Acta Oeconomica, Vol. 52 (2) pp. 205–219 (2002)

EUROPEAN POLICY LESSONS IN THE PROCESS OF REGIONAL TRANSFORMATION IN HUNGARY

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(Received: 5 July 2001; revision received: 20 November 2001; accepted: 11 December 2001)

The applicability of selected aspects of the European regional policy approach to Hungary is analysed in the present paper. The *balanced approach* of European regional development – one combining structural change with performance improvement of existing actors – is contrasted with the *one-sided Hungarian approach* – one restricting modernisation efforts to facilitating structural change and attracting new economic actors. The paper – funded by the INCO-Copernicus – argues that in order to achieve the required regional transformation, besides institution building, strengthening, i.e. "empowering", existing regional development institutions is also necessary.

Keywords: regional policy, regional transformation, structural change, institution building, industrial linkages, networks

JEL classification index: L50, O18, R48

INTRODUCTION

In spite of Hungary's spectacular modernisation achievement during the transition decade, in spite of the acceleration of its economic growth, in spite of the deep-rooted transformation of regional development policy, -institutions and -practice, and finally in spite of the relatively huge sums devoted to regional development – backward regions did not manage to catch up with the developed ones.[1] Just the other way round, the spatial concentration of foreign capital has

[1] Empirical experience in both transition and advanced economies rejects the hypothesis that the acceleration of national growth leads to the diminution of regional disparities. Just the other way round: see Martin (1999) for a literature overview and European Investment Bank Papers (Volume 5, No. 1 and 2) devoted to the topic of regional inequalities in the European Union. About the relation of national growth and regional inequalities in transforming economies, see Rechnitzer (1998), Faragó (1999), Szemlér (2000).

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exacerbated regional differences. Some regions have been catching up very fast and are becoming growth poles while the situation of others keeps deteriorating and some regions simply remain hopelessly underdeveloped.

The process of spatial differentiation has not only taken place in transforming economies: spatial concentration has recently considerably accelerated all over the developed world (Brülhart, 1998). This can partially explain the remarkable stability of regional inequalities throughout Europe.

In his EIB-Prize winning essay, Martin (1999) was struck by the weak results the great amount of regional transfers within the European Union could achieve. (The sums devoted to regional policies account for one third of the Community budget, the second largest item after the Common Agricultural Policy.) In spite of the huge transfers, regional inequalities among European regions proved to be persistent over time and the process of convergence is extremely slow.

In line with Martin's (1999; 2000) reasoning, spatial concentration cannot be considered bad in itself. There is extensive literature on the beneficial effects of spatial concentration, about the agglomeration effects deriving from geographical specialisation.[2] What is more, in his above-cited papers Martin reviews that there is a widely shared consensus about the existence of a trade-off between efficiency and geographical equity. Therefore, the sense of measures that try to counter spatial concentration and the efficiency of resource-allocation devoted to achieve this aim are doubtful.

The other side of the coin is however the general recognition that market-driven geography is not optimal because of its huge welfare costs. Policy measures to promote catching up, to moderate regional income inequalities are necessary. Empirical experience shows that it is very difficult to elaborate efficient regional development strategies that do not waste resources, do not counter beneficial agglomeration effects, and have no boomerang effect.[3]

Transforming economies are trying to adopt the western policy approach, implement strategic measures that have proved to be fruitful according to western experience. This is a demanding task not only because of the above-mentioned theoretical difficulties but also because of the fact that the volume of resources available is just a fragment of the one that has been available for regional development objectives in Europe. Resources are much scarcer, while the stakes are much higher, as regional development is a precondition of their modernisation and con-

[2] See for example Pouder – St. John (1996), Porter (1998).

[3] One example for the boomerang effect is the well-known (Martin, 2000 and Puga, 2001) phenomenon of huge resources devoted to improve transport infrastructure between the developed northern regions of Italy, and the relatively underdeveloped southern ones, which have finally resulted in an increase of regional disparities.

vergence to developed countries. The timeframe of this exercise is much shorter as well.

Drawing upon western experience and on international academic literature on regional development, this paper analyses the applicability of western policy approach and selected policy measures aimed at restructuring and revitalising old (traditional) industrial regions to the specific Hungarian situation.

DEFINING THE STRATEGIC PRINCIPLES

Trying to improve the performance of existing actors or involving new actors?

How can the competitiveness of a backward, underdeveloped region, the industry composition of which shows a dominance of declining traditional industries, be efficiently improved? What objectives should regional policy decision-makers focus on and what kind of measures should they introduce in order to achieve the optimal results? Should decision-makers concentrate on

- the promotion and the acceleration of structural change,
- the substitution of emerging industries for ailing traditional industries and
- attracting *new* economic actors, the representatives of emerging industries, who would compensate for the losses and the exit of the representatives of traditional industries?

Or, are the results more promising, if decision-makers focus on the performance improvement of *existing* economic actors? The above question can be formulated also in a different way. Can the difference between the growth rate of individual economies be explained with the fact that some economies are simply more efficient, the representatives of their manufacturing industries produce better quality and technologically more sophisticated products, they have a more efficient market acquiring strategy, etc. Or, can the difference between the growth performance be explained with the fact that some countries are specialised in emerging and quickly expanding industries while the structure of other economies is dominated by declining, crisis-prone, traditional industries? Better performance or better structure? – This is the question.

Regional policy decision-makers in developed countries gave completely different answers to the above questions than their Hungarian counterparts.

In developed countries both structural change and performance improvement were among the stated objectives of economic, regional and technology policies. The capacity reduction and the closing down of some of the ailing representatives of traditional industries were accompanied by huge investments aimed at the modernisation, technological upgrading and competitiveness increase of the remaining representatives of these industries.

EU-funded regional policy aiming at the modernisation of ailing regions, the industrial structure of which is dominated by crisis-ridden traditional industries usually announced development projects with two objectives: *modernisation and diversification*. The former objective was realised by promoting technological upgrading and the modernisation of existing companies, representatives of traditional industries. The latter objective was met by promoting entrepreneurship, i.e. by providing support to entrepreneurs who would introduce new industries. In other words, in order to solve regional problems measures were taken not only at the regional, but also at the sectoral level.

In Hungary, such a balanced, dual policy approach that combines structural change with performance improvement cannot be observed. Both the Hungarian national and regional growth strategies have been based exclusively on attracting the largest possible FDI. According to the reasoning of Hungarian economic and regional policymakers, new players will not only contribute to structural change, but will guarantee competitiveness and will promote growth.

As far as the national economy is concerned, this reasoning seems correct in a way. FDI did contribute to the upswing of the economy. However, the policy of attracting the largest possible FDI failed to contribute to the diminishment of regional disparities. Although there were a few regions that managed to get rid of their exposure to traditional industries with the help of a massive inflow of FDI, the presence of FDI was quantitatively less significant in backward regions.

Although eastern scholars usually enumerate reasons why specific western economic policy instruments and practices are inapplicable in their countries, in this case the situation is just the opposite, the so far disregarded western policy practice ought to be adopted. Structural change should not be restricted to facilitating the exit of the representatives of declining industries from the market and to substituting them with emerging industries. Industrial policies aiming at structural change should also involve the promotion of the internal renewal of traditional industries (by technological upgrading, new market-acquiring strategies, etc.). *Structural change should thus encompass both sectoral upgrading and sectoral re-allocation.*

Are the problems primarily of regional or of sectoral character?

The other side of the question discussed in the preceding section is whether the problems of ailing regions are mainly of sectoral or of regional character. While recognising that location matters a lot, academic literature still tends to give priority to sectoral characteristics.

In fact, there are important sectoral differences in ways firms innovate, develop, and market their products.[4] Sectoral specificity influences the firms' institutional and market embeddedness characteristics as well (Belderbos–Capannelli, 2001). This section argues, however, that the modernisation of ailing regions should rather be regarded as the complex task of providing solutions for *regionally concentrated forms of sectoral problems*.

In an extensive research – funded by INCO-Copernicus – on the renewal process of traditional industrial regions we surveyed two selected industries (textile and clothing and steel) in a selected crisis region of Hungary.[5] When comparing the restructuring results of the sample of textile and clothing (hereafter TC) companies in the chosen region to the efforts and results of other companies belonging to the same industry but operating in prosperous regions, it turned out that the restructuring perspectives of the TC-industry were much weaker than the perspectives of other TC-companies in prosperous regions.

The explanation cannot be restricted to the general crisis of the region and to the relatively lower purchasing power of the consumers in this region. The above statement can be explained with an additional factor, which points to the regional embeddedness of sectoral problems.

Having examined the structure of the TC-industry in the selected region and compared it to the structure of the TC-industry in other regions,[6] we discovered thought-provoking differences. A dominant part of TC-companies in the surveyed crisis region turned out to belong to the most threatened segments of this traditional industry. These companies were vulnerable not only from the point of view of the crisis of the industry segment they were operating in, but also from the point of view of other indicators that have an effect on the companies' performance. The average vintage of the capital equipment was higher while the average stock of current capital was lower than the national average.[7]

[4] See Montobbio (1998) for details especially concerning the relationship between sectoral specificity and innovation strategy.

[5] We carried out field investigations in the NUTS III. region of Borsod county at a sample of 22 local companies and interviewed representatives of local authorities.

[6] Due to the lack of detailed statistical data (which are unavailable both at the regional and at the national, aggregate level), this statement can be proved only in the light of specific case studies and specific samples. We compared the structure of the sample of this investigation – gained from the Industry Almanach of Hungary – to the data of textile and clothing companies in other regions of Hungary.

[7] Details are provided in Szalavetz (2000c).

Can we formulate the hypothesis that in declining regions traditional industries are declining more intensively than on the average? The results of our empirical investigations seem to suggest that within the TC-industry, the industry segments that are the most prone to crisis abound in crisis regions, while the representatives of technologically more demanding and less crisis-ridden segments of the TC-industry can be found mostly in prosperous regions.

We must keep in mind that the individual industries that are grouped together in the category of "traditional industries" are not homogeneous from the point of view of decline. Heterogeneity stems from the fact that each manufacturing industry consists of decline segments and growth segments. What is more, innovative, competitive and prosperous firms, with spectacular performance indicators do exist even among the representatives of the declining segments of declining industries.

The regional embeddedness of sectoral problems is best demonstrated by the fact that the heterogeneous character of even the traditional industries is not manifested in the declining regions. In declining regions the decline of traditional industries is nearly homogeneous, most of their representatives are in crisis. The adjustment, modernisation and development perspectives of the companies in the TC-industry are much weaker than the perspectives of other TC-companies in prosperous regions. Fewer of them have been taken over by foreign investors, fewer managed to change their product mix, fewer could diversify their corporate function portfolio, e.g. include some strategic planning and marketing activities besides production (Szalavetz, 2000b). The majority remained purely producers.

Another area where we could observe the interplay of regional and sectoral problems is the crisis management efforts of economic policy in declining regions. Let us consider the post-transformation business "history" of the Hungarian steel-industry:

The three main Hungarian steel-making sites are in Dunaújváros, on Csepel Island in Budapest, and in Borsod county. According to a simplified categorisation, the Budapest-site is in a quickly restructured, prosperous "region", the plant in Dunaújváros is in a region the development level of which is close to the national average, while the steel-making cluster in Borsod county is in a crisis region.

Steel plants at the Csepel-site (Budapest) were closed already at the beginning of the 1990s. The government took this decision relatively easily, given that unemployment in Budapest was much below the national average.

Due to its relatively modern technology and to the professionalism of its top management, the Dunaferr Group in Dunaújváros had quickly achieved a turnaround and operated profitably from 1995 to 2000.

The crisis hit mainly the producers in Borsod county. The closure of these plants was out of question, given that liquidation was feared to cause enormous regional and social problems. Survival – the objective of preventing these companies from being liquidated – was considered as an absolute necessity.

The 1991–1996 period was characterised by ad hoc governmental intervention (individual trouble shooting measures in the case of threatening crises). The government decided to

- guarantee further loans to the heavily indebted companies,
- purchase the tangible assets of companies facing liquidation procedure,
- pour money into steel companies in order to help them overcome their liquidity crises,
- grant them aid to make them able to purchase raw material and continue production, or – on other occasions – to make them able to pay wages and continue production, or – on yet other occasions – to allow them to start some repair and maintenance or retrofit tasks,
- grant them aid to finance the social obligations related to downsizing, etc.

These grants and aid decisions were, without exception, of an ad hoc character. Money injections always came too late and were aimed at financing the operational losses rather than promoting the upgrading process. (More than HUF 40 billion was invested into the survival of the producers in Borsod county, and they are still facing heavy losses. There was no coherent strategy, no plan with the help of which the restructuring of the whole sector could be initiated and carried out, there were only ad hoc measures to ensure survival, to help the companies overcome liquidity crises.)

The above regional differences in the efficiency of economic policy leads us to the following hypothesis. *In declining regions, excessively specialised in specific traditional industries, and facing a devastating crisis because of the crisis of these industries, the crisis management efforts of economic policy are less successful than in other regions.* In these regions decision-makers always have to bear in mind the enormous social risks the failure of these industries to survive would create. The threatening consequences “tie their hands” and they postpone the hard decisions as long as they can. Thereby, they fall into the trap of financing current operations, instead of initiating a complex restructuring and technology development programme. Hard decisions are taken much more easily in more prosperous or at least average regions.

This section reviewed the evidence for the claim that declining regions exhibit *regionally concentrated forms of sectoral problems.* This explains why it is inevitable to apply the dual approach of western regional policy practice in transforming economies instead of the present single-minded policy of concentrating exclusively on structural change. The next section discusses the relevance of selected regional policy recommendations mentioned by western academic literature.

Institution building versus the empowerment of institutions

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

While the role of institutions has been extensively treated by academic literature,[8] little research has been performed in the area of efficiency disparities among institutions of identical functions and setup, operating in different countries. However, one of the general experiences of transforming economies that have sooner or later set up a more or less EU-conform system and institutional network of regional development is the fact that the existence of a well-designed institutional network will not guarantee in itself the prevalence of a good policy practice. The gap between the performance, the practice and the efficiency of identical institutions in developed and transforming countries is an everyday experience. Although the representatives of institutional economics claim that national (and regional) economic evolution and performance are linked to and determined by the institutional structure, from the experiences of the first decade of transforming economies[9] the important conclusion can be drawn that it is not sufficient to *create* the necessary institutions.

Restricting our analysis to the regional policy of Hungary, we may claim that Hungary has successfully finalised the first phase of regional transformation and *that of institution building,* and has achieved EU-conformity in this respect (Horváth, 1998). The most important task *in the second stage of the transformation of regional policy* is referred to as *institutional empowerment,* e.g. the strengthening of the functioning of regional development institutions with the help of enabling regulations.

8 See for example Williamson (1995), Olson (1996), Hall – Jones (1999), Rodrik (2000).

9 See for example Kolodko (2000). In his paper Kolodko quotes Douglass North, one of the best-known representatives of institutional economics saying, that “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).

Examples for the necessity of institutional empowerment include the fact that the decision-making power of regional development institutions (of both NUTS II and NUTS III-levels) is rather limited concerning the utilisation of the decentralised funds. The allocation procedure – during which the financing of specific development projects is decided upon – is thoroughly regulated. Development priorities linked to the specific allocation procedure are prescribed at the national level and there are many restrictions on how funds may be used. Thus, regional development institutions have a pure administrative role in this system. The EU-conform devolution of "spending responsibilities" means that the decentralised levels of government should take the centrally prescribed regional development priorities into account. The rigidity of the transfer system and the centrally prescribed development objectives prevent county-level characteristics from being taken into account.

Another deficiency that calls for institutional empowerment is that the decentralised planning process has no links to the budgeting process. The quality of the individual NUTS III-level development strategies does not influence the volume of the budget transfers. As a result of this deficiency the possibility of preparing a financially sensible local development program is excluded. Without a predictable pool of transfer resources, regional development authorities have no choice but to prepare wish lists.

Another aspect of the above-described lack of coordination between the various levels of government concerns the financing and administration mechanism of separate state funds. Besides decentralised funds, regional development projects can be financed from separate state funds, administered by various ministries. Separate state funds grant allowances to support sectoral and functional objectives (education, training, tourism, environment protection, the development of transport infrastructure, employment creation, technical development, etc.). In principle, the utilisation of these funds should be coordinated with regional development objectives. In practice however, coordination is lacking and thus the EU-principles of partnership and additionality cannot be met either.

Promoting intra-district linkages

Western academic literature argues, in our view persuasively, for the promotion of networks within the regions. Networks refer to inter-firm relationships, which may be subcontracting networks (vertical relationships), or horizontal ones aimed at achieving collective efficiency through collective action. In the latter case firms engage in different forms of joint action: in joint R&D, joint marketing campaigns, joint training activities, mutual technical consultation and experience sharing, or joint procurement. Other areas of collaboration include the sharing or pooling of production facilities, machines and tools, joint contracting, joint tendering for orders (Helmsing, 1999). Networks also encompass industry–university relations as well as linkages between agents of the public and the private sector. The latter type of linkages include strategic business services offered in the frame of subsidised programs (training, loan guarantees, finance, counselling, technology centres, etc.).

Helmsing overviews the literature and provides case studies to demonstrate that the policy objective of strengthening industrial linkages has been very popular both at EU-level and at national level. Large-scale institutional support programs have been initiated to promote all kinds of network building. However, a tight network of industrial linkages cannot be achieved easily, not even with the help of targeted programs. Network-focused programmes have brought particularly little results in Hungary (and in other transforming economies).

Hungarian districts, both hot growth regions and declining ones, are characterised by particularly weak intra-regional industrial linkages. Local growth poles, e.g. emerging industrial districts can be identified as "satellite industrial platforms" (Markusen, 1996) with co-located branch plants of foreign firms having minimal intra-district linkages. The low intensity of inter-firm cooperations can be explained partly by the sectoral specificity of production in hot-growth regions. Belderbos and Capannelli (2001) studied the country-specific, parent-firm-specific, and sector-specific determinants of local content ratios of the production of 272 Japanese companies in 24 countries, as well as their willingness to establish local linkages. As it is persuasively demonstrated in their study, industry characteristics have a significant effect on the extent of local vertical linkages. Such linkages are less frequent in high-tech sectors than in mature ones. Therefore the efficiency of network-building regional development programs in the Hungarian "satellite type" regions, specialised on high-tech industries, is doubtful.

As far as old industrial regions are concerned, support schemes aiming at the intensification of intra-district linkages have brought much poorer results in transforming economies than in developed ones. Explanation for this phenomenon can be given partly by business history means (pointing at the fact that intra-regional industrial linkages have been traditionally lacking). The phenomenon can also be explained by the overwhelming differences between the situation and the needs of the targeted actors in the two country groups.

The lack of traditional intra-regional linkages was already explained in Csernok et al. (1975) who describe the exceptional transport intensity of Hungarian manufacturing and explain it with the fact that the backward and forward production linkages of the individual, large state-owned enterprises (SOEs) were rarely located in the region of the SOEs themselves.

Especially in old industrial regions of transition economies, regional actors have much weaker growth and development perspectives, e.g. it is much more difficult for them to attain the minimum efficient size in their respective industries than for similar actors in developed economies. With the still prevailing huge technology and financing gaps, local actors would need a *direct* support (investment support schemes, technological upgrading programs, market acquiring support, etc.) much more generous than at present.

One of the principles of regional development policy in the European Union is the focus on *indirect* effects. Institution building or network building are typical examples with such expected indirect effects as the mobilisation of endogenous resources, technology spillovers and localised learning. In transforming economies, however, where infrastructure deficits are high, local firms' independent accumulation capability is low, venture capital is scarce and the market-acquiring capabilities of local entrepreneurs are poor, policy measures concentrating exclusively on indirect beneficial effects can hardly yield the expected results or may only do so with a prohibitive time lag.

Furthermore, it must be kept in mind that there were several decades when economic actors in specific EU regions, targeted by regional policy programmes were also receiving large-scale direct support. It was not long time ago that focusing on indirect effects became the guiding principle of EU regional policy practice. The present policy approach was preceded by a practice of direct support during long decades.

Promoting endogenous innovation

In line with the increased propensity to combine economic and geographical approaches (Martin, 1999; Porter, 1998), literature[10] and policy practice[11] have turned to the analysis of regional innovation systems beside the analysis of national innovation systems. The beneficial effects of spatial agglomerations were described not only from the point of view of collective efficiency and reduced transaction costs (agglomerated firms share the costs of certain collective resources, take

[10] See Howells (1999) for an extensive literature survey, or Dőry and Rechnitzer (2000).

[11] 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."

benefit from the local labour market, as well as from local business services) (Porter, 1998), but the literature has also come to emphasise the importance of knowledge spillovers.[12]

Promoting endogenous innovation and localised learning has become a key element of regional development policies. The specific focus of western academic literature and policy practice on innovative clusters rather than on industrial clusters is based on the well-founded belief that innovation is the key to competitive economic growth. Therefore, the mobilisation of the endogenous innovation potential of the regions with policy instruments like support schemes for innovating companies, incubators, financial incentives focused on SMEs, figure high on the policy recommendation lists of western consultants and scholars.

In transforming economies, however, the key element of both regional and national economic growth is the promotion of technology and direct capital transfer, rather than endogenous innovation. The excessive emphasis of the western concept on innovation generation, i.e. "strengthening the regional innovation support system" can be considered as the main reason for its rather weak applicability to the regional development practice of transforming economies. Although it is increasingly recognised 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), the recommended policy instruments (incubators, support schemes, etc.) tend to promote local innovation generation (in its most traditional sense, by promoting local R&D activity) rather than technology transfer from outside the region. Policymakers have to keep in mind that even in the second phase of regional transformation, the key to transforming economies' regional development is innovation in the sense of technology absorption, i.e. the successful absorption of direct capital transfers, rather than endogenous innovation. Policy approach should focus on systems of regional accumulation of technology rather than on regional innovation systems (Radosevic, 2000).

CONCLUSIONS

This paper addressed the applicability of selected key issues of western regional policy approach to the Hungarian case. The main statements of the paper were as follows:

[12] See Malmberg – Maskell (2001) for a literature review.

- Declining regions exhibit regionally concentrated forms of sectoral problems.
- While the first phase of regional transformation involved institutional transformation, e.g. EU-conform *institution building*, the second phase necessitates *institutional empowerment*, e.g. enabling regulations that contribute to the effective functioning of the institutions.
- Regional development practice should increase its sophistication in this second phase, which phase is also about the preparation to become a fully-fledged applicant for EU regional development funds.
- Regional innovation-system promoting efforts should include the strengthening of existing innovation nodes and the promotion of technology transfer rather than the creation of new innovation poles.
- Regional development policymakers ought to be aware of the specifics that determine the pattern and the perspectives of the Hungarian regional structure, because these specifics may jeopardise the effectiveness of development programmes. At the same time, they must also be aware of western regional development best practice and adopt the promising approaches.
- "Hungarian specifics" – part of which apply to other transforming economies as well – include the fact that in emerging industrial districts it is the specialisation pattern that shows a bias against intra-district industrial linkages, while in old industrial districts it is the general lack of growth perspectives and the abundance of the most basic financing problems that hinder the effectiveness of programs focusing on network building.
- The most important element of western best practice that ought to be adopted is the dual approach of programs aiming at the revitalisation of old industrial regions – which combines structural change (attracting new actors and introducing new industries) with measures aiming at the performance improvement of existing actors.

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