Nonetheless, the regional inequalities among European regions have proved persistent and the process of convergence is extremely slow.

In line with P. Martin's reasoning (1999 and 2000), spatial concentration

cannot be considered bad in itself. There is an extensive literature about the beneficial effects of spatial concentration and the agglomeration effects deriving from geographical specialization.² Furthermore, Martin reviews the widely shared consensus about the trade-off between efficiency and geographical equity. This casts doubt on the wisdom of measures that try to counter spatial concentration and on the effectiveness of allocating resources to achieving this aim.

The other side of the coin is the general recognition that market-driven geography is not optimal, because of its huge welfare costs. Policy measures to promote catching up and moderate regional income inequalities are therefore needed. Empirical experience shows it is very difficult to discover efficient regional-development strategies that do not waste resources, do not counter agglomeration effects that are beneficial in principle, and do not have a boomerang effect.³

The transition economies are trying to adopt a Western policy approach and implement strategic measures that have proved fruitful in Western experience. This is a demanding task, because of the theoretical difficulties mentioned already, and because the volume of resources available is a fraction of what has been available for regional-development objectives in the EU. While resources are much scarcer, the stakes are much higher, as regional development is a prior requirement for modernization and convergence towards the developed countries. Furthermore, the time available is shorter.

Drawing on Western experience and international literature on regional development, this paper analyses the applicability

¹ Empirical experience in the transition and the advanced economies refutes the hypothesis that acceleration of national growth tends to diminish regional disparities. For evidence to the contrary, see the literature overview and discussion of regional EU inequalities in P. Martin (1999 and 2000). On the relation of national growth to regional inequalities in transition economies, see Rechnitzer (1998), Faragó (1999) and Szemlér (2000).

² See, for example, Porter (1998), and Pouders and St. John (1996).

³ One well-known example of a boomerang effect is described in Puga (2001) and P. Martin (2000). Huge resources have been devoted to improving the transport infrastructure between the developed North and relatively underdeveloped South of Italy, but the result has been to *increase* the regional disparity between them.

to Hungary of the Western policy approach and of certain measures to restructure and revitalize old (traditional) industrial regions.

1) IMPROVE THE PERFORMANCE OF EXISTING ACTORS OR INVOLVE NEW ONES?

How can the competitiveness of a backward, underdeveloped region, whose industry is dominated by declining, traditional trades, be improved more efficiently? What kind of objectives and methods allow regional-policy decision-makers to achieve better results? Is it more rewarding for decision-makers concentrate on promoting and accelerating structural change, substituting emerging industries for ailing traditional ones and attracting new economic actors from emerging industries, to compensate for the losses and exits of firms in traditional industries? Or are the results more promising if decision-makers concentrate on the performance improvement of *existing* economic actors? The question can also be formulated in a different way. Can the difference between the growth rate of individual economies be explained simply by the fact that some economies are more efficient, their manufacturers produce better-quality, technologically more sophisticated products, they have more efficient market-acquiring strategies, *etc.*? Or can the difference in growth performance be explained by the fact that some countries are specialized in emerging, rapidly expanding industries, while other economies are dominated by declining, crisis-prone, traditional industries? Better performance or better structure—that is the question.

Regional policy decision-makers in developed countries gave completely different answer to these questions than their Hungarian counterparts have done. In developed countries, both structural change and performance improvement were among the stated objectives of economic, regional and

technology policies. The capacity reduction and closure of some ailing representatives of traditional industries were accompanied by huge investment in the remaining representatives of those industries, to further their modernization, technological upgrading and competitiveness. EU-funded regional policy for modernization in ailing regions, whose industrial structures are dominated by crisis-ridden traditional industries, usually produced development projects with two objectives: *modernization and diversification*. The former was realized by promoting the technological upgrading and modernization of existing companies in traditional industries. The latter was realized by promoting entrepreneurship, through entrepreneurs who would introduce new industries. This means that the EU approach combined sectoral and regional policies in seeking to resolve regional problems.

Hungary shows no sign of such a balanced, dual approach of combining structural change and performance improvement. Both national and regional growth strategies have been based exclusively on attracting as much FDI as possible. Hungarian economic and regional policy-makers reason that the new players attracted in this way will contribute to structural change, guarantee competitiveness and launch growth. At a national economic level, this reasoning seems correct in a sense. The FDI has furthered economic growth. However, the policy of maximizing the FDI attracted has been inefficient in diminishing regional disparities. Although a few regions managed to reduce their exposure to traditional industries through a massive inflow, the volume of FDI was quantitatively less significant in backward regions.

Although Eastern European scholars usually enumerate reasons why specific Western economic policies and practices are inapplicable to their countries, the situation here is just the opposite. The Western policies so far disregarded ought indeed to be adopted. Structural change should not be restricted to facilitating the market exit of representatives of declining industries and substituting emerging industries for them.

Industrial policies aiming at structural change should also promote internal renewal of traditional industries, through technological upgrading, new market-acquiring strategies, *etc.* Structural change should cover both sectoral upgrading and sectoral reallocation.

ARE THE PROBLEMS MAINLY REGIONAL OR SECTORAL?

The other side of the question discussed in the last section is whether the problems of ailing regions are mainly sectoral or regional in character. Writers acknowledge the importance of location, but still tend to give priority to sectoral characteristics. Firms show big sectoral differences in the way they innovate, develop and market their products.⁴ Sectoral specificity influences the features of their institutional and market embeddedness as well (Belderbos and Capanelli, 2001). It will be argued here, however, that modernization of ailing regions entails providing solutions for *regionally concentrated forms of sectoral problems*.

The author was involved in extensive research funded by INCO-Copernicus on the renewal process of traditional industries in Hungary. Two industries (textile and clothing, and steel making) were chosen in a crisis region of Hungary,⁵ using a case-study method.⁶ Comparing the restructuring results of the sample of textile and clothing (TC) firms with the efforts and results of other firms in the same industry, operating in prosperous regions, it emerged that the prospects of the former were much weaker in this respect. The explanation for this can-

not be confined to the general crisis and consequently lower purchasing power of consumers in the region. There has to be an additional factor, which points to the regional embeddedness of sectoral problems.

Examination of the structure of the TC industry in the selected region and compared it with the structure of the same industry in other regions⁷ revealed thought-provoking differences. It turned out that most of the TC companies in the surveyed region belonged to the most threatened segments of this traditional industry. These companies were vulnerable not only due to the crisis in their industry segment, but from the point of view of other indicators affecting company performance. The average age of their capital equipment was higher and the average stock of current capital lower than the national average (Szalavetz, 2000c).

Can the hypothesis therefore be formulated that traditional industries in declining regions are declining more intensively than average? The results of these empirical investigations suggest at least that in the TC industry, the industry segments most prone to crisis abound in crisis regions, while representatives of technologically demanding, less crisis-ridden segments are found mainly in prosperous regions.

It must be borne in mind that the industries grouped in the category of 'traditional industries' are not uniform from the point of view of decline. Their heterogeneity derives from the fact that each embraces declining segments and growth segments. Furthermore, even in declining segments of declining industries, there are some innovative, competitive and prosperous firms with spectacular performance indicators.

The regional embeddedness of sectoral problems is best demonstrated by the fact

⁴ See Montobbio (1999) for details, especially about the relation between sectoral specificity and innovation strategy.

⁵ In the NUTS III region of Borsod-Abaúj-Zemplén County.

⁶ Field investigations were carried out on a sample of 22 local firms and representatives of local-government authorities were also interviewed.

⁷ For want of deep statistical data (which they are not even available at national, aggregate level, let alone regional level), this statement can be tested only in the light of specific case studies and samples. Here the structure of the sample (obtained from the Industry Almanac of Hungary) was related to the data for textile and clothing firms in other regions of Hungary.

that this heterogeneity in the traditional industries is not manifest in the declining regions. There the decline of traditional industries is almost uniform, so that most representatives of them are in crisis. The adjustment, modernization and development prospects of firms in the TC industry are much weaker than those of TC companies in prosperous regions. Fewer of the former have been taken over by foreign investors. Fewer have altered their product mix. Fewer have diversified their corporate-function portfolio (Szalavetz, 2000a), for instance by including design and marketing activities alongside the simple processing one.

Another area where the interplay of regional and sectoral problems can be observed is in the much lower-than-the-average efficiency of the crisis-management efforts made in declining regions. Consider the post-transformation business history of the Hungarian steel-industry. The three main Hungarian steel-making sites are Dunaújváros, Csepel Island (Budapest) and Borsod County. To simplify somewhat, the Budapest site is in a quickly restructured, prosperous region, the Dunaújváros site in a region whose development level is close to the national average, and the steel-making cluster in Borsod-Abaúj-Zemplén County is in a crisis region.

Steel plants at the Csepel-site closed in the early 1990s. The government took the decision relatively easily, since unemployment in Budapest was much below the national average. Due to relatively modern technology and high management qualities, the Dunaferr Group in Dunaújváros quickly achieved a turnaround and now operates profitably. The crisis hit mainly the producers in Borsod County. Closure of the plants was out of question, since liquidation would have caused huge regional and social problems. Survival—preventing these companies from being liquidated—was considered vital. The 1991–6 period was marked by *ad hoc* government intervention, with individual trouble-shooting measures as each crisis loomed. The government decided to:

- * guarantee further loans to the heavily indebted companies,
- * buy up the tangible assets of companies that faced liquidation procedures,
- * pour money into the steel companies to help them overcome their liquidity crises,
- * grant them aid for purchasing raw materials to continue production, or on other occasions, for paying wages to continue production, or on other occasions again, for starting repair and maintenance or retrofit tasks, and
- * grant them aid to finance the social obligations related to downsizing, *etc.*

These grants and aid decisions were all of an *ad hoc* character. The money injections always came too late, to finance the losses of daily operation rather than upgrading. More than HUF 40 billion was invested into the survival of the Borsod producers, who still face heavy trading losses. There was no coherent strategy or plan with which restructuring of the whole sector could be initiated and implemented.

The cited regional differences in the efficiency of economic policy lead to the following hypothesis. In declining regions, excessively specialized on specific traditional industries and facing devastation through the collapse of these industries, the crisis management efforts of economic policy are less successful than they are in other regions. Decision-makers have to bear in mind the huge social losses that the failure of these industries would bring. The threatening consequences tie their hands and encourage them to postpone tough decisions as long as they can. Thereby, they fall into the trap of financing current operations, instead of initiating complex restructuring and technological development. Tough decisions are taken much more easily in more prosperous, or at least intermediate regions.

This review of evidence for the claim that declining regions exhibit regionally concentrated forms of sectoral problems points to the importance for the transition economies of applying the dual Western ap-

proach in regional policy, instead of concentrating exclusively on structural change. The next section discusses the relevance of certain regional-policy recommendations mentioned in the Western literature.

INSTITUTION BUILDING VERSUS EMPOWERMENT OF INSTITUTIONS

Western writers emphasize the importance of regional institutions that set up and coordinate the implementation of regional development strategy. These have to possess local political legitimacy (Smoke, 1999) and a certain influence potential *e.g.* decision-making autonomy to exercise specific rights and responsibilities.

While the role of institutions has been extensively treated in academic literature (see Hall, 1999, Olson, 1996, Rodrik, 2000 and Williamson, 1995, for example), little research has been done on efficiency disparities among institutions with identical functions and set-ups operating in different countries. One general experience in the transition economies, which have sooner or later set up more or less EU-compatible systems and institutional networks of regional development is that a well-designed institutional network in itself does not guarantee good policy practice. The gap between the performance, practice and efficiency of otherwise identical institutions in developed and transition countries is an everyday experience. Although institutional economists claim that national (and regional) economic evolution and performance are linked to and determined by institutional structure, especially in transition economies⁸ – an important conclusion from the first decade of

transformation is that simply *creating* the institutions is not enough.

Restricting the analysis to the regional policy of Hungary, it can be said that the country has successfully completed the first phase of regional transformation—institution building—and achieved EU conformity in this respect (Horváth, 1998; Szalavetz, 2000b). The main task in the second stage is referred to as institutional empowerment: strengthening the functioning of regional-development institutions, with the help of enabling regulations. Examples of the necessity of institutional empowerment include the fact that the decision-making power of regional development institutions (at NUTS II and NUTS III levels) over the utilization of decentralized funds is rather limited. There is thorough regulation of the allocation procedure, during which the financing of specific development projects is decided. Development priorities linked to the specific allocation procedure are prescribed at national level and there are many restrictions on how funds may be used. Thus, regional development institutions have a purely administrative role in the system. The EU-compatible devolution of spending responsibilities means in reality that the decentralized levels of government have to take into account the centrally prescribed regional development priorities. The rigidity of the transfer system and the centrally prescribed development objectives prevent county-level features from being considered.

Another deficiency that calls for institutional empowerment is that the decentralized planning process has no links with the budgeting process. The quality of the individual development strategies at NUTS III level does not influence the volume of the budget transfers. This deficiency excludes the possibility of preparing a financially sensible local development programme. Without a predictable pool of transfer resources, regional development authorities are preparing wish-lists.

Another aspect of this discontinuity between the various levels of government concerns the financing and administration

⁸ See Kolodko (2000), for example. He quotes Douglas North, one of the best-known representatives of institutional economics: 'The institutions, *i.e.* the rules and the organizations that help to enforce the rules, always matter, and during transition they matter even more' (p. 20).

mechanism of separate state funds. Regional development projects can also be financed from separate state funds, administered by various ministries. These funds grant allowances to support sectoral and functional objectives (education, training, tourism, environmental protection, development of transport infrastructure, employment creation, technical development *etc.*) In principle, utilization of these funds should be coordinated with regional development objectives. In practice, such coordination is lacking and the EU principles of partnership and additionality are not met.

PROMOTING INTRA-DISTRICT LINKAGES

Western writers argue, in the author's view persuasively, for promoting networks within regions. Networks here denote inter-firm relationships, which may be subcontracting networks (vertical relationships) or horizontal networks aimed at achieving collective efficiency through collective action. In the latter sense, firms engage in various forms of joint action, on R and D, marketing, training, technical consultation and experience sharing, and procurement. Other areas of collaboration include sharing or pooling of production facilities, machines and tools, joint contracting, and joint tendering for orders (Helmsing, 1999). Networks also encompass industry-university relations and linkages between agents of the public and the private sectors. Among the forms of the last are strategic business services offered under subsidized programmes of training, loan guarantees, finance, counselling, technology centres and so on. Helmsing reviews the literature and provides case studies to demonstrate that the policy objective of strengthening industrial linkages has been popular at EU and at national level. Large-scale institutional support programmes have been initiated for all kinds of network building. However, a tight network of industrial linkages cannot be achieved easily,

even with targeted programmes. Network-focused programmes have had noticeably meagre results in Hungary and other transition economies.

Hungarian regions—both hot-growth regions and declining ones—show particularly weak intra-regional industrial linkages. Local growth nodes such as emerging industrial districts belong to the type of 'satellite industrial platforms' (Markusen, 1996) with co-located branch plants of foreign firms having minimal intra-district linkages. The low intensity of inter-firm co-operation can be explained partly by the sectoral specificity of production in hot-growth regions. It was persuasively demonstrated that industry characteristics have a significant effect on the extent of local vertical linkages by Belderbos and Capannelli (2001), who studied the country-specific, parent firm-specific, and sector-specific determinants of local-content ratios in the production of 272 Japanese companies in 24 countries, along with willingness to establish local linkages. Such linkages are less frequent in high-tech sectors than in mature ones. It is therefore doubtful whether network-building regional-development programmes in Hungarian 'satellite-type' regions specialized in high-tech industries will prove effective.

In old industrial regions, support schemes aiming at intensifying intra-district linkages have had much poorer results in transforming economies than in developed ones. This can be explained by business history (intra-regional industrial linkages have been traditionally lacking) and by the huge differences of situation and needs between the actors in the two groups of countries. The lack of traditional intra-regional linkages was explained in Csernok *et al.* (1975). They put the exceptional transport intensity of Hungarian manufacturing down to the fact that the backward and forward production linkages of individual state-owned enterprises (SOEs) were rarely located in the same region.

Regional actors have weaker growth and development prospects in transition economies, especially in old industrial re-

gions. In other words, it is much harder for them to attain the minimum efficient size in their industries than it is for similar actors in developed economies. Huge technological and financing gaps remain, so that local actors need much more generous direct support (investment-support schemes, technological upgrading programmes, market-acquisition support, *etc.*) than they get at present.

One principle of EU regional-development policy is a focus on *indirect* effects. Institution building or network building are typical examples, with expected indirect effects such as mobilization of endogenous resources, technology spillovers and localized learning. In transforming economies, infrastructural deficits are high, local firms' independent accumulation capabilities low, venture capital scarce and the market-acquiring capabilities of local entrepreneurs poor. Policy measures that focus exclusively on indirect beneficial effects cannot yield the expected results or only after a prohibitive time lag.

PROMOTING ENDOGENOUS INNOVATION

In line with the recent geographical turn in economics (R. Martin, 1999; Porter, 1998), literature⁹ and policy practice¹⁰ have recently turned to analysing regional innovation systems alongside national ones. The beneficial effects of spatial agglomerations have been described, not only from the point of view of collective efficiency and reduced transaction costs. (Agglomerated firms share

the costs of certain collective resources, while benefiting from the local labour market and local business services, see Porter, 1998). Writers have come to emphasize rather the importance of knowledge spillovers.¹¹

Promoting endogenous innovation and localized learning has become an essential element of regional development policies. The focus of Western academic literature and policy practice on innovation and innovative clusters, rather than industrial clusters in general, is based on a well-founded belief that innovation is the key to competitive economic growth. The mobilization of endogenous innovation potential in regions, with policy instruments like support schemes for innovating companies, incubators, financial incentives focussed on small and medium-sized firms, *etc.*, figure high among the policy recommendations of Western consultants and scholars.

In transitional economies, however, the key to both regional and national economic growth is promotion of technology transfers and direct capital transfers, rather than endogenous innovation. The main reason why the Western concept of 'strengthening the regional innovation-support system' applies only weakly to the regional development practice of transitional economies is the excessive emphasis on generating innovation. It is increasingly recognized that 'innovation extends beyond formal research and development activities to include continuous improvement in product design and quality... and modifications to production processes that bring costs down, [and] increase efficiency...' (Mytelka and Farinelli, 2001, p. 8). Nonetheless, the recommended policy instruments (incubators, support schemes, *etc.*) tend to promote local innovation generation (in its most traditional sense, by promoting local R and D), rather than technology transfers from outside the region. Policy-makers have to remember that even in the second phase of regional

⁹ See Howells (1999) for an extensive literature survey, or Döry and Rehnitz (2000).

¹⁰ According to Diez and Esteban (2000) 'The European Union has been one of the main "animateurs" of regional innovation policies. In particular, since the mid-1990s the General Directorate for Regional Policy and Cohesion started to become the most enthusiastic promoter of a new regional approach to promoting innovation in the less developed regions.'

¹¹ See Malmberg and Maskell (2001) for a literature review.

transformation, the key to regional development in transitional economies is innovation in the sense of technology absorption, *i.e.* successful absorption of direct capital transfers, rather than endogenous innovation. The policy approach should be focused on systems of regional technology accumulation, rather than regional innovation systems (Radosevic, 2000).

CONCLUSIONS

In addressing the applicability of selected aspects of Western regional policy to the Hungarian case, the following main statements have been made:

- * Declining regions exhibit regionally concentrated forms of sectoral problems.
- * While the first phase of regional transformation involved institutional transformation (EU-compatible institution building) the second phase necessitates institutional empowerment and enabling regulations, which contribute to the effective functioning of the institutions.
- * Regional development practice should increase its sophistication in this second phase, which is also about preparing to become a fully-fledged applicant for EU regional development funds.
- * Efforts to promote regional innovation should include strengthening existing innovation nodes and promoting technology transfers, rather than creating new focuses of innovation.
- * Regional development policy-makers should heed the specifics that determine the pattern and the prospects of the Hungarian regional structure, because these may jeopardize the effectiveness of development programmes. At the same time, they must be aware of best Western practice in regional development and adopt promising approaches hitherto ignored.

- * The 'Hungarian specifics', some of which apply to other transition economies as well, include a specialization pattern that has a bias against intra-district industrial linkages in emerging industrial districts. In old industrial districts, the effectiveness of programmes focusing on network building is hindered by a general lack of growth prospects and an abundance of basic financing problems.
- * The main element of best Western practice that ought to be adopted is the dual approach found in programmes aimed at revitalizing old industrial regions. These combine structural change (attracting new actors and introducing new industries) with measures to improve the performance of existing actors.

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